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News Bulletin

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Proposed European Regulation on Short Selling and Credit Default Swaps

On 15 September 2010, the Commission published its proposals in respect of stand-alone legislation intended to address the risks associated with short selling and certain aspects of credit default swaps ("CDS") in the European Union (the "Proposed Regulation").[1]

Background

The recent period of financial instability, and in particular the focus on the creditworthiness of various financial institutions, and even certain Eurozone countries, has cast a spotlight on the roles played by short selling and CDS within the financial system. Some regulators have even blamed some of the recent financial system instability on the use of those instruments. This has led to the introduction in various jurisdictions of ad-hoc measures banning or imposing conditions on the use of those instruments in certain circumstances.

In an effort to try and coordinate the approach of the EU member states to these instruments (and prevent responses at the national level being circumvented by the exploitation of cross-border differences in policy), the European Commission (the "Commission") and the Committee of European Securities Regulators ("CESR") have focused on how to reduce the potential risks associated with short selling and CDS. In March 2010, CESR issued a report and feedback statement setting out its proposals for a pan-European model for the disclosure of short positions in EU shares and technical details in respect thereof (the "CESR Model").[2] The contents of the CESR Model are outlined in our updates of 9 March 2010[3] and 2 June 2010.[4] Also in June 2010, the Commission published a consultation to aid the finalisation of proposals on stand-alone legislation dealing with short selling (the "Consultation"). Details of the Consultation can be found in our update of 14 June 2010.[5]

The Proposed Regulation is the next evolutionary step in the process and focuses on two main areas. The first area of focus is the short selling of a company's shares or debt instruments issued by an EEA Member State or the European Union, as well as transactions referencing such instruments under which a person obtains a financial benefit from a fall in value of such an instrument. The second area of focus is the buying of credit protection, through CDS and similar instruments, on the debt instruments issued by EEA member states and the European Union bodies. The person obtaining such a financial benefit from a short sale or buying credit protection on a debt instrument is referred to in the Proposed Regulation as having a "short position" in the relevant instrument,

[1] European Commission, "Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps," September 2010: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0482:FIN:EN:PDF.
[2] Committee for European Securities Regulators, "Model for a pan-European short selling disclosure regime," CESR/10-088, March 2010: http://www.cesr.eu/data/document/10_088.pdf.
[3] MoFo, "CESR Proposals for a Pan-European Short Selling Regime": http://www.mofo.com/files/Uploads/Images/100409CESR.pdf.
[4] MoFo, "CESR Releases Technical Details of the Pan-European Short Selling Disclosure Regime": http://www.mofo.com//files//Uploads/Images/100602CESR.pdf.
[5] MoFo, "European Commission Public Consultation on Short Selling": http://www.mofo.com/files/Uploads/Images/100618ShortSelling.pdf.

and "shorting" when used herein means the obtaining of a short position (which potentially encompasses not only short selling, but also derivatives and other instruments having the same economic effect, and not only CDS but also other activities such as the issuance of credit-linked notes).

The Proposed Regulation aims to achieve each of the following when applied from 1 July 2012: 1) increased transparency with respect to short positions; 2) provision of emergency powers to member states to act in circumstances where shorting most likely should be restricted in order to aid financial stability; 3) greater coordination between member states and the European Securities and Markets Authority ("ESMA"); and 4) a reduction in the risk of uncovered (or naked) shorting.

Scope of the Regulation

The Proposed Regulation is intended to apply to all natural or legal persons who engage in shorting across all market sectors, regardless of whether they are regulated by financial services regulations or not. However, the Commission has stated that so far as possible, the requirements should apply to those entering into such trades, as opposed to intermediaries who execute them on behalf of others.

In drafting the Proposed Regulation, the Commission has adopted the approach taken in the CESR Model, in that the provisions have been drafted as broadly as possible to cover the shorting of 1) any EEA sovereign debt instruments (or debt instruments with prices that bear high correlations to the prices of such sovereign instruments), and 2) all financial instruments that are admitted to trading on an EEA-regulated market or an EEA Multilateral Trading Facility (each, a "Trading Venue"). This will include any such instruments when traded outside of the relevant Trading Venue. In addition, the Proposed Regulation's coverage extends to all economic short positions created by the use of derivatives (including options, futures, swaps and contracts for differences[6]) related to such instruments (including any such derivative instruments that are traded outside of the Trading Venue). In exceptional circumstances (such as a threat to the stability of the financial system), the Proposed Regulation also empowers competent authorities to request disclosure (on a temporary basis) in respect of other financial instruments.

Transparency of Net Short Positions

As described in the CESR Model, a two-tiered disclosure system has been incorporated into the Proposed Regulation in respect of persons with net short positions in the issued share capital of a company that has its shares admitted to trading on a Trading Venue. Such persons must notify the relevant competent authority whenever their net short position at the end of a trading day (12:00 noon) reaches 0.2% of the issued share capital of the company concerned, and at each movement of 0.1% above that. Notification must be made by 3:30 p.m. the following trading day.[7] However, when the net short position is greater than 0.5% of the relevant company's issued share capital, the short seller has an obligation to make a disclosure to the public. The Proposed Regulation also requires all Trading Venues to establish procedures which facilitate the marking or flagging of any sell orders as being "short" when persons enter into a short sale of a share, and for a daily summary of short orders to be published.

As regards persons with a net short position relating to EU sovereign debt instruments, or an uncovered position (i.e., a position which is not wholly offset by a long position in the instrument referenced by the CDS) in a CDS referenced to an EU sovereign obligation, disclosure will only have to be made to the relevant competent authority (based on the same requirements for notification as set out in the paragraph above[8]). However, the applicable thresholds for such disclosure have not yet been determined by the European Commission. The competent

[6] As set out in Annex 1, Section C of Directive 2004/39/EC (Markets in Financial Instruments Directive).
[7] Notifications under the Proposed Regulation must set out the identity of the person holding the relevant position, such position's size, the issuer/company in relation to which the position is held, and the date on which the position was created, changed or ceased to be held.
[8] However, it is not clear exactly what is meant by a "trading day" in the context of a CDS, or indeed other Over the Counter derivative transactions caught by the Proposed Regulation.

authorities must then provide a summary of relevant information (in respect of net short positions relating to shares or sovereign debt, as well as uncovered positions relating to CDS) to ESMA, both at its request and on a quarterly basis.

Uncovered Short Sales

In respect of uncovered short sales, the Proposed Regulation reflects the options set out in the Consultation. Accordingly, persons may only enter into short sales of shares or sovereign debt instruments in circumstances where they have either 1) borrowed the relevant share or sovereign debt instrument; 2) entered into an agreement to borrow the relevant share or sovereign debt instrument; or 3) entered into a third party arrangement whereby such third party confirms that the relevant underlying instrument has been located and is available for lending to the person such that their obligations can be settled. This will ensure that persons who have entered into prime brokerage arrangements are not unfairly caught by the restrictions. In this regard, the Commission has the ability to implement technical standards in respect of the types of agreements and arrangements that can be entered into, although it is not presently clear from the Proposed Regulation what the requirements will be.

As mentioned in our 14 June update, the Proposed Regulation does not impose equivalent conditions in respect of the acquisition of uncovered positions in CDS. This is not surprising given the inherent difficulties associated with determining what qualifies as a naked CDS, and the common situation where the buyer of CDS protection would often not have any obligation to physically deliver the referenced instrument in order to receive payment from the seller of protection.

In relation to the shorting of traded shares, Trading Venues also have the responsibility of ensuring that, where settlement failure arises (within 4 trading days of the relevant trade or 6 trading days for market making activities), procedures are automatically triggered whereby the relevant Trading Venue or central counterparty ("CCP") will buy-in the shares or sovereign debt instruments to ensure that settlement takes place. If the Trading Venue or CCP cannot buy-in the instruments, then cash compensation must be paid by the Trading Venue or CCP to the relevant buyer (based on the value of the shares or debt to be delivered on the delivery date, plus any losses incurred by the buyer). The person who failed to settle must then compensate the Trading Venue or CCP for its failure. The Proposed Regulation also introduces a system of fines, whereby the Trading Venue must require the person who failed to settle to make daily payments to the Trading Venue for each day on which the failure continues. The level of such fines is not prescribed, although it must be "s*ufficiently high not to allow the seller to make a profit from the settlement failure*." In addition, Trading Venues can prevent persons that have failed to settle trades from entering into any new short sales.

Exemptions

Following the Consultation and recommendations in the CESR Model, market makers acting in their capacity as providers of liquidity in the market have been exempted from obligations to make disclosures. This includes primary dealers acting as principals in financial instruments relating to primary or secondary market operations in sovereign debt. Proprietary trading, however, is not exempted. In addition, the Proposed Regulation also exempts trades in respect of shares in a company where the principal market for such shares is located outside of the EU. This will be determined by the relevant competent authority and with notification sent to ESMA, who will publish a list of shares to which this exemption applies.

Enforcement

As described in our June 14 update, it is proposed that competent authorities be given expansive powers to prohibit or restrict, or require additional disclosure of short selling activities in exceptional circumstances. Such restrictions would be on a temporary basis (up to 3 months), which can be extended for additional periods of up to 3 months, if required.

Competent authorities will also be given broad powers in exceptional circumstances to prohibit or restrict any CDS transactions referencing obligations of an EEA member state or the European Union, or to limit the value of any uncovered CDS transactions referencing such instruments.

In addition, one element of the Proposed Regulation, which may prove to be controversial amongst EU Member States, is that ESMA has been empowered to take temporary measures (such as banning short selling) across the EU, if it considers that competent authorities have failed to adequately address a particular issue (perhaps because there are cross-border concerns which cannot be managed at the Member State level). This, however, would not prevent investors from moving their activities outside of the EU and beyond ESMA's remit, in order to circumvent such a ban. The Proposed Regulation attempts to solve this by encouraging EU regulators to enter into cooperation agreements with regulators (covering the mutual exchange of information and mutual enforcement of obligations imposed by other countries) in non-EU countries. However, the effectiveness of this approach remains to be seen.

Implementation

The Proposed Regulation will be put before the European Parliament for negotiation and adoption. It is then intended that the legislation will enter into force from 1 July 2012.

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