TRAVERS SMITH

Financial Services and Markets

A pan-European short selling regime draws nearer

On 15 September 2010 the European Commission adopted a proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps (the Proposal). Based on the Commission's current reckoning, a pan-European short selling regime could be in place as early as 1 July 2012.

Introduction

In June 2010 the European Commission published a consultation paper which set out its high-level proposals as regards a possible pan-European short selling regime. As we reported at the time, this was open for consultation for less than a month. The consultation paper had been prepared in the light of, but in some ways went further than, recommendations made by the Committee of European Securities Regulators (CESR) in a report published in March 2010 (as supplemented by a further report published in May 2010 setting out certain technical details).

The Proposal adopted yesterday includes the draft text of the proposed Regulation.

The Proposal in outline

Scope and application

The new regime will have extraterritorial effect. Some of the requirements of the regime, such as the notification and disclosure requirements relating to net short positions in relevant instruments, will apply irrespective of where the person is located.

In terms of overall scope, the Regulation will apply to all financial instruments admitted to trading on a regulated market or MTF in the European Union (whether traded on- or off-exchange), a wide range of derivatives related to such instruments and debt instruments issued by a Member State or the European Union (and derivatives relating to such debt instruments). However, as will be seen below, the public and private disclosure requirements will apply to a narrower range of instruments.

Transparency and disclosure

In its June consultation paper, the European Commission had floated two options as regards transparency. The first of these (Option A) was for a two-tier disclosure requirement applied to *all* financial instruments admitted to trading on an EU trading venue. The Commission has elected to proceed with (broadly) Option B so that the disclosure obligation will apply to a narrower range of instruments. Under the Proposal the disclosure requirements would be as follows:

- in relation to net short positions in **shares** admitted to trading on an EU regulated market and/or an MTF a "two-tier" disclosure model (based on the CESR model) will apply. This will require disclosure of positions of 0.2% or more to the regulator and public disclosure to the market of positions of 5% or more – with further disclosures as positions move (up or down) through 0.1% integers. The Commission will have the right to change these thresholds "taking into account the developments in the financial markets";
- in relation to net short positions in **EU sovereign bonds** of a Member State or the European Union and **uncovered positions in credit default swaps** relating to an obligation of a Member State or the European Union there will be a "private" disclosure requirement – i.e. to the relevant regulator. The relevant notification thresholds will be as specified by the Commission in delegated legislation. A person will be considered to have an uncovered position in a credit default swap relating to an obligation of a Member State or the European Union to the extent that the person has a long position in the sovereign debt of an issuer (or in the debt of another issuer the price of which has a "high correlation with" the price of a Member State/European Union obligation)) and the swap is not serving to hedge against the risk of the issuer's default.

These transparency requirements will apply not only to short positions created by trading on a regulated market or MTF in the EU but also to OTC trading, whether by way of "cash" trading or through the use of derivatives.

Delegated legislation will set out how a net short position would be calculated, although presumably the work which CESR has already done in this regard will be relevant.

The relevant trading venue will be required to impose requirements on brokers executing trades to mark sell orders as short orders where the seller is entering into a short sale. The trading venue will be required to publish a summary of the volume of orders marked as short orders at least on a daily basis.

Ban on naked short selling in relation to shares and sovereign debt instruments

The Commission proposes the introduction of a ban on uncovered short sales (or "naked short selling") in relation to shares and sovereign debt instruments. A person would not be allowed to enter into a short sale of any shares admitted to trading on an EEA regulated market and/or an MTF or any sovereign debt instruments unless the short is covered - i.e. the person:

- has already borrowed the share or debt instrument; or
- has entered into an agreement to borrow the share or debt instrument; or
- has a "locate and reserve" arrangement in place with a third party whereby that third party has confirmed that it has located the relevant shares or debt instruments and has reserved them for the borrower so that settlement can take place when due.

The Commission will adopt implementing technical standards identifying the types of agreements or arrangements that will adequately ensure that an instrument is available for settlement.

Buy-in procedures and fines for late settlement

The Commission also proposes that the relevant trading venue must:

- have (or must ensure that the relevant central counterparty has) buy-in procedures which are triggered in the event that a short seller is unable to deliver the shares or sovereign debt instruments for settlement within **four trading days** after the trade date (or six trading days in the case of market making activities);
- have (or ensure that the relevant settlement system has) procedures whereby sellers are fined for late settlement; and
- have rules which will enable it to prohibit a member from entering into further short sales for as long as it fails to settle a short sale on that venue.

Exemptions

The draft Regulation contains a number of proposed exemptions. These are as follows:

- **principal trading venue is outside the EU** - the transparency requirements, the ban on naked short selling and the buy-in requirements will not apply in the case of shares admitted to trading on a regulated market or MTF in the EU where the principal venue for trading is outside the EU. The relevant EU competent authority in this regard would be required to determine at least every two years whether the principal venue for trading remains outside the EU;
- **market making and primary market operations** – there are three exemptions here:
    - the transparency requirements and the ban on naked short selling will not apply to firms that are members of a trading venue or market in a third country whose legal and supervisory framework has been declared "equivalent" where those firms deal as principal (whether on- or off-exchange) in a market-making capacity;
    - the obligation to notify a relevant competent authority of short positions in sovereign debt instruments and credit default swaps and the ban on naked short selling of sovereign debt instruments will not apply when a firm acts as an authorised primary dealer for a sovereign debt issuer; and
    - the transparency requirements and the ban on naked short selling will not apply to a firm when carrying out stabilisation activities in accordance with the Buy-back and Stabilisation Regulation (Regulation No.2273/2003).

Emergency powers

Subject to the requirement to notify the European Securities and Markets Authority (ESMA), competent authorities will be able to take unilateral action where there are "adverse events or circumstances which constitute a serious threat to financial stability or to market confidence". In such circumstances, national regulators may:

- impose short selling disclosure requirements (private and/or public) in relation to a specific financial instrument or class of financial instrument (other than the instruments covered by the Regulation's disclosure requirements (see above));

- impose restrictions relating to:
  - short sales of financial instruments or classes of financial instruments;
  - a transaction, other than a short sale, by a person "which creates, or relates to, a financial instrument and the effect or one of the effects of the transaction is to confer a financial advantage on the person in the event of a decrease in the price or value of another financial instrument";
- prevent persons from entering into transactions relating to financial instruments or limit the value of transactions in the financial instruments that may be entered into; and
- limit persons from entering into credit default swap transactions relating to the obligation of a Member State or the Union or limit the value of uncovered credit default swap positions that may be entered into.

Measures imposed by the emergency powers outlined above could only be imposed for up to three months – but those measures could be extended for further periods of up to three months at a time.

In addition, competent authorities will be able to impose restrictions where the price of a financial instrument has fallen by a significant percentage (being in the case of a share, 10%, and in the case of other instruments such percentage as specified by the Commission).

A competent authority would have to notify ESMA and every other competent authority in advance of any emergency measure it proposes to take. ESMA would issue an opinion to the competent authority within 24 hours as to whether it considers the emergency measure to be necessary. As the Regulation is drafted, it appears that a national regulator will be able to proceed to take measures contrary to an ESMA opinion provided it publishes its reasons for doing so on its website.

The powers of ESMA

It is clear that ESMA will have significant powers. Not only will it perform a "facilitation and coordination role" in relation to the measures taken by competent authorities, but it will also have direct intervention powers to impose disclosure requirements, to ban or limit short sales and to restrict credit default swap transactions where there is a threat to the stability of the financial markets and one or more competent authorities have not sufficiently addressed that risk.

What happens next?

The Commission's proposal will now pass to the European Parliament and the Council for a process of negotiation, involving a parallel consideration of the draft text by a working group of the Council and the ECON committee of the European Parliament with a view to reaching two sets of approved texts. Thereafter, there will be negotiations in order to reach an agreed text for adoption.

At this stage it is difficult to predict how long this process will take. However, the draft Regulation tentatively suggests that it might apply from 1 July 2012 (with transitional relief to allow Member States to continue with their existing short selling regimes until 1 July 2013, provided they have notified the Commission). Of course, depending upon how the negotiation process goes these dates could slip. The Regulation will have direct effect in Member States – meaning that no domestic legislation would be required in the UK. We would expect the FSA to copy out the provisions of the Regulation into Chapter 2 of its Financial Stability and Market Confidence Sourcebook (FINMAR).

The European Commission Proposal is available at:
http://ec.europa.eu/internal_market/securities/short_selling_en.htm

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