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New European Proposals on Short Selling

On 15 September 2010 the European Commission published a legislative proposal for a Regulation on short selling and credit default swaps (the "Proposed Regulation"). Previously, there have been disparate, inconsistent, national measures for short selling across Europe. The Proposed Regulation seeks to create a harmonised framework for the disclosure of short positions. It also establishes harmonised rules for the imposition of emergency restrictions on short selling, with specific provisions on the shorting of sovereign obligations of EU Member States.

Introduction

The European Commission has published a "Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps". A "short position" arises when a person enters into a transaction seeking to gain a financial advantage in the event that the value of the financial instruments to which it relates decreases. It has been argued that such behaviour may dangerously exacerbate falls in the prices of securities. Uncovered (naked) short selling, where the seller has not secured in advance securities to deliver to the buyer at the moment of required delivery, can give rise to settlement issues and market disruption. In addition, there has been public pressure in some countries to "name and shame" institutions or persons profiting from the falls in securities values resulting from the financial crisis.

Hitherto, national European regulators have taken widely divergent approaches to short selling in the light of the financial crisis. This uncoordinated approach has had chaotic consequences. Disparate national disclosure regimes for short selling were introduced in various countries. Some Member States took steps to restrict uncovered short selling. Other states sought to ban certain types of short selling entirely. The differences between the national regimes resulted in compliance difficulties for many firms. These difficulties took an absurd turn when, in May 2010, Germany unilaterally prohibited the writing of credit default swaps ("CDS") on EU sovereign reference entities. The UK, which hosts the bulk of the European financial markets, did not follow suit, meaning that the German restrictions were of little practical effect since they could be circumvented by trading in the UK.

The Proposed Regulation seeks to harmonise the disclosure standards throughout Europe for short positions in relation to shares admitted to trading on a European exchange or trading facility. Any short positions of 0.2% (and all 0.1% increments above that level) will be disclosable to the relevant national regulators. Short positions of 0.5% (and all 0.1% increments above that level) will be disclosable to the public. Restrictions will also apply to holdings of sovereign bonds and uncovered sovereign CDS of Member States. Notification thresholds have yet to be established for such instruments. The Proposed Regulation will separately establish processes and give regulators powers to restrict short selling entirely, in moments of emergency.

The new measures will be implemented by way of Regulation, making it directly applicable in all Member States so that there should be no inconsistencies in implementation or interpretation. The Proposed Regulation is intended to be a “maximum harmonisation” measure, which means that, as from the implementation date, Member States may not impose additional restrictions beyond those set out in the Regulation.

Scope

The Proposed Regulation contains some provisions empowering regulators to take certain actions, which potentially apply to a broad class of financial instruments. There are also specific rules on the short selling of certain listed shares and sovereign debt and CDS.

The restrictions relating to shares apply to any short position taken in respect of a share admitted to trading on an EU regulated market and/or an EU multilateral trading facility (MTF) (a "Trading Venue"). However, the short position itself need not be taken or closed out pursuant to a trade on a Trading Venue: all derivatives referencing such shares are potentially caught. There is an exception for shares admitted to trading on a Trading Venue where the principal venue for trading the financial instruments is located in a country outside the EU. A list of such financial instruments will be published by the European Securities and Markets Authority ("ESMA") every two years.

The provisions relating to sovereign debt cover all short positions that relate to debt instruments issued by a Member State, or to any obligations of a Member State. Sovereign debt for these purposes includes debt issued by a Member State's treasury but also debt issued by any ministry, department, central bank, agency or instrumentality of the Member State. However, the debts of regional or local governmental bodies and “quasi-public bodies” (which would presumably include nationalised companies) are excluded from this definition. Uncovered CDS will be included within the relevant restrictions applicable to sovereign debt (and included when calculating short positions), but additional regulatory powers to impose restrictions will be established in relation to these instruments. Uncovered CDS are defined as arising in the situation where the buyer of protection does not hold an equal amount of underlying debt instruments of the sovereign in question.

All short positions will be determined on a "net" basis in respect of any financial instrument. As a result, persons with long positions in relation to the same financial instrument would be able to offset such positions against their short positions in determining whether their holding is disclosable.

Disclosure Requirements: Shares

The following notification requirements would be established under the Proposed Regulation for short selling of EU shares:

0.2%: disclosure to relevant regulator

0.3%: disclosure to relevant regulator

0.4%: disclosure to relevant regulator

0.5%: public disclosure and disclosure to relevant regulator

0.6% and any additional increment thereafter of 0.1%: public disclosure and disclosure to relevant regulator

Notifications are required each time one of these thresholds is crossed (whether due to an increase or decrease). The Proposed Regulation does not specify whether increases or decreases caused by a rights issue, buy back or other corporate action give rise to a notification obligation. As things stand, the Proposed Regulation would require notification or disclosure in such circumstances.

Trading Venues will also be required to flag all short trades on share orders and publish daily summaries of the volume of short orders.

Disclosure Requirements: Sovereign debt and uncovered CDS

There will be a requirement to notify the relevant national regulator for persons with a net short position relating to the issued sovereign debt of a Member State, or an uncovered short position in a CDS referencing the Member State. The thresholds for notification have yet to be determined. However, only a private notification to the regulator (and not a public disclosure) will be required.

The rules requiring Trading Venues to flag short trades will also apply to these instruments.

Regulators Receiving Notifications

The relevant regulator for the purposes of disclosures for shares is that of the country which is the "home member state" for purposes of the Transparency Directive for the issuer of the shares in question. For short selling on sovereign instruments, it is the financial regulator of the sovereign concerned; and for European Central Bank debt, the regulator of the jurisdiction in which the European Financial Stability Facility is established, which is currently Luxembourg.

Restrictions on Uncovered Short Sales

There will be new restrictions on entering into uncovered short sales of shares or sovereign debt instruments. However, there will be no outright ban such as that which currently applies in Germany. Uncovered short trades cannot be effected on such instruments, unless the person taking the short position has:

- (a) borrowed the share or sovereign debt instrument,
- (b) entered into an agreement to borrow the share or sovereign debt instrument, or
- (c) an arrangement with a third party under which that third party has confirmed that the share or sovereign debt instrument has been located and reserved for lending for the person so that settlement can be effected when it is due.

The European Commission intends to adopt technical standards to clarify the types of agreements and arrangements that will satisfy the provisions mentioned above. It is proposed that ESMA will submit drafts of the technical standards to the European Commission by 1 January 2012.

Buy-in Procedures and Fines for Late Settlement

Should a person who sells shares or sovereign debt instruments on a Trading Venue fail to deliver them within four days of the date of settlement, or six days in the case of market-making activities, then the Trading Venue or central counterparty will be required to buy in the shares or sovereign debt instrument in order to ensure effective settlement. If this is not possible, then the Trading Venue must provide cash compensation to the buyer. As a result, Trading Venues or central counterparties may end up having to hold greater amounts of physical settlement margin, particularly for instruments which are difficult to price.

These provisions do not appear to take account of mandatory cash settlement protocols, such as those which apply pursuant to auctions under the "big bang" process for CDS pursuant to the International Swaps and Derivatives Association (ISDA) credit derivatives definitions. If the entire market (including Trading Venues and CCPs) is contractually obliged to cash settle an instrument, then it would be inconsistent for the Proposed Regulation to require a Trading Venue or CCP to make physical settlement. The drafting in this respect should be clarified so that physical settlement is only mandatory in instances where the participant with the relevant long position would expect to receive physical delivery.

Exemption for Market Makers

There is an exemption from the notification and disclosure requirements for market-makers acting in their capacity as such. Were it not for this exemption, institutions who offer both "buy" and "sell" prices for a market in order to provide liquidity would fall foul of the provisions in any situation where there are a greater number of participants on one side of the market. In order to rely upon the exemption, market-makers must either (i) post firm, simultaneous two way quotes or (ii) hedge positions resulting from client dealings. Market makers must notify relevant the competent authority in writing 30 days in advance of seeking to rely on the exemption.

It is unclear whether the market-maker exemption could be relied upon by clearing houses acting as central counterparty. A clearing house will act as buyer to every seller and seller to every buyer of a particular contract. As a result, its positions will generally be flat, with one buyer to each seller. However, this will not always be the case. For example, if a contract is void or there has been an event of default, a clearing house may have a net short position for a certain period of time. Clearing houses do not post two-way quotes but could, on a broad interpretation, be considered to hedge positions resulting from client dealings in some circumstances. It would be desirable were the Proposed Regulation expressly to include clearing houses within the market-maker exemption. Notoriously, the German sovereign CDS measures technically rendered illegal the operation of a clearing house for CDS in Germany (although informal guidance was later given to German clearing houses and their participants "clarifying" that the intention of the legislation was not to capture clearing). Given the importance placed by the European Commission on encouraging central counterparty clearing for over-the-counter products, and its proposed separate new regulation in that area, an implicit (especially if unintentional) prohibition of central counterparty clearing for instruments subject to short selling restrictions would be a most unwelcome result.

Additional Powers for use in Exceptional Circumstances

National regulators will have powers to take further measures when necessary to combat a serious threat to the financial stability or market confidence in any Member State. Such measures may include:

- (a) requiring private notification or public disclosure of details of short positions,
- (b) prohibition of, or imposition of conditions or limits on, a person entering into short sale in relation to any share or debt instrument or any transaction with similar effect, and
- (c) limiting persons from entering into CDS transactions relating to an obligation of a Member State.

Any measures adopted would be required to be detailed in a notice on the website of the national regulator and would be valid for an initial period of up to three months. The measures may be renewed, upon their expiry, for a further period of up to three months.

National regulators would be able to restrict or prohibit the short selling of any financial instrument where the price has fallen by a certain amount. In the case of shares, a 10% fall in a single day would be required to exercise these powers. For other financial instruments, the percentage will be specified by the European Commission. Such a measure must be temporary only and may not exceed the end of the trading day following the day on which the price fall occurred. Again, details of any such measure must be posted on the website of the national regulator.

The Role and Powers of ESMA

ESMA will have powers to facilitate and coordinate efforts of national regulators. Before a national regulator imposes any new or renewed notification or disclosure requirements or short selling restrictions it must first notify ESMA 24 hours in advance, with details of the proposed measures with evidence supporting the need to take them. ESMA would then issue an opinion within 24 hours on whether it considers proposed measure to be necessary to address the exceptional situation. If

the national regulator proposes to act, or acts, contrary to the ESMA opinion then it must immediately publish on its website a notice fully explaining its reasons for doing so.

ESMA would also have powers to introduce its own intervening measures should it be satisfied that they address a threat to the orderly functioning and integrity, or stability of the financial markets. This would only be permitted in instances where there are cross border implications and if the relevant national regulators have not taken measures to sufficiently address the threat. In such circumstances, ESMA may exercise any of the powers that would be available to national regulators, but on a pan-European basis. ESMA would also be given powers to prevent a person from entering into a transaction relating to a financial instrument, or limit the value of transactions that may be entered into relating to a financial instrument. ESMA would have to notify national regulators, no less than 24 hours before the measure is intended to take effect, of the details of its proposed measures with supporting evidence for why they are necessary. The measures will take effect when this notice is published, or at a time specified in the notice. The measures so notified by ESMA will prevail over any previous measures taken by national regulators.

These powers of ESMA provide an interesting insight into the developing shape of the new EU regulatory architecture that will come into force in 2011. In particular, the new authorities will have greater reach and intervention powers than similar European bodies have previously had. However, under this new dual supervisory regime, the EU regulators will need to rely upon the enforcement powers of national authorities.

Comparison with Existing Requirements

UK: The proposed European disclosure provisions relating to shares have a broader ambit than those presently in place in the UK. Currently, the scope of the disclosure requirements is limited to short positions relating to companies in the financial sector or those carrying out a rights issue. In contrast, the Proposed Regulation would apply to all listed companies regardless of sector or corporate activities. Secondly, there is currently only a *public* disclosure requirement in the UK, and this is for 0.25% and incremental thresholds of 0.1%. As a result, the proposed new regime will require a regulatory disclosure to be made at a lower percentage trigger, but a public disclosure would be required at a higher threshold. There are at present no UK measures requiring disclosure in relation to short positions in sovereign debt or sovereign CDS.

Germany: In the wake of the financial crisis, the German Regulator BaFin prohibited short selling in the shares of 10 financial institutions, governmental bonds and CDS by general decree. In July 2010, these decrees were repealed following the adoption of the Act on the Prevention against Abusive Dealings in Securities and Derivatives, which implements a general prohibition of short selling in shares traded on a regulated market in Germany, short selling in government securities and trading in sovereign CDS, as well as a reporting regime of certain short sale positions. The Act corresponds to the Proposed Regulation in a very large measure. However, it remains to be seen whether the new decision making processes set out in the Proposed Regulation will result in additional requirements in Germany.

US: The restrictions on naked short selling compare with those under Regulation SHO, which imposes penalties and restrictions on further short selling for market participants who fail to satisfy settlement obligations under a short trade affecting a publicly traded equity security. The SEC has also adopted a rule imposing restrictions on short trading subject to various price tests, which are similar in concept to the intervention powers in the Proposed Regulation. However, to date the US has not imposed regulatory or public disclosure requirements on short sellers, but maintains a transaction reporting system that requires market participants to mark sales short (if applicable) and to report short sales to the applicable reporting facility. Under the Dodd-Frank Act, the SEC is required to commence a further study into the effect of short selling and to propose rules in response. There is as yet no detail on what these rules will be.

Implementation

The Proposed Regulation is now being considered by the European Parliament and the Council of Ministers where the final text will need to be agreed. It is anticipated that the Proposed Regulation will come into force on 1 July 2012. However, existing national measures, imposed by national regulators before 15 September 2010, may continue to apply until 1 July 2013. This means that both the new requirements of the Regulation and disparate national short selling restrictions may remain operative in parallel in various parts of the EU for up to a year. Full harmonisation may not be achieved until 1 July 2013.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Barney Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Bertrand Senechal
Paris
+33.15.389.7086
bsenechal@shearman.com

Pierre-Nicolas Ferrand
Paris
+33.15.389.8921
pferrand@shearman.com

Katja Kaulamo
Frankfurt
+49.69.9711.1650
katja.kaulamo@shearman.com

Roger Kiem
Frankfurt
+49.69.9711.1672
rkiem@shearman.com

Tobia Croff
Milan
+39.02.0064.1509
tcroff@shearman.com

Hans Diekmann
Düsseldorf
+49.211.1788.8818
hdiekmann@shearman.com

Geoffrey Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Bradley Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Russell Sacks
New York
+1.212.848.7585
russell.sacks@shearman.com

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

Simon Weiß
Frankfurt
+49.69.9711.1614
simon.weiss@shearman.com

Michael Blankenship
New York
+1.212.848.4727
michael.blankenship@shearman.com