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Financial Services and Markets

Short Selling: Remember, Remember the First of November

From 1 November 2012, the European Regulation on Short Selling and Certain Aspects of Credit Default Swaps (the "**Regulation**") and its associated implementing measures will apply with direct effect in the UK and other EU Member States.

In this briefing note we outline at a high level some of the key practical issues facing firms.

Part A: The headlines

- The Regulation covers short positions in (i) **shares** admitted to trading on EU-regulated markets and MTFs; (ii) **EU sovereign debt instruments** (including some but not all regional debt) and (iii) **credit default swaps on EU sovereign debt**.

- The regime has **extraterritorial effect**. Anyone who sells short or has short positions in relation to relevant EU instruments is subject to the regime, regardless of where they are based.

- The regime applies to anyone **trading as principal** and to **investment managers** whose funds sell short or have short positions. There are limited exemptions for market makers.

- **Uncovered or short transactions are prohibited.** The Regulation prescribes what counts as "cover". For instance in relation to shares this includes a stock borrowing arrangement or a "locate" arrangement such that you have a reasonable expectation that you will be able to effect settlement when due.

- There will be a **new harmonised transparency** regime across Europe for **net short positions in shares** with **disclosure to the relevant competent authority** (i.e. broadly the Home State regulator of the issuer in respect of net short positions of 0.2% or more in the issued share capital of a company admitted to trading on an EU-regulated market or MTF). Further notifications to the relevant regulator must be made for each incremental rise in the net short position of 0.1% (i.e. at 0.3%, 0.4% etc.). **Public disclosure** is also required to the market in respect of net short positions of 0.5% or more.

- There will also be **reporting requirements** in relation to **net short positions in EU sovereign debt**. There are two different reporting threshold scales depending upon the total amount of sovereign debt in issue. **Reporting is only to the relevant competent authority** (there is no public disclosure requirement).

- EU member States are permitted to maintain **national temporary short selling restrictions** in addition to the Regulation. Austria, Italy and Spain have already announced they will do this.

Part B: Behind the headlines

Timing

On 1 November 2012 the Regulation and its associated implementing measures will apply with direct effect in the UK and most other EU Member States. This is despite the fact that, immediately prior to implementation, there are still some significant unresolved issues both at the European and domestic level. The FSA's final details as to how notifications should be made to it (where it is the competent authority), and indeed its final rules on necessary amendments to the Handbook generally, will be published only a matter of days before the regime goes live. Some of the critical pieces of legislation have only recently been published in their final, official form: two of the four Commission Delegated Regulations which supplement and provide detail on and (sometimes) clarification of the requirements of the Regulation itself were finally published in the Official Journal on 9 October 2012. In the UK, the Financial Services and Markets Act 2000 (Short Selling) Regulations 2012 were laid before Parliament on the same day – these broadly address the powers that the FSA (and in due course the FCA) will have as the relevant competent authority for the UK.

Austria and Spain have indicated that they will retain their existing short selling measures. These will apply in addition to the Regulation.

Questions of scope

Remember that the scope of the Regulation, in terms of the relevant instruments to which the short selling requirements apply, is wider than the pre-Regulation UK regime. In addition to the fact that there are new private and (in the case of shares) public reporting thresholds (to the relevant EU regulator and to the market), the regime broadly applies to *all* shares and sovereign debt instruments admitted to trading on an EU-regulated market or multilateral trading facility (MTF). This will catch activities in relation to such instruments even where they are traded outside that trading venue on an OTC basis. Furthermore, broadly speaking derivatives referable to such EU shares or sovereign debt instruments are also caught. There is as yet no single list of instruments traded on MTFs caught by the Regulation.

Also ***remember*** that the territorial scope of the Regulation is defined by the nature of instruments traded, and not by the location of the person trading. In other words, the Regulation will apply to non-EU persons which take short positions in certain EU instruments and/or which enter into CDS in relation to EU sovereign debt. They will be subject to the same restrictions and reporting requirements as EU-based firms.

Prohibition on uncovered or "naked" short sales in shares and sovereign debt

Remember that the new regime is not just about disclosure requirements. Uncovered short sales in such instruments are in most cases prohibited. This means that short sales are only permitted if, broadly, the short seller has borrowed the relevant instrument (or has entered into an agreement to borrow it – e.g. under a stock borrowing arrangement) or has a "locate" arrangement in place such that he has a reasonable expectation that settlement can be effected when due. Different types of locate arrangement will be required depending upon the nature and liquidity of the securities over which the short position has been taken (with a distinction being drawn between same day locates, same day and "easy to borrow or purchase" locates and other arrangements). For instance, in the case of illiquid shares the seller will need to have a "put on hold confirmation" from the third party lender to the effect that it has at least put the requested number of shares on hold. If a firm seeks to rely on locate arrangements to avoid breaching the prohibition on naked short selling, it must ensure that these comply with the requirements of the EU legislation. Similar, but not identical, requirements apply in relation to EU sovereign debt. We are advising firms as to whether their locate arrangements will be acceptable in the light of the new requirements. Prime brokerage industry standards are being developed but these are not being adopted universally.

Remember that these arrangements must in any event be evidenced by confirmations in a durable medium – in other words, the confirmations must be in hard copy or be capable of being printed in hard copy. It will not help you if you cannot prove to the relevant regulator at a later date that you had compliant locate arrangements in place *at the time* of entering into the short sale.

But certain trades will not be short sales

Sales or transfers by parties under repos and securities lending agreements (even if the seller/lender is technically short at the time of the individual sale) are expressly carved out of the definition of short sales. In addition, futures contracts and other derivatives under which it is agreed to sell specified securities at a specified (spot) price at a future date will also not be short sales for the purposes of the prohibition on naked short selling. ***Remember*** that these may nonetheless be relevant for the purposes of calculating the reportable net short position in a particular issuer.

Transparency requirements

The notification requirements apply to "net short positions" in relation to issued share capital or issued sovereign debt. In order to determine whether your firm has a net short position you will have to determine what "short positions" and "long positions" are in place.

Remember that the definition of "short position" includes, but goes wider than, "short sales" as defined. You must include in your calculations not only short sale positions, but also any transactions (other than short sales) which create, or relate to, a financial instrument where the transaction confers a financial advantage on the firm in the event that the price of the relevant underlying share or debt instrument falls. This will capture a broad range of both cash or physically-settled derivative instruments (whether exchange-traded or OTC) – such as futures, put options, contracts for differences and credit-linked notes. ***Remember*** also that you must include within your calculation positions held by the firm through indices, baskets of securities and exchange-traded funds. To do this you will need to assess the proportional interest of your firm "acting reasonably having regard to publicly available information" as to the composition of the relevant index, basket or ETF. While it is not necessary to have "real-time" information, there is a lack of clarity – given the acting reasonably requirement – as what sources you can rely on and how up-to-date they are.

The concept of a "long position" is, correspondingly, wide.

As regards net short positions in shares:

- a net short position of 0.2% or more in the issued share capital of a company admitted to trading on an EU-regulated market or MTF must be notified to the **relevant competent authority** (i.e. broadly the Home State regulator of the main EU market or MTF for trading the stock) – further notifications to the relevant regulator must be made for each incremental rise in the net short position of 0.1% (i.e. at 0.3%, 0.4%, 0.5%, 0.6% etc.);

- a net short position of 0.5% or more in the issued share capital of a relevant company must, in addition to being notified to the relevant regulator, also be **publicly disclosed** to the market.

Remember that, while a net short position in relevant shares of 0.5% of issued share capital will trigger public disclosure to the market in addition to notification to the regulator, in the case of short positions in sovereign debt there will be no such public disclosure requirement. However, there will be two separate threshold scales at which notification to the relevant competent authority would be required, depending upon the total amount of outstanding issued sovereign debt:

- *where the total amount of the relevant issued sovereign debt is up to 500 billion euros (and where there is no "liquid futures market")*: an initial notification threshold of 0.1% (with further notifications when incremental thresholds of 0.05% over the initial threshold are reached – i.e. at 0.15%, 0.2%, 0.25% etc);

- *where the total amount of the relevant issued sovereign debt is above 500 billion euros (or, regardless of the amount in issue, there is a "liquid futures market" in that debt)*: an initial notification threshold of 0.5% (with further notifications when incremental thresholds of 0.25% over the initial threshold are reached – i.e. at 0.75%, 1%, 1.25% etc).

Neither the Regulation nor its implementing measures define a "liquid futures market".

Separate absolute prohibition as regards uncovered/naked EU sovereign CDS

Remember that, with effect from 1 November 2012, the ban on entering into uncovered positions in EU sovereign CDS will become effective, subject to a transitional provision which allows uncovered positions entered into before 25 March 2012 to be held uncovered until maturity. It follows that any uncovered positions in EU sovereign CDS entered into after 25 March 2012 and before 1 November 2012 will have to be unwound by 1 November 2012.

Remember you must ensure that the sovereign CDS position will be covered in accordance with the requirements of the legislation *in advance of* entering into it, otherwise the absolute prohibition will be breached. A firm will only be considered to have a covered position in an EU sovereign CDS if that position serves to hedge against an exposure to:

- the risk of default of the reference issuer, where the firm has a long position in its sovereign debt; or

- the risk of a decline of the value of the sovereign debt where the firm holds one of a narrowly defined set of permissible assets or exposures, the value of which is "correlated to" the value of the sovereign debt and where the CDS cover is "proportionate" to the asset.

The correlation test will be deemed to be met in a few fairly self-evident circumstances – e.g. where the exposure being hedged relates to a majority owned subsidiary of the sovereign or is a regional, local or municipal government or is an enterprise whose cash flows are significantly dependent on contracts from the sovereign. Otherwise, passing the correlation test will be harder. A quantitative correlation test will be met by showing a Pearson's correlation coefficient of at least 70% between the price of the assets or liabilities and the price of the sovereign debt. This calculation would have to be done on an historical basis using data for at least a period of 12 months of trading days preceding the date on which the sovereign CDS position will be entered into. This would, at least, have the virtue of mathematical and statistical objectivity. The alternative, the "qualitative correlation" test, would only be met if you could show "meaningful correlation" based on "appropriate data" which is not "evidence of a merely temporary dependence". Again, the calculation would have to be made on an historical basis using 12 months' trading data. This would be an inherently riskier exercise, given the stakes. Getting this wrong and being unable to evidence to the competent authority after the event that the data you had used was appropriate or that the correlation was not temporary in nature will mean the prohibition will have been breached.

Investment managers: reporting short positions

Details on the methodology for calculating positions for management activities relating to several funds or managed portfolios is set out in Commission Delegated Regulation (EU) No.918/2012. A manager cannot, in calculating the net short position in a particular issuer, net a short position it has taken against a particular issuer in one fund or managed portfolio against a long position it has taken against the same issuer in another fund or managed portfolio – this is based on the premise that the manager, as a "management entity" as defined (see below), will necessarily be pursuing two different "investment strategies" for these different funds in relation to the particular issuer – one short and one long. Things are less straightforward when there is co-management or delegation of funds. The strict position is that each of the co-managers of the same fund or managed portfolio will have a discrete reporting obligation even though this would result in two managers making reports in respect of the same fund. Neither will be able to take account of positions taken by the other, even if it can be argued that they are pursuing the same investment strategy. However, the particular facts of a co-management/delegation structure may be relevant in determining exactly what each entity is required to report. For instance, there may be questions as to whether, in particular circumstances, a "manager" is actually exercising a meaningful management activity (i.e. exercising its discretion in relation to transactions for the fund or portfolio) or whether that activity has been fully delegated. We can advise further on these issues if they are relevant to your firm.

Remember that there are specific provisions governing the situation where a single entity is performing both management activities and non-management activities (broadly net short positions must be reported separately for each set of activities).

Remember also that the methodology for calculating positions within groups (which will allow for netting across holdings in different group entities) does not apply to management entities performing management activities.

Practical steps

Firms must be taking a number of practical measures to prepare for the imminent implementation of the new regime. These will include, for instance:

- ensuring that any naked sovereign CDS entered into on or after 25 March 2012 are unwound before 1 November 2012;
- ensure that procedures and controls are in place to be able to identify sovereign debt instruments and shares admitted to trading on an EU-regulated market or MTF – and to determine the amount of such instruments in issue or outstanding and so be able to take account of positions taken (whether on or off exchange) for the purposes of the regime;
- examining whether the firm's existing borrowing or "cover" arrangements will be sufficient to avoid breaching the restriction on naked short selling and ensuring that such arrangements are adequately evidenced (e.g. by written (or printable) confirmations);
- determining to what extent the firm is invested in indices, baskets or ETFs and, if so, identify what information is publicly available in determining the firm's interest and what reasonable steps will be required in order to have regard to that information;
- ensure that internal systems are able to identify when net short positions exceed the relevant reporting threshold(s) and that the onward reporting to the relevant competent authority is completed within the time allowed (i.e. by 15:30 local time on T+1);
- assessing, in the case of an investment manager, the responsibility for reporting (including amongst co-managers/delegates).

Relevant documents

Some key documents of relevance include:

EU Regulations:

- The Short Selling Regulation
- Regulatory technical standards on notification and disclosure requirements, information to be provided to EMSA and method for calculating turnover
- Implementing technical standards regarding the means for public disclosure of net positions, the format of information to be provided to EMSA, the types of agreements, arrangements and measures to ensure instruments are available for settlement and the dates and period for the determination of principal venue
- Delegated regulation regarding definitions, the calculation of net short positions, covered CDS, notification thresholds, liquidity thresholds, significant falls in value and adverse events
- Regulatory technical standards regarding the method of calculation of the fall in value of liquid shares and other instruments

EU Guidance:

The ESMA Q&As on the Regulation

UK legislation:

- The Financial Services and Markets Act 2000 (Short Selling) Regulations 2012:
- CP12/21: Short selling regulation – Handbook changes
- Market Watch: Issue No.42 – Special short selling edition
- Market maker/Authorised Primary Dealer exemptions process and forms (note that we are aware that there are issues with some of these forms on which we can advise)

In addition, a number of trade associations (including AIMA and AFME) have been working on guidance notes and resources for their member firms.

For further information on how we may be able to help you these issues please contact one of the following partners in our Financial Services and Markets Department or your usual contact at Travers Smith..

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