

Financial Services and Markets

EC Consultation Paper on Short Selling

16 June 2010

On 14 June 2010 the European Commission published a high-level working document setting out its potentially far-reaching proposals as regards a possible pan-European short selling regime.

Introduction

This consultation (see http://ec.europa.eu/internal_market/consultations/2010/short_selling_en.htm) is the forerunner to a formal Commission proposal which is scheduled to be adopted in September 2010. In certain ways it goes significantly beyond the recommendations which CESR made in its proposals for a pan-European short selling disclosure regime. See our previous briefing ([CLICK HERE](#)) on the CESR proposals. The consultation period for the Commission paper is short and closes on 10 July 2010. The consultation period is shorter than the usual 8 weeks because the issue is one of "high political priority and urgency in the context of the financial crisis and recent volatility in Euro-denominated sovereign bonds" and because of previous public consultation in the context of the Market Abuse Directive review.

The proposals in outline

Scope

The new regime will have extraterritorial effect. The Commission envisages that 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.

Transparency

The Commission suggests two options:

- Option A: A transparency regime based on the CESR "two-tier" disclosure model but applied in relation to net short positions in all instruments admitted to trading on an EEA regulated market and/or an MTF that can be subject to short selling – the two-tier regime "would need to be adapted" for different types of financial instruments. (The two-tier model proposed would require disclosure of positions of 0.2% or more to the regulator and public disclosure to the market of positions of 0.5% or more with further disclosures as positions move (up or down) through 0.1% integers.)
- Option B: A transparency regime limited to net short positions in EU shares and EU sovereign bonds only – the disclosure requirements in relation to shares would be as recommended by CESR (i.e. the two-tier model). The proposals in relation to EU sovereign bonds (which were not covered by CESR's proposals) suggest that there should be disclosure to the regulator only (i.e. no public disclosure) when net short positions pass through "relevant notification thresholds" – these are currently unspecified.

Net economic short positions held by way of derivatives would be included under either option (including, under Option B, credit default swaps (CDS) in relation to the EU sovereign issuer).

Ban on naked short selling in relation to shares

The Commission proposes the introduction of a ban on uncovered short sales (or "naked short selling") in relation to shares. 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 unless covered by a stock borrowing arrangement.

The Commission also proposes that the relevant trading venue (or the relevant CCP or settlement system) has buy-in procedures which are triggered in the event that a short seller is unable to deliver the shares for settlement within a specified period of trading days after the trade date.

Market making exceptions

As CESR recommended, the Commission proposes that there should be appropriate exceptions for those involved in market making activities. These would extend to:

- the transparency requirements – in the terms suggested by CESR in its report on Technical Details of the Pan European Short Selling Regime (May 2010);
- the naked short-selling ban;
- the buy-in procedures.

Emergency powers in relation to short selling and credit default swaps

The Commission suggests that competent authorities should be given the power to impose short selling restrictions in an emergency relating to:

- short sales of shares or bonds;
- a transaction by a person "which creates, or relates to, another 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 a share or bond".

In addition, competent authorities should be able to prohibit or restrict the purposes for which persons may enter into CDS transactions relating to the default of an EU Member State or the European Union, or restrict the value of such transactions.

Measures imposed by such emergency powers could only be imposed for up to three months – but "in exceptional circumstances" those measures could be extended for a further three months.

The European Securities and Markets Authority (ESMA) would have a "facilitation and coordination" role in relation to any powers to be taken by competent authorities under the emergency powers. A competent authority would have to notify ESMA and every other competent authority in advance of any measure it proposes to take. ESMA would be empowered to give advice to the competent authority about the action it proposes to take.

Enforcement and information-gathering powers

The Commission proposes that competent authorities should be given the necessary powers to enforce the new legislation.

Furthermore, it suggests that competent authorities might be given the power to seek information from a person regarding the purpose for which he has entered into a CDS transaction.

What happens next?

As we mention above, the consultation period is short and replies must be submitted by 10 July 2010 (just over three weeks away). After that, the next public document showing the Commission proposals will be the formal proposal in September – unlike the high-level approach adopted by the consultation document the formal proposal will contain the detailed text which the Commission recommends. Given the urgency with which these matters are being pushed through it may not be possible to make further representations heard at that stage. In the light of this, it is important to reply to the high-level consultation now.

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