OnPoint Dechert LLP

Financial Services Monthly Update on Regulatory Developments

Part A – Regulation of Financial Markets

Short Selling Disclosures and Restrictions Under EU Regulations

The European Parliament has adopted final Regulations on short selling of shares and sovereign debt and various sets of related technical standards. The Regulations applied on 1 November 2012 and have direct effect throughout the EU.

The Regulations introduce: (i) mandatory disclosure of net short positions to the regulator; (ii) restrictions on naked short selling; (iii) a prohibition on uncovered positions on sovereign credit default swaps and (iv) regulator powers to impose temporary restrictions during stressed markets. Firms must disclose to the regulator a net short position in shares or sovereign debt when the position reaches or falls below a relevant notification threshold. Derivative positions are included. The relevant thresholds are 0.2% (when the firm must make a private notification to the regulator) and 0.5% (when the firm must make a disclosure to the regulator which the regulator makes publicly available), in each case measured as a percentage of the issuer's total issued share capital. Disclosure must also be made when the net short position reaches or falls below 0.1% increments above 0.2% or 0.5%. The time for calculation of the net short position is midnight at the end of the trading day on which the person holds the position. The disclosure must be made no later than 15.30 on the following trading day. The relevant regulator is generally the competent authority of the Member State in which the relevant financial instrument was first admitted to trading on a trading venue.

There is no disclosure obligation in relation to shares of a company admitted to trading on a trading venue in the EU where the principal venue for the trading of the shares is located in a third country. ESMA maintains a list of shares for which the principal trading venue is located in a third country.

Each fund manager must aggregate the net short positions of the funds and portfolios under its management for which it pursues the same investment strategy in relation to a particular issuer, and reported the aggregated position.

The FSA will introduce electronic reporting through an internet portal in due course. In the meantime, it has made the disclosure forms available from a webpage (http://www.fsa.gov.uk/about/what/international/short-selling/notifications-disclosures). The forms will need to be downloaded, completed and returned by email to the FSA.

Timing and recommended actions: The Regulations are currently in force. Firms should monitor all short sales and ensure that disclosure is made in compliance with the Regulations.

Short Selling Bans Introduced by Individual EU Member States

The European Securities and Markets Authority (ESMA) maintains a table of the short selling bans currently in force by EU securities regulators. Regulators in Greece, Italy and Spain have imposed various temporary bans on short selling.

Timing and recommended actions: Firms should monitor all short sales and ensure that net short sales do not take place in breach of restrictions.

Mandatory Central Counterparty Clearing of OTC Derivatives Under EU Regulations

The European Parliament adopted the European Market Infrastructure Regulation (EMIR) on 4 July 2012. ESMA has subsequently published draft Level 2 technical standards.

The Regulation introduces mandatory clearing of OTC derivatives via one or more central counterparties (clearing houses) which will be authorised to clear classes of derivatives by an EU regulatory authority. The obligation covers those classes of standardised derivatives which ESMA identify as subject to the clearing obligation or which the clearing houses themselves identify with the approval of their regulator. All types of derivatives are covered, other than physically settled forward foreign exchange transactions. Clearing houses will require daily mark to market collateralisation of all cleared derivatives.

The clearing obligation applies if the derivative transaction has been concluded between two "'financial counterparties" or where one or both of the parties is a non-financial counterparty for whom the 30-day rolling average of its positions exceeds a threshold set by ESMA. "Financial counterparties" include, inter alia, UCITS funds and EU and non-EU AIFs under the Alternative Investment Fund Managers Directive.

The Regulation also provides that financial counterparties, and non-financial counterparties exceeding the applicable clearing threshold, which enter into uncleared trades, must have appropriate measures in place to monitor, minimise and mitigate credit risk and operational risk. Whether this amounts to an obligation to post collateral for uncleared trades is unclear and ISDA have sought clarification from the Commission in this regard.

The Regulation also introduces mandatory reporting of all derivative trades to authorised trade repositories.

Timing and recommended actions: The clearing obligation will not apply until regulatory authorities authorise clearing houses, which is unlikely to be prior to July 2013. The reporting obligation applies on 1 July 2013 for interest rate and credit derivatives. Firms will need to consider the new documentation suite which will be put in place with brokers which will act as their "clearing member" in relation to each clearing house. ISDA and the UK Futures and Options Association (FOA) are currently working on an addendum to the ISDA Master Agreement or FOA standard futures terms which will govern the clearing relationship across all clearing houses.

EMIR's impact will be significant, particularly in terms of: (i) the cost of posting margin; (ii) changes to booking systems and processes; and (iii) the clearing documentation required with each clearing member.

Following finalisation of the ISDA/FOA addendum, Dechert will issue a detailed client guide to EMIR.

Review of the Market Abuse Directive

The Commission published a proposal to revise the Market Abuse Directive (MAD II) on 20 October 2011. It consists of the Market Abuse Regulation (MAR) and a supplementing EU Directive on criminal sanctions for insider dealing and market manipulation (CSMAD). The UK government has for present exercised its discretion not to opt in to CSMAD.

The Commission intends that the scope of the existing market abuse regime will be extended to multilateral trading facilities (MTFs) and organised trading facility (OTFs), as well as regulated markets. Also in scope are related financial instruments traded on an OTC basis which can have an effect on instruments traded on a trading venue. Under the existing regime, the market integrity and transparency rules apply to commodity derivatives markets, but not to the underlying markets. The Commission intends that MAR will govern transactions or behaviour in the underlying spot markets which are related to, and have an effect on, the financial and derivative markets which are within the scope of MAR. The trading of emission allowances will also fall within the scope of MAR.

The definition of inside information in MAR will be widened. One issue is that there will be a new category of inside information which is information which is not generally available, but, if it were, would be likely to be considered "relevant" to a reasonable investor's decisions. The information need neither be "precise" or,

apparently, “price sensitive”.

MAR also specifies certain examples of strategies using algorithmic and high frequency trading which will fall within the prohibition against market manipulation or attempts to engage in market manipulation.

MAR also proposes a new offence of “attempted market manipulation”, which is taking steps to manipulate the market without executing an order.

Timing and recommended actions: The EU parliament will consider the proposals in March 2013. Prior to adoption, firms will need to identify relevant instruments in scope and undertake a full compliance review of market abuse procedures, including reporting procedures.

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