



## The Long and Short of it: EU Regulation on Short Selling and Sovereign CDS

The Council of the European Union (the “**Council**”) has adopted a regulation (the “**Regulation**”)<sup>1</sup> on short selling and certain aspects of credit default swaps (“**CDS**”), which aims to create a harmonised short selling and sovereign CDS regime across the European Union (the “**EU**”) and also to align the powers that regulators from different member states may use in exceptional circumstances. The Regulation was published in the Official Journal of the EU on 24 March 2012 and will come into force on 1 November 2012 at which time it will become directly applicable in all EU member states.

### Background

As we have mentioned in previous updates, the Regulation was conceived out of the need to harmonise the fragmented approach of different regulators throughout the EU towards restricting short selling and the use of CDS, which, according to the Council in its press release<sup>2</sup> on the adoption of the Regulation, limits the effectiveness of adopted measures and results in regulatory arbitrage. The Regulation seeks, in particular, to improve the transparency related to significant short positions and address risks of negative price spirals and settlement failures, especially in relation to uncovered or ‘naked’ short selling. This update summarises the main provisions of the Regulation, describes major changes from previous texts of the Regulation, and considers the Regulation’s potential implications in practice.

### Scope of the Regulation

The Regulation has been broadly drafted to include the short selling of equity securities and sovereign debt (as well as transactions referencing such securities) and the buying of credit protection through CDS in relation to sovereign debt. The Regulation will apply, so far as possible, to those entering into trades rather than intermediaries.

<sup>1</sup> <http://register.consilium.europa.eu/pdf/en/11/pe00/pe00068.en11.pdf>.

<sup>2</sup> Council of the European Union: Regulation adopted on short selling and credit default swaps available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/128081.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128081.pdf).

## Key Provisions of the Regulation

### Disclosure

The Regulation creates a two-tier disclosure regime of public and private disclosure in relation to equity securities, and also introduces disclosure requirements for the shorting of sovereign debt and trading in naked sovereign CDS as summarised in the table below.

	<b>Equity (Private Notification)</b>	<b>Equity (Public Notification)</b>	<b>Sovereign Debt</b>	<b>Naked Sovereign CDS</b>
<b>When notification obligation arises</b>	Net short position at midnight in relevant member state at end of trading day reaches or falls below 0.2% of issued share capital, and each 0.1% above that, up until 0.5%.	Net short position at midnight in relevant member state at end of trading day reaches or falls below 0.5% of issued share capital, and each 0.1% above that.	Net short position at midnight in relevant member state at end of trading day reaches or falls below thresholds to be set by the Commission. ESMA to publish notification thresholds on its website.	Where restrictions on uncovered positions in sovereign CDS are suspended, notify when net short position at midnight in the relevant member state at end of the trading day reaches or falls below thresholds for sovereign debt set by the EU Commission.
<b>Who to notify</b>	Private notification to the relevant competent authority, where the relevant share was first admitted to trading. <sup>3</sup>	Public notification through the relevant competent authority where the relevant share was first admitted to trading.	Private notification to the relevant competent authority of the member state issuer. Where the issuer is the EU or an associated institution, notification to the competent authority of the jurisdiction where the entity issuing debt is situated.	Private notification to the relevant competent authority.

In each case, notification must be made by 3.30 p.m. on the following trading day in the relevant member state. The notification must specify the identity of the person holding the position, the size of the short position, the entity in relation to which the position is held, and the date on which the position was created, changed or ceased to be held.

<sup>3</sup> If the share was first admitted to trading on more than one regulated market simultaneously, then the 'relevant competent authority' is that of the member state where the turnover of the share is highest.

The Regulation envisages that all short positions be reported within the same timeframe, which could give rise to difficulties in relation to certain derivative positions (particularly basket transactions) which take longer to calculate. The disclosure requirement is at an individual entity level, rather than at a group level. However, the Commission is entitled to adopt delegated acts to set out provisions for calculating net short positions in complex entities, and it is expected that such delegated acts will be subject to substantial negotiation, within the parameters set by the Regulation, before being finalised.

The calculation of net short positions is required to take into account all long and short positions which the holder has in relation to the relevant shares or sovereign debt as well as any other form of economic interest therein. In particular, it is required to take into account interests obtained directly or indirectly through the use of derivatives (including options, futures and contracts for differences) and indices, baskets of securities and exchange traded funds. In the case of positions relating to sovereign debt it should also take into account credit default swaps relating to sovereign debt issuers.

The Regulation also obliges holders of short positions to keep records for five years of their net short positions, as well as the gross positions supporting these net short positions. Also, the requirement to identify short sales in (private) transaction reports to competent authorities, which was in previous versions of the Regulation text, has been deferred to the Commission in its consideration of amendments to the Markets in Financial Instruments Directive 2004/39/EC<sup>4</sup>.

The Regulation states that ESMA may issue an opinion to the Commission in relation to changing the disclosure thresholds in light of developments in the financial markets.

The rationale for private notification in relation to sovereign debt is that public notification could have an adverse effect on markets, especially since liquidity is likely to be already impaired. 'Sovereign debt' includes debt issued by the EU, member states and associated bodies such as the European Financial Stability Fund and the European Stability Mechanism. Debt issued by regional, local and quasi-public bodies is, however, excluded. The thresholds for notification will be set by the Commission through delegated acts, which may involve significant administrative work, and accompanying costs.

The public disclosure requirement in relation to equities has given rise to a number of concerns. Many market participants regard confidentiality as important in relation to trading activities and this will be undermined if a public reporting requirement arises. Furthermore, as many European and UK funds focus their investments on SMEs, obliging public disclosure at such a low level as 0.5% could result in a loss of market confidence and liability, giving rise to the very downward pricing spirals that these measures are designed to prevent.

## **Ban on Naked Shorting**

The table below highlights the restrictions imposed by the Regulation on uncovered or 'naked' short selling, which is banned for shares and sovereign debt, subject to certain exemptions, and restricted in relation to dealing with naked sovereign CDS:

<sup>4</sup> [http://www.esma.europa.eu/system/files/FIMD\\_official\\_Journal\\_version.pdf](http://www.esma.europa.eu/system/files/FIMD_official_Journal_version.pdf).

	<b>Shares and Sovereign Debt</b>	<b>Sovereign CDS</b>
Extent of prohibition / restriction	<p>Seller may short sell where it has:</p> <p>borrowed the security;</p> <p>entered into an agreement to borrow the security or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due; or</p> <p>entered into an arrangement with a third party under which that third party has confirmed that the security has been located and<sup>5</sup> there is a reasonable expectation that settlement can be effected when it is due.</p>	<p>Permitted where there is an “insurable interest” in the underlying sovereign debt position. This includes where the investor has an interest that it is seeking to hedge either the sovereign debt itself or assets or liabilities whose value is correlated to the sovereign debt.</p>
Exemption(s)	<p>The ban for naked short sales of sovereign debt does not apply to hedges of long positions in debt instruments of an issuer, where the pricing has a “high correlation” with that of the given sovereign debt.</p>	<p>There are no exemptions specified, although the Regulation does not impose a complete ban on naked sovereign CDS positions, as in earlier drafts.</p>
Suspension of ban	<p>After notifying ESMA and competent authorities of the other member states, the relevant competent authority can temporarily suspend the ban in relation to sovereign debt, where liquidity falls below certain thresholds to be set according to the parameters and methods specified by the Commission through delegated acts.</p>	<p>After notifying ESMA and competent authorities of the other member states, the relevant competent authority can temporarily suspend the ban where it has objective grounds for believing that its sovereign debt market is not functioning properly. The Regulation lists indicators upon which such objective grounds may be based, including high or rising interest rates and the amount of sovereign debt that can be traded.</p>
Period of suspension of ban	<p>6 months, renewable for 6 months at a time. If not renewed, then the suspension expires.</p>	<p>12 months, renewable for 6 months at a time. If not renewed, then the suspension expires.</p>

<sup>5</sup> For sovereign debt, ‘and’ is replaced by ‘or’.

The ban on short selling of shares and sovereign debt is not designed to cover repo and securities lending agreements or futures contracts.

In previous versions of the Regulation text, the ban on uncovered sovereign CDS was much broader, but it has now been softened to restrict its scope to prevent speculation on the price of sovereign debt. This concession was due to lobbying from the European Parliament and member states that banning uncovered sovereign CDS in their entirety would severely affect the liquidity of member states' debt markets.

The requirement to "locate and reserve" securities, to facilitate settlement of a short selling transaction, contained in earlier versions of the Regulation has been relaxed to allow selling where there is a "reasonable expectation" that settlement can be effected when it is due. The Regulation indicates what factors can create such a "reasonable expectation", including that a third party has allocated the securities for borrowing or purchase and (where the purchase is to be covered during the same day), confirmation from a third party that the shares are easy to borrow or purchase. However, somewhat contrary to the terms of the Regulation, ESMA's second consultation paper on technical standards (referred to below) seems to indicate that the existing practice of relying on a third party's easy-to-borrow list for liquid shares / intraday borrowing will not be sufficient. ESMA also proposes that the third party must be a different legal entity from the seller, which is designed to prevent arrangements between different teams within the same legal entity, which may currently be in place. However, it is important to note that these provisions are currently under review due to a consultation process being undertaken by ESMA to develop technical advice for the Commission for the purpose of possible delegated acts.

In relation to both sovereign debt and naked sovereign CDS, ESMA is obliged to provide an opinion on any suspension or renewal by a competent authority within 24 hours and publish such opinion on its website. A negative opinion from ESMA, although it would not invalidate a competent authority's decision, would nevertheless have political influence that could result in such competent authority revising its decision or impact any future decisions of competent authorities.

## Dealing with Settlement Failure for Shares

The settlement failure provisions previously applied to both shares and sovereign debt, but they have now been restricted to the former. Central counterparties that provide clearing services for shares are required to ensure that adequate procedures are in place for them to buy-in shares to ensure delivery for settlement in the event that a settlement failure arises in respect of shares cleared through such counterparties (and for this purpose, failure is where settlement has not occurred within four days of the date on which settlement should have been effected). If buy-in is not possible, the central counterparty must pay cash compensation to the relevant buyer, based on the value of the shares on the delivery date, plus any losses incurred by the buyer. The seller who failed to settle will then be required to reimburse all amounts paid by the central counterparty as specified above. The seller will also be subject to a daily fine from the central counterparty for settlement failure, the level of which should be, "sufficiently high to act as a deterrent". The Regulation no longer contains provisions preventing those who have failed to settle from entering into any further transactions.

## Exemptions

There are two main exemptions to the Regulation:

1. Shares for which the principal trading venue is outside the EU; and
2. Market making activities and primary market operations in relation to sovereign debt.

## Principal Trading Venue Is Outside the EU

Determining the principal trading venue of a share is the responsibility of the relevant competent authority where the share was first admitted to trading and it should be undertaken every two years. The authority must notify ESMA of any such shares which it believes have their principal trading venue outside the EU and ESMA will publish a list of such shares, such list to be effective for a two-year period. The decision should be based on analysing the turnover of the relevant shares in different markets, with the parameters for such calculation to be drawn up by ESMA in its draft technical standards, which will be adopted by the Commission through its delegated acts powers.

## Market Making Activities and Primary Market Operations

Market makers acting in their capacity as providers of liquidity in the market are exempted from the requirements of the Regulation. Primary dealers acting as principals in financial instruments relating to primary or secondary market operations in sovereign debt are also exempted. However, for both of these exemptions, the person wishing to make use of the relevant exemption must notify the appropriate competent authority (either the competent authority of the home member state in the case of the former, and the relevant competent authority in relation to the sovereign debt in the case of the latter) at least 30 days before it intends to make use of such exemption, and at the earliest, 60 days before the application of the Regulation on 1 November 2012. The market making exemption is very similar to the current UK market making exemption, which should make conforming to the Regulation relatively easy for such entities.

Primary dealers are also exempt in relation to buy-back programmes or stabilisation schemes. Competent authorities have the power to prohibit the use of the exemption if they feel that an entity does not fulfil the requirements of the exemption, either initially or if there is a change in its circumstances. Making use of the exemption has certain conditions attached to it, however, one of the most onerous being that persons must respond to a request for information from their home competent authority, and provide the requested information within four calendar days. ESMA is also required to publish and keep up-to-date on its website a list of market makers and authorised primary dealers who are using the exemption.

## Powers of Intervention for Competent Authorities

Competent authorities may intervene in market activities in two main situations: (i) when there is a significant fall in the price of a security; and (ii) during stressed markets.

Where there is a significant fall in the price of a security on a trading venue in a single day, the competent authority of the home member state for that venue may impose restrictions or a prohibition on short selling until the end of the next trading day, which may be extended up to a further two days if there is a further significant fall in price, in order to prevent a “disorderly decline” in the price of such security. An initial significant fall means, in relation to liquid shares, a fall of at least 10% of the closing price of such security on the previous trading day. For illiquid shares and other securities, the amount will be specified by the Commission, through delegated acts. A further significant fall means at least 5% for liquid shares and for other securities will be set at half the amount determined by the Commission for the initial fall in value. If there is a significant fall in the price of a security, the competent authority in the home member state of the trading venue in which such fall occurs must notify ESMA of its decision whether or not to exercise this power by, at the latest, two hours after the end of the trading day on which the fall occurs, so that ESMA may in turn notify the competent authorities of member states in which the security is also traded. Although this provision is intended to aid harmonisation of measures taken during significant price falls, it seems quite onerous for the competent authority, especially if it chooses not to exercise the power.

During times of stressed markets where there is a serious threat to financial stability or market confidence, competent authorities may prohibit or restrict short selling, limit sovereign CDS transactions, impose emergency disclosure requirements and require lenders to notify them of significant changes in fees charged for the lending of specific securities. These powers are in addition to the powers mentioned above relating to suspending the ban on naked short selling of sovereign debt and uncovered CDS relating to sovereign debt. However, all such measures may only be taken where their benefit is proportionate to any detrimental effect on the efficiency of financial markets. Competent authorities must notify ESMA and other competent authorities of such measures at least 24 hours before the measure is intended to take effect. Competent authorities will also be required to publish any such measures, with such measures only taking effect upon publication.

Competent authorities will also be responsible for the administration and enforcement of the Regulation provisions, including in relation to investigating short selling practices, sanctions and pecuniary measures.

### **ESMA's Powers of Intervention**

During times of financial crisis, ESMA also has powers to intervene where a situation has cross-border implications and competent authorities have not adequately addressed the issue. In such circumstances ESMA may introduce emergency disclosure measures or bar or restrict short selling for a period of three months (such measure to expire if not renewed after such period); although it is important to note that ESMA would not be able to ban short selling of sovereign debt and related CDS or equivalents. ESMA's powers of intervention apply to market making and primary market activities too. The interrelationship between the measures taken by ESMA and those of competent authorities may require further clarification because, although the hierarchical supremacy of ESMA as a supranational body suggests that its decisions would be accorded primacy, there could be situations where an entity is subject to conflicting measures from different competent authorities and ESMA.

### **ESMA's Role**

As discussed earlier, ESMA primarily provides a coordination role in developing technical standards for the implementation of the Regulation and ensuring consistency of application across the EU. Further, as noted throughout this update, ESMA is obliged to provide an opinion on certain proposed measures from competent authorities. However, although such opinion carries political weight, competent authorities are not compelled to follow it, but if they choose to depart from it they must publish a website notice explaining their reasons for doing so. If ESMA feels the response of the competent authority is inadequate, then it may instigate its intervention powers to resolve the situation, as discussed above.

ESMA may also investigate any situation relating to short selling that may pose a threat to financial stability, and must publish a report within three months of the inquiry ending. Further, ESMA may use summary data that competent authorities are obliged to provide it on a quarterly basis for its inquiries, and may request information from competent authorities for such purpose, with such information to be provided within seven calendar days, or within 24 hours if there is a serious threat to financial stability. This is another onerous requirement for competent authorities, which although may be beneficial for the supervision of short selling activity and is intended to provide a rapid response to potentially serious threats, may also be unnecessarily burdensome for competent authorities, and perhaps a more flexible time period would have been more appropriate.

### **Timetable of Key Events Relating to Technical Standards**

Below is a list of the key events relating to the development and implementation of technical standards by ESMA that will be crucial in providing guidance on the consistent application of the Regulation across the EU.

Date (2012)	Event
24 January	ESMA issued first consultation paper <sup>6</sup> on draft regulatory and implementing technical standards
13 February	Responses to first consultation paper due
15 February	ESMA issued second consultation paper <sup>7</sup> on proposed technical advice from ESMA to the Commission on delegated acts
29 February	ESMA held open hearing <sup>8</sup> on short selling
9 March	Responses to second consultation paper due
31 March	Deadline for ESMA to submit draft technical standards and then publish final report

### Transitional Provisions and Effect of Regulation

Transitional provisions provide that existing measures adopted by member states that are within the scope of the Regulation and in force before 15 September 2010 may remain in force until 1 July 2013, provided that they are notified to the EU Commission by 24 April 2012. Uncovered CDS transactions in sovereign debt entered into before 25 March 2012 are permitted to be held until maturity of the transaction. Considerable doubts remain as to the effectiveness of short selling bans and restrictions that have been imposed by member states during the financial crisis and as to whether these have had any meaningful effect on volatility of markets in relevant securities. In recent months, a number of EU jurisdictions including Spain, France and Belgium have lifted bans or restrictions on short selling. However, in view of potential continuing volatility in European financial markets in the coming months, it would not be surprising if further measures are introduced by some member states. The creation of a unified reporting approach across the EU is welcome, although, as mentioned above, concerns remain that the reporting thresholds are low and could have consequences on trading activity in relevant securities and restrict liquidity.

Under the new regime, national competent authorities will still be able to act on an individual basis to impose short selling bans and restrictions but they will be required to report measures in advance to ESMA which has increased powers in seeking a coordinated approach across the EU, including being able to intervene where it believes a competent authority has failed to act.

<sup>6</sup> [http://www.esma.europa.eu/system/files/2012-30\\_0.pdf](http://www.esma.europa.eu/system/files/2012-30_0.pdf).

<sup>7</sup> <http://www.esma.europa.eu/consultation/Consultation-ESMAs-draft-technical-advice-possible-Delegated-Acts-concerning-regulation>.

<sup>8</sup> The agenda for the open hearing can be found at: <http://www.esma.europa.eu/system/files/2012-112.pdf>.

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