

December 14, 2011

Financial Regulatory Reform Center

European Parliament Resolution on Short Selling and Aspects of Credit Default Swaps

By David Elphinstone

On 15 November 2011, the European Parliament passed a resolution adopting, with amendments, the European Commission's proposal for a regulation relating to short selling and certain aspects of credit default swaps (the "Regulation"). The Regulation must now be approved by the European Council before it comes into force.

The original proposal was published on 15 September 2010 (the "Proposal"). This followed a public consultation period and also took into account work carried out by the Committee of European Securities Regulators ("CESR") and the European Securities and Markets Expert Group (CESR has now been replaced by the European Securities Market Authority ("ESMA")).

The Proposal had four principal objectives:

- (i) to increase transparency on short positions held by investors of certain types of securities;
- (ii) to give member states power to intervene in exceptional circumstances to reduce systemic risk and risks to financial stability and market confidence arising from short selling and credit default swaps;
- (iii) to ensure coordination between member states and ESMA in exceptional circumstances; and
- (iv) to reduce settlement risk and other risks linked with uncovered short selling.

Background

During the height of the financial crisis in 2008, several EU Member States along with the US and Japan (among others) adopted emergency measures to restrict or ban short selling of some or all securities. This stemmed from a concern that short selling could aggravate the downward spiral in shares prices, most notably in financial institutions.

The Proposal and now the Regulation seek to consolidate the divergent measures taken by Member States in 2008 and since into a single regulatory framework which would govern short selling across the EU. Whilst the Regulation notes that under normal market conditions short selling plays an important role in ensuring the proper functioning of financial markets, it notes that to further ensure the proper functioning of such markets requires a common regulatory framework to guarantee greater coordination and consistency between Member States.

Scope of the Regulation

The Regulation provides a broad preventive framework. The permanent measures it introduces apply only to particular types of instrument with clearly identifiable risks. However, it also allows competent authorities in Member States and ESMA to take measures concerning all types of financial instruments in exceptional circumstances. The role of ESMA in the Regulation has caused some controversy in the UK – see paragraph entitled "ESMA" below.

Transparency

The Regulation introduces a two tier transparency model for significant net short positions on shares admitted to trading on a trading venue in the EU - this is in line with a recommendation made by CESR in March 2010.

Shares

Any person who has a net short position in relation to shares admitted to trading on an EU trading venue must notify the relevant competent authority whenever the position reaches or falls below 0.2% of the issued share capital of the relevant company concerned and each 0.1% above or below that. This will allow the competent authority to monitor the position and, if necessary, investigate if the short selling may create systemic risk. If the position reaches or falls below 0.5% and each 0.1% above or below, disclosure must be made to the market so that market participants are aware of significant short selling positions.

Sovereign Debt

Notification requirements for short positions on sovereign debt are the same as those for short positions on shares, save that there is no requirement to notify the market.

The Regulation's transparency requirements also apply to net short positions created by trading outside trading venues or by the use of over-the-counter derivatives such as options, futures, index-related instruments, contracts for difference and spread bets relating to shares and sovereign debt.

It should also be noted that the transparency requirements apply regardless of where the relevant person is located. This means that any person located outside

the EU, but with a significant net short position in a company whose shares are admitted to trading on an EU venue (or a net short position in sovereign debt issued by a Member State or the EU), will be caught by the Regulations.

Uncovered Short Sales

The Regulation notes that uncovered, or "naked", short selling might be viewed as increasing the potential risk of settlement failure and volatility.

Shares

The Regulations therefore directs that a person may only enter into short sales of shares if that person:

- (i) has already borrowed the share;
- (ii) has entered into an agreement to borrow the share; or
- (iii) has made an arrangement with a third party, who has confirmed that the share has been located and has taken necessary measures vis-à-vis other third parties for the person entering into the short sale to have a reasonable expectation that settlement can be effected when it is due.

The measures necessary to have such a "reasonable expectation" will be determined by ESMA.

Sovereign Debt

The restrictions on short sales of sovereign debt are broadly similar to those on shares, save that there is a further exemption if the transaction serves to hedge a long position in debt instruments of an issuer, the pricing of which has a high correlation with the pricing of the given sovereign debt. The restrictions on short sales of sovereign debt may be temporarily suspended by the relevant competent authority where the liquidity of sovereign debt falls below a particular threshold.

CDS transactions relating to sovereign debt are permitted only where the transaction does not lead to an uncovered position in a credit default swap (although a competent authority may temporarily suspend this restriction where it believes that its sovereign debt market is not functioning properly and that the restriction might have a negative impact on the sovereign credit default swap market).

Central counterparties that provide clearing services must ensure that there are procedures in place for the buy-in of instruments where there is a failure to settle the transaction within four business days and that daily fines are raised where settlement fails. This is designed partly to incentivise sellers of shares of sovereign debt to settle their trades quickly.

Exemptions

Shares of a company where the principal venue for the trading of the shares is located in a country outside the Union are exempted from certain provisions of the Regulation (i.e. those covering notification of short positions on shares, restrictions on naked short selling of shares and buy-in procedures). There are also exemptions for transactions performed for market making, primary dealing and stabilisation activities. These exemptions cover notification of short positions on shares and sovereign debt, restrictions on naked short selling of shares and sovereign debt and restrictions on uncovered credit default swaps in sovereign debt.

Emergency powers of competent authorities

Where adverse developments constitute a serious threat to financial stability or market confidence in a Member State or in the EU, the Regulation grants competent authorities powers of intervention to require further transparency or to impose

temporary restrictions on short selling, CDS transactions or other transactions in order to prevent a further decline in the price of a financial instrument. Competent authorities also have power to temporarily restrict short selling of financial information in case of a significant fall in the price of a financial instrument in a single trading day. As well as restricting short selling of an instrument in its own jurisdiction, a competent authority may also ask ESMA to restrict short selling in other jurisdictions. Such measures are limited to an initial period of three months but may be renewed for further periods if necessary.

ESMA

The powers granted to ESMA by the Regulation are twofold. Firstly, alongside powers granted to national competent authorities, the Regulation gives ESMA a facilitation and coordination role. Competent authorities are directed to cooperate with ESMA where it is necessary or expedient to do so and ESMA is responsible for ensuring that competent authorities in Member States take a consistent approach. Secondly, ESMA is given power to intervene in exceptional circumstance, either by requiring persons with net short positions to notify a competent authority or by prohibiting persons from entering into short sale transactions. This second power has caused some controversy.

The proposed role of ESMA has

caused some controversy. The United Kingdom had indicated that it was unhappy with the wide powers granted to ESMA under the Regulation. The UK's view was that ESMA's proposed role would be unlawful and contravene the judgment of the ECJ in *Meroni*. This 1956 judgment is often referred to as the "Meroni Doctrine" and is used to determine the extent to which the EU can give powers to agencies.

Next Steps

The Regulation must now be approved by the European Council. Once adopted, the Regulation will apply from 1 November 2012.

Definitions

Credit default swap or CDS a derivative contract in which one party pays a fee to another party in return for a payment or other benefit in the case of a credit event relating to that reference entity, and of any other default, related to that derivative contract that has a similar economic effect.

Short sale in relation to a share or debt instrument...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.

but excluding

(i) a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price;

(ii) a transfer of securities under a securities lending agreement; and

(iii) entering into a futures contract or other derivatives contract where it is agreed to sell securities at a specified price at a future date.

Sovereign debt debt instrument issued by a sovereign issuer.

Sovereign issuer

(i) the Union;

(ii) a Member State, including any ministry, agency or special purpose vehicle of that Member State;

(iii) if the Member State is a federal union, one of the federal states making up that union;

(iv) a special purpose vehicle for several Member States;

(v) an international financial institution established by two or more Member States for the purpose of mobilizing funding and providing financial assistance to the benefit of its members that are experiencing or threatened by severe financial problems; or

(vi) the European Investment Bank.

The **London Financial Regulation Practice** will continue to monitor any developments with this proposal and provide coverage at Weil's Financial Regulatory Reform Center. If you are interested in discussing the proposal, please contact Practice members Peter King (+44 20 7903 1011 or peter.king@weil.com) or David Elphinstone (+44 20 7903 1043 or david.elphinstone@weil.com).