Clients&FriendsMemo

New Pan-European Restrictions on Short Selling

10 April 2012

On 24 March 2012, the European Parliament's Regulation on "short selling and certain aspects of credit default swaps" (the **Regulation**)[1] came into force. The Regulation:

1. creates a two-tier disclosure requirement for "significant" net short positions in shares and disclosure obligations for net short positions in EU sovereign debt and uncovered positions in credit default swaps that relate to European sovereign debt issuers (**Sovereign CDS**);
2. imposes a locate requirement, which essentially prohibits uncovered short sales;
3. exempts Sovereign CDS from some of its provisions when that Sovereign CDS demonstrably hedges counterparty or systemic risk; and
4. allows national regulators to suspend restrictions on the short selling of sovereign debt in times of liquidity stress.

Timetable and the role of ESMA

While the Regulation is directly applicable, *i.e.*, it came into force immediately upon publication in the Official Journal without having to be enacted locally in the European member states, the majority of its provisions do not apply until 1 November 2012.

Although there is a period of implementation available to firms, the overall timetable has been unusually tight. The European Securities and Markets Authority (**ESMA**), the body charged with producing "technical standards" under the Regulation which specify the detail of the Regulation's implementation, produced two consultation papers[2] on those technical standards on 24 January 2012 and 15 February 2012, with deadlines for comments of 13 February 2012 and 9 March 2012 respectively. These deadlines were based on ESMA's obligation to submit its technical standards and other implementing measures under the Regulation to the European

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[1] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps. The Regulation can be found here:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF

[2] http://www.esma.europa.eu/system/files/2012-98.pdf and http://www.esma.europa.eu/system/files/2012-30_0.pdf

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Commission for their consideration by 31 March 2012 and mid-April. ESMA's Final Report on some of the measures was published on 30 March 2012.[3]

What is a "short sale"?

Article 2(1)(b) defines a short sale as "any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement." The definition specifically excludes: (i) sales under a repo agreement; (ii) transfers under a securities lending agreement; and (iii) futures or other derivative contracts to sell securities at a specified price at a future date. Note that net short positions are calculated by deducting long positions from short positions, and that when making that calculation for the purposes of the reporting thresholds (see below), positions under relevant derivatives will count towards those thresholds.

Disclosure requirements

Shares of companies listed on a European market: Net short positions in shares meeting certain thresholds ("significant short positions") must now be disclosed when those shares are admitted to trading on a regulated market or multilateral trading facility in Europe, except where the principal venue for trading is outside Europe.

The first threshold for disclosure requires a notification to the relevant regulator of a net short position that reaches 0.2% of the issued share capital and at each 0.1% above that threshold. This disclosure is non-public. At a second, higher threshold of 0.5% of the issued share capital the net short position must be publicly disclosed to the market, and again at each 0.1% above that threshold.

ESMA has proposed that the notification be presented as a percentage rounded to two decimal places and as a number of shares, both to be expressed in absolute values, identifying the issuer by ISIN code. The disclosure must include the identity of the holder of the short position, and the Regulation requires that public disclosure must be made on a central, regulator-controlled website.

Reportable net short positions in EU sovereign debt: ESMA has proposed that the initial thresholds for reporting net short positions in EU sovereign debt be set at 0.1%, 0.25% and 0.5% of the total monetary amount of outstanding issued sovereign debt. Issuers will be assigned one of these thresholds and additional increment levels for further disclosures, based on a number of factors (*e.g.*, average size of position held by market participants). Reports will only be required to be made to the relevant regulator and will therefore not be public.

[3] http://www.esma.europa.eu/system/files/2012-228_0.pdf

Note that the definition of "sovereign" issuer includes, amongst others, an SPV for several Member States, an international financial institution established by two or more Member States which has the purpose of providing assistance to the benefit of its members that are experiencing financial problems and the EIB (Article 2(d)). Shorting of debt issued by the European Financial Stability Facility and possibly other multinational entities may therefore also be caught by the Regulation.

Reportable uncovered positions in Sovereign CDS: When a national regulator suspends restrictions on uncovered positions in Sovereign CDS (see below), holders of such positions will be required to notify positions reaching or falling below relevant thresholds. Again, reports will only be required to be made to the relevant regulator and will therefore not be public.

A common form of standard notification? ESMA's consultation on the issue of transparency is centred on a proposal that there be a common, standard form of notification to regulators by investors and a common, standard form of public disclosure. ESMA's consultation includes a requirement to include the full name of the natural person short seller or an identification number if the short seller is a legal entity. In the case of the latter, once the Financial Stability Board has concluded its work on LEI codes, that should be used, and in the meantime, entities with a Bank Identifier Code or BIC should use that number. ESMA's consultation includes proposal drafts of standard form notifications, including contact information (which will not be made public) and how information may be disclosed to the public. In the event that a third party is making a notification on behalf of a net short position holder, the third party should be identified and provide contact details.

Extra-territorial notification requirements: Note that Article 10 of the Regulation makes it clear that all disclosure requirements apply to natural or legal persons domiciled or established within the European Union or elsewhere.

Uncovered short sales

Uncovered short sales of shares and sovereign debt are now significantly restricted in the following ways:

1. Natural or legal persons are now prohibited from entering into uncovered Sovereign CDS. Positions in Sovereign CDS that hedge against a default risk or the risk of a decline in the value of the sovereign debt will not be considered to be uncovered (see below);

2. Natural or legal persons may only enter into a short sale of a share admitted to trading on a regulated market or multilateral trading facility in Europe when that natural or legal person has (i) borrowed the share or made alternative arrangements that arrive at a similar legal effect, (ii) entered into an agreement to borrow the share or has another enforceable claim to ownership of a corresponding number of securities of the same class such that settlement can be made when due, or (iii) made an arrangement with a third party whereby the third party confirms that the share has been located and the

natural or legal person can have a reasonable expectation that settlement can be effected when due. Where this last category is relied on, ESMA is proposing that suitable third parties can only be those with "skin in the game", *i.e.*, other investment firms, central counterparties, trading venues, other authorised firms, *etc.* and should be different legal entities (thereby excluding borrowing by one desk from another within the same firm and also excluding data providers);

3. Similar restrictions are in place for short sales of sovereign debt as are set out above, but these are in the shape of a "soft locate" requirement. The person entering into the short sale must have an arrangement with a third party whereby the third party has confirmed that the cash bond has been located **or** that the third party has a reasonable expectation that settlement can be effected when due. To demonstrate compliance with the Regulation, the short seller would need to keep a record of the confirmation of the location under the third party arrangement, the identity and amount of the debt concerned and the date of the relevant agreement. In addition, the restrictions on short sales of sovereign debt will not apply when the transaction hedges a long position in the debt instrument of an issuer, the pricing of which has a "high correlation" with that of the relevant sovereign debt.

ESMA's consultation includes a list of agreements and enforceable claims that can satisfy the requirement for an agreement to borrow the shares or sovereign debt. The list includes futures, options, repurchase agreements, standing agreements, rolling facilities, subscription rights or other claims or agreements leading to physical exchange. Subscription rights that can be converted into new shares before or at the settlement date may also be used to cover short selling. ESMA's proposals with respect to such agreements is that (amongst others) they:

- ensure that the right amount of shares/sovereign debt is made available for settlement;
- are entered prior to or concomitantly with the investor entering into the short sale;
- are legally binding for the duration of the contract; and
- are recorded in a durable medium.

When are uncovered positions in Sovereign CDS permitted?

Article 4 of the Regulation provides that certain positions in Sovereign CDS will not, by definition, be uncovered. A position will be considered uncovered when the Sovereign CDS does not hedge against:

"(a) the risk of default of the issuer where the natural or legal person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates; or

(b) the risk of a decline of the value of the sovereign debt where the natural or legal person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is correlated to the value of the sovereign debt."

Permissible hedging is to be the subject of further legislation (*via* a delegated act). ESMA has already given its draft technical advice on the contents of this delegated act[4]. The draft advice requires a consistent, significant and positive correlation between the value of the asset or liability being hedged and the value of the referenced sovereign debt, *i.e.*, a correlation test for a Sovereign CDS to not be treated as uncovered. A recent Reuters blog on the Regulation and the ESMA draft advice[5] reports that ESMA has confirmed at a public hearing that proxy hedging strategies, such as buying CDS on the debt of a country other than that where the hedged exposure is located, would fail the correlation test. ESMA is also proposing that firms should demonstrate correlation through trading data going back across a 12-month period.

ESMA's deadline for comments on its draft technical advice on this aspect of the Regulation was 9 March 2012, and its final report and submission of the draft advice on delegated acts to the European Commission is expected in mid-April.

You should also note that Article 46(2) of the Regulation allows uncovered positions in Sovereign CDS that were concluded before the date the Regulation came into force to be held to maturity.

National regulators able to suspend restrictions on short selling sovereign debt and uncovered Sovereign CDS

Regulators in individual European Union member states may suspend the restrictions on uncovered short selling of their own countries' sovereign debt where the liquidity of that debt falls below a threshold calculated by reference to a "basket" of benchmarks. The suspension will be temporary and for an initial period of six months that can be renewed for periods not exceeding six months.

In addition, regulators in individual European Union member states may suspend the restrictions on uncovered Sovereign CDS where the regulator has objective grounds for believing that its sovereign debt market is not functioning properly and that such restrictions might have a negative impact on the sovereign credit default swap market. The suspension will be temporary and for an initial period of 12 months that can be renewed for periods not exceeding six months.

Commentary

The full impact of the Regulation will become easier to assess when ESMA's technical details are finalised and adopted, but most of the trading community will be affected, for example:

[4] http://www.esma.europa.eu/system/files/2012-98.pdf

[5] "Short-selling and CDS regulation in EU: Less to nakedness than meets the eye, funds and firms argue" 5 March 2012

- Prime brokers may factor in and pass onto their clients the increased costs associated with matters such as (i) buy-ins and compensation for settlement failure; (ii) keeping records of confirmation of the location of the securities for borrowing, the identity and amount of the shares concerned, etc.;
- Brokers will have to monitor whether the orders they receive from clients involve short-selling;
- Participants shorting will have to ensure that identifiers are in place for reporting purposes; and
- Buy-side participants will experience reduced liquidity in the sovereign debt market, increased reporting/compliance costs, and additional risk monitoring requirements relating to the level of correlation required for sovereign debt hedging to be permissible. Certain trading strategies may no longer be viable.

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