EU Short Selling Regulation - an overview

The EU Short Selling Regulation was published in the Official Journal on 24 March 2012 and came into force the day after. It introduces a pan European disclosure regime for net short positions in EEA listed shares and sovereign debt, as well as a ban on naked physical short sales of EEA listed shares and sovereign debt, and a ban on credit default swap positions in EEA sovereign debt which, broadly speaking, do not serve to hedge exposure to the underlying debt (so called naked CDS positions). The Regulation came into force on 25 March 2012, and its provisions started to apply from 01 November 2012.

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On 24 March 2012 the EU Regulation on short selling and certain aspects of credit default swaps was published in the Official Journal of the European Union. The Regulation came into force on 25 March 2012, and its provisions started to apply from 01 November 2012. Amongst other things, the Regulation introduced a pan European disclosure regime for net short positions in EEA listed shares and sovereign debt, as well as a restriction on physical naked short selling and a restriction on so called “naked CDS” positions in EEA sovereign debt.

Unlike EU Directives, EU Regulations have direct effect (once they come into force) without the need for them to be implemented in individual member states through national legislation or rules. This reduces the scope for variation between member states resulting from differing implementation approaches.

The following is a summary of the main points. The final Level 2 measures were also discussed in this conference call and this five minute video podcast.

Timing and transitional provisions

The Regulation was published in the Official Journal on 24 March 2012 and came into force the day after on 25 March 2012. Its provisions started to apply from 01 November 2012.

The secondary (Level 2) legislation containing the necessary extra detail was published in the Official Journal on 18 September 2012 and 09 October 2012. It too started to apply from 01 November 2012 (Commission Delegated Regulation 826/2012, Commission Implementing Regulation 827/2012, Commission Delegated Regulation 918/2012 and Commission Delegated Regulation 919/2012). The Level 2 provisions, as adopted by the EU Commission and published in the Official Journal, differ from the versions recommended by ESMA, particularly in relation to CDS.

As far as pre-existing national short selling regimes are concerned, there is a transitional period until 01 July 2013, during which national regimes in force before 15 September 2010 (and notified to the Commission by 24 April 2012) will continue to apply. Only Austria notified the Commission of its intention to take advantage of this transitional provision. All other pre-existing EEA national short selling regimes should, therefore, have lapsed when the new pan-European regime started to apply. Nevertheless, the possibility of emergency measures imposed by national regulators remains. See later in this article for further details. As far as the UK is concerned, as anticipated with effect from 01 November 2012 the FSA repealed in its entirety the pre-existing UK short selling regime covering significant short positions in the shares of listed issuers undergoing a rights issue and quoted UK financial companies.

Since 01 November 2012 it is only possible to hold uncovered credit default swap (naked CDS) positions on EEA sovereign debt if the position was concluded before 25 March 2012. Such positions can be held to expiry but cannot be "rolled". A naked CDS position concluded on or after 25 March 2012 but before 01 November 2012 must, therefore, have been closed-out or covered by 01 November 2012.

Scope

The regime applies to short sales of/short positions relating to:

- the issued share capital of companies that have shares admitted to trading on a regulated market or MTF in the EEA (ie the EU plus Norway, Liechtenstein and Iceland), and
- debt instruments issued by a sovereign issuer (broadly speaking an EEA member state or the European Union itself (the relevant debt does not have to be listed to be within scope)).

The Regulation applies even if the relevant trading activity does not take place on a regulated market or MTF and even if it takes place entirely outside of the EEA.

Shares admitted to trading on a regulated market or MTF in the EEA will fall outside the scope of the regime if the principal trading venue for those shares is located in a country outside the EEA. The Level 2 provisions require ESMA to maintain a list of such shares and for this to be updated once every two years. The first list (published by ESMA on 04 October 2012) became effective on 01 November 2012 and subsequent updated versions will be effective from the first day of April following their publication by ESMA.

It is important to note that the Regulation contains express wording providing for the disclosure regimes in respect of short positions in EEA listed shares and sovereign debt to apply to all natural or legal persons (whether regulated or unregulated) located inside or outside the EEA. No such wording has, however, been included for the bans on naked short selling and naked CDS positions. Although the application of these bans to natural or legal persons domiciled or established outside the EEA has been questioned, ESMA has expressed the opinion (which is shared by the EU Commission) in a Q&A document on the Regulation that the bans extend to transactions taking place, and market participants located, outside the EEA. Our recommendation is that as non-EU trading could be regarded as having an effect in the EU, the bans should be treated as applying irrespective of the location of the market participant and wherever the trade is concluded.

Disclosure regimes

EEA listed shares

The Regulation provides for a two tier disclosure regime involving:

- a private disclosure requirement (ie disclosure to the relevant local regulator) in respect of net short positions in shares at an initial threshold of 0.2 per cent and at each successive 0.1 per cent threshold thereafter, and
- a public disclosure requirement (ie disclosure to the market) in respect of net short positions in shares at an initial threshold of 0.5 per cent and at each successive 0.1 per cent threshold thereafter.

The disclosure regime covers both physical and synthetic short positions held through financial instruments (including derivatives). Relevant financial instruments for these purposes are as defined in Annex 1, Section C of the Markets in Financial Instruments Directive

(MiFID) and further set out in Annex 1 of the relevant Commission Delegated Regulation. The disclosure obligation is triggered for net short positions reaching, exceeding or falling below any of the relevant thresholds. The denominator for calculation purposes is the issued share capital of the relevant issuer.

The relevant local regulator is, broadly speaking, the regulator for the market on which the issuer concerned is admitted to trading. For issuers admitted to trading on multiple EEA markets, the disclosure would have to be made to the regulator of the most relevant market in terms of liquidity, determined in accordance with the MiFID Level 2 implementing Regulation.

The following points are worth noting.

- Only positions relating to the issued share capital of a company count towards the net short position calculation. On that basis, long (and short) positions in convertible bonds, warrants (other than covered warrants) and rights resulting from rights issues and placings will not count.
- Long and short positions in underlying shares held through baskets, index derivatives and ETFs are included in the net short position calculation. Although there are cost implications and operational difficulties associated with deconstructing indices, the Regulation does provide useful confirmation that the calculation should be performed on a reasonable basis having regard to publicly available information and that no person shall be required to obtain any real time information as to the composition of a basket, index or ETF from any person. According to the Level 2 provisions, positions held through baskets, indices and ETFs must be calculated taking into account the weight of that share in the basket, index or ETF.
- The Level 2 provisions state that non delta one instruments should be included in the net short position calculation using their delta adjusted value and Annex II to the relevant Commission Delegated Regulation sets out more detail on this calculation.

EEA sovereign debt

The Regulation provides only for private disclosure of net short sovereign debt positions to the relevant local regulator. This applies in respect of net short positions in debt instruments issued by a sovereign issuer (broadly speaking an EEA member state or the EU itself) at disclosure thresholds which are to be determined separately. The definition of net short position includes credit default swap (CDS) positions and so CDS positions held as protection buyer (including pre-existing CDS positions that continue to be held after 01 November 2012) and CDS positions held as protection seller will form part of the calculations.

The thresholds are expressed as a monetary amount (in Euros) based on a percentage of the total amount of outstanding sovereign debt for each sovereign issuer. In this context it is important to note that the thresholds are set by reference to the duration adjusted value of the relevant sovereign issuer's outstanding debt. The concept of duration adjustment is discussed later in this section. ESMA published an initial list of disclosure thresholds for use from 01 November 2012 on 11 October 2012. The list was expressed to be an indicative list at that stage aimed at assisting market participants in preparing for implementation. Although ESMA stated that it would publish the definitive list by 01 November 2012, it is yet to do this. The disclosure thresholds will be updated quarterly.

The disclosure thresholds are based on the following percentages:

- where the total amount of outstanding issued sovereign debt is 500 billion Euros or less – initial disclosure at 0.1% and at each successive 0.05% threshold thereafter (0.15%, 0.2% etc)
- where the total amount of outstanding issued sovereign debt is more than 500 billion Euros or where there is a liquid futures market for the particular sovereign debt – initial disclosure at 0.5% and at each successive 0.25% threshold thereafter (0.75%, 1% etc).

The disclosure regime covers both physical and synthetic short positions held through financial instruments (including derivatives). Relevant financial instruments for these purposes are as defined in Annex 1, Section C of the Markets in Financial Instruments Directive (MiFID) and further set out in Annex 1 to the relevant Commission Delegated Regulation. The disclosure obligation is triggered for net short positions reaching, exceeding or falling below any of the relevant thresholds.

The relevant local regulator is, broadly speaking, the regulator in the member state to which the sovereign debt or credit default swap relates. As far as debt issued by the EU itself (or a credit default swap relating to the EU itself) is concerned, this would be the regulator for the member state in which the department issuing the debt is situated.

The following points on the net short position calculation, as set out in the Level 2 provisions, are worth noting.

- In the same way as with the disclosure regime for EEA listed shares, long and short positions in underlying sovereign debt held through baskets, index derivatives and ETFs should be included in the net short position calculation taking into account the weight of that sovereign exposure in the basket, index or ETF.
- When calculating the net short position in the debt of a particular sovereign issuer, it is also possible to include long positions in debt issued by a highly correlated sovereign issuer. However, only the net long position can be included in this way. In other words when calculating the amount of the net short position in the debt of A, any long position in the debt of B must first be set against any corresponding short position in the debt of B. Sovereign debt of non-EEA issuers cannot be used and, where a particular sovereign issuer is highly correlated with more than one other sovereign issuer, it is only possible to allocate the relevant position once. Anyone applying correlated sovereign debt in this way is expected to maintain records showing their allocation methods. The Level 2 provisions provide details of how to calculate the necessary level of correlation in this context. Sovereign debt issued by one EEA sovereign issuer will be "highly correlated" with the sovereign debt of another EEA sovereign issuer where it exhibits a Pearson's correlation coefficient of 80% over the immediately preceding 12 month period, although the correlation coefficient is permitted to fall to 60% or above for a temporary period of up to 3 months. Industry feedback on the "high correlation" test is that it will be rare for the sovereign debt of two different member states to satisfy the test. The text of the relevant delegated act (which uses the word "shall") could be read as requiring netting of highly correlated debt of different member states. However, the more sensible reading is that this is a permissive, rather than a mandatory, requirement.
- As far as CDS positions on EEA sovereign debt are concerned, purchases of CDS are to be treated as notional short positions in the relevant sovereign debt and sales of CDS are to be treated as notional long positions. To the extent that a CDS position is being used to hedge a risk other than the sovereign debt specified as the relevant reference obligation, the risk being hedged cannot be treated as a long position for the purposes of the net short position calculation.
- In performing the netting calculations, cash positions shall be taken into account using their nominal value 'duration adjusted'; options and derivatives shall be included at their delta adjusted value. The reference to duration adjusted nominal value for cash positions was an unexpected change by the Commission from the draft text proposed by ESMA, which contemplated nominal value, regardless of maturity. ESMA has now clarified via a Q&A document published on 13 September 2012 (and updated on 10 October 2012) that the duration adjustment will use the “modified duration” concept. Modified duration is a standardised duration adjustment concept calculated using a standard formula. We understand that the modified duration number for a given bond can be obtained from a number of information services providers that operate in the financial sector. According to ESMA’s Q&A document, each EEA sovereign issuer will be required to report to ESMA a duration adjusted figure for its total outstanding debt (using the same modified duration methodology). ESMA will then publish the adjusted figures on its website and it is this adjusted figure that will be used as the denominator for the purposes of the net short position calculation. It is, as yet, unclear whether the duration adjustment requirement will be applied only to cash market positions or whether it will also be applied to derivatives and other financial instruments. If it is applied to derivatives this raises further questions about how to select the modified duration figure (eg for bond futures referenced to a hypothetical sovereign bond or a CDS referenced to multiple reference obligations).
- Non delta one instruments should be included in the net short position calculation using their delta adjusted value. CDS positions are considered to have a delta of one.

The Regulation also provides for naked CDS positions to be disclosed separately if they are of themselves above the threshold where the prohibition on such positions (as to which, see below) has been suspended by the relevant EEA member state.

Position calculation and disclosure

The calculation and disclosure of relevant positions are done primarily at the level of the entity which holds the position. However, different requirements apply in the context of group structures and discretionary fund management activities. The details are contained in the Level 2 provisions which substantially follow the ESMA recommendations.

Discretionary fund management

In the fund management context, the Level 2 provisions provide for calculation at fund level and for aggregation and disclosure at manager level.

Separate net position calculations should be made for each individual fund (irrespective of its legal form) and each managed account using the standard calculation methodology. In other words, long positions held by a particular fund or managed account cannot be used to reduce a short position held by another fund or account managed by the same manager. The manager must then calculate the aggregated net short position for all of the funds and managed accounts under management for which the same "investment strategy" is pursued. The manager is required to take account of the positions of any funds or managed accounts where the management of such positions has been delegated to it by a third party and to **exclude** the positions of any funds or managed accounts where it has delegated the management of such positions to a third party. For these purposes an "investment strategy" is an aim to be either long or short in an issuer. The worked examples in ESMA's final report to the EU Commission on the relevant Level 2 provisions make it clear that **only** those funds having a net short position are permitted to be aggregated. Although this is not explicitly stated in the final Level 2 provisions, based on the ESMA commentary, the fund will not itself have a reporting requirement.

Where a threshold has been crossed, the fund manager shall make the necessary disclosure.

Groups

As far as group structures are concerned, the Level 2 provisions provide for calculation at the level of each group member and then for disclosure either at the level of the individual group member or at the holding company level, depending on the circumstances.

Each group member calculates its own net position using the standard calculation methodology. Long positions held by a particular group member cannot at this stage be used to reduce a short position held by another group member. Group members who are fund managers must calculate the net position for all of the funds and portfolios they manage using the process described above and such positions are excluded from the group calculation.

The net position for the group as a whole is calculated by aggregating and netting all of the net short and long positions for all group members other than those which are fund managers. At group level it is, therefore, possible for long positions held by a particular group member to reduce a short position held by another group member, but only to the extent that both group members are not fund managers.

Where a threshold has been crossed either at the level of an individual group member or at the level of the group as a whole, responsibility for disclosing the net short position is determined in accordance with the principles set out below.

- Where the net short position of an individual group member crosses a threshold but the net short position of the group as a whole does not, the individual group member is responsible for disclosing its own net short position.
- Where the net short position of the group as a whole crosses a threshold but the net short positions of the individual group members do not, a designated group company is responsible for disclosing the net short position for the group as a whole. The positions of group members which are fund managers are excluded from the group calculation and so can cross a threshold without triggering a disclosure obligation at group level.
- Where the net short position of an individual group member (other than a group member which is a fund manager) **and** the net short position of the group as a whole cross a threshold, it is only necessary for a designated group company to disclose the net short position for the group as a whole.
- The net short position of a group member which is a fund manager will only trigger a disclosure obligation at the level of that group member.

Timing and mechanics of disclosure

The Regulation provides that disclosure must be made in respect of relevant positions held at midnight at the end of a particular trading day. The deadline for disclosure is 3:30 pm the following trading day. These times must be determined by reference to the time in the member state where the competent authority to which disclosure must be made is located.

The Regulation contains very little detail as to the precise mechanisms to be used to make public and private disclosures, beyond stating that public disclosures must be made “in a manner ensuring fast access to information on a non discriminatory basis” and that private disclosures must “ensure the confidentiality of the information and incorporate mechanisms for authenticating the source of the

notification". Although the Level 2 provisions specify the information to be included in the various disclosures, as well as the format in which that information should be presented, they provide no further detail as regards the mechanisms to be used to make disclosures beyond specifying that public disclosures should be made by posting the relevant information on a central website operated or supervised by the relevant competent authority, as well as requirements concerning the functionality of the website and the way users can access and manipulate the information posted. As a result, anyone disclosing positions in more than one jurisdiction should be prepared for considerable variation in this area. Because of the need for each competent authority to maintain a central website containing searchable information and also for each regulator to supply certain aggregated data to ESMA, it is very unlikely that disclosures will be capable of being made by email or fax.

Record keeping requirement

For the purposes of the disclosure regimes relating to short positions in EEA listed shares, EEA sovereign debt and naked CDS positions on EEA sovereign debt, the Regulation requires the holders of disclosable positions to keep records of the gross positions which make up a significant net short position for a period of five years.

Naked short selling restrictions

Short sales of EEA listed shares and sovereign debt

The Regulation contains prohibitions on uncovered or naked short sales of EEA listed shares and sovereign debt issued by an EEA sovereign issuer. Our reading of these prohibitions is that they apply only to physical and not synthetic short sales (subject to the separate prohibition on naked credit default swaps on EEA sovereign debt mentioned below).

A short sale of EEA listed shares or sovereign debt issued by an EEA sovereign issuer will be covered as long as the seller has:

- pre borrowed the relevant share or debt instrument, or made alternative provisions resulting in a similar legal effect **or**
- entered into an agreement to borrow the relevant share or debt instrument, or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due, **or**
- (in the case of EEA listed shares) an arrangement with a third party broker who: (i) has confirmed that the relevant share has been located **and** (ii) has taken measures vis a vis other third parties that are necessary for the seller to have a reasonable expectation that settlement can be effected when it is due, ("arrangements and measures") **or**
- (in the case of sovereign debt issued by an EEA sovereign issuer) (i) an arrangement with a third party broker who has confirmed that the relevant sovereign debt has been located **or** (ii) a reasonable expectation that settlement can be effected when it is due.

Where the shares or debt instruments in question have not been pre borrowed and a stock lending arrangement is not in place, there is a distinction between what needs to be done in the context of short sales of shares as compared with short sales of sovereign debt in order for the sale to be seen as covered. For a short sale of EEA listed shares to be covered, the seller must have an arrangement with a third party who confirms that the relevant shares have been located **and** must also have a reasonable expectation that settlement can be effected when it is due. However, as far as short sales of EEA sovereign debt are concerned, it is sufficient for the seller either to have an arrangement with a third party who confirms that the relevant sovereign debt has been located **or** to have a reasonable expectation that settlement can be effected when it is due. Also (somewhat illogically), the naked short sale restrictions do not apply if the short sale of sovereign debt 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 sovereign debt. For these purposes, we assume that "high correlation" has the same meaning as it does when used in the context of the sovereign debt net short position disclosure regime.

The Level 2 provisions set out quite detailed requirements concerning the types of arrangements that need to be put in place to ensure that physical short sales of EEA listed shares and sovereign debt satisfy the coverage requirements set out in the Regulation. These follow the ESMA recommendations.

- Shares: the "arrangements and measures" required in relation to EEA listed shares differ depending on: (i) whether or not the shares are liquid shares (defined in MiFID to mean shares with a free float of EUR 500m and average daily turnover of not less than either 500 transactions or EUR 2m); and (ii) whether the investor intends to do an intra-day trade. If liquid shares, a locate and

easy to borrow confirmation from the broker will be sufficient. If not, a put on hold confirmation will be required prior to trade. If the intention is to execute a short sale and cover intra-day, a locate and easy to borrow confirmation is sufficient provided that the broker is informed that the short sale will be covered by purchases during the same day as the short sale takes place, and certain other conditions are met.

- Sovereign debt: it is not necessary to distinguish between whether or not the debt in question is liquid. Four types of equally acceptable arrangement are listed in this context, ranging from a relatively informal locate or easy to purchase confirmation or a more formal repo confirmation, to a "time limited confirmation arrangement" where the broker is informed that the short sale will be covered by purchases during the same day as the short sale takes place and confirms prior to trade that it has a reasonable expectation that sovereign debt can be purchased on the same day as the short sale takes place.

In practice, we expect that the sell-side community will develop an approach that best ensures compliance with the Regulation whilst avoiding the liquidity squeeze that might be caused were a hard locate approach to be followed. Initial indications are that, where the relevant shares are not liquid shares, certain brokers may favour giving an enforceable claim to deliver in preference to a hard locate, whereas, where the shares are liquid, the locate and easy to borrow confirmation approach is likely to be used.

Naked CDS positions on EEA sovereign debt

The Regulation imposes a prohibition on uncovered credit default swaps referencing sovereign debt issued by an EEA sovereign issuer (so called "naked CDS").

A credit default swap position will be uncovered for these purposes if held by a protection buyer other than for the purpose of hedging:

- risk in respect of a long position in the sovereign to which the CDS position relates, or
- the risk of a decline in the value of the sovereign debt where the protection buyer holds assets or is subject to liabilities, including financial contracts, a portfolio of assets or financial obligations whose value is correlated to the value of the relevant sovereign debt.

The recitals and the Regulation text envisage a potentially wide definition of hedging, to include exposure to private sector entities in the relevant member state.

The Level 2 provisions contain additional information regarding how to calculate the necessary level of correlation in this context, as well as further details of the sorts of hedging arrangements which are recognised.

As far as the second limb referred to above is concerned, it is important to note that as a general rule, the counterparty in relation to the exposure which is being hedged must be located in the EEA member state for which credit protection is provided under the CDS. There are a number of exceptional situations, however, in which cross-border hedges will be recognised. These are set out in the Level 2 provisions. The cases given by the Commission in the Level 2 Regulation include:

- where a loan to a subsidiary has been made and the parent is providing explicit or implicit credit support to the subsidiary – hedging the exposure to the subsidiary by taking a CDS referenced to the EEA member state in which the parent is located
- where a bond has been issued by a parent company but the relevant assets and revenues are located in an operating subsidiary – hedging the exposure to the parent by taking a CDS referenced to the EEA member state in which the subsidiary is located, and
- where a company located in a particular EEA member state is heavily invested in the sovereign debt of another EEA member state, such that there is a greater correlation with the state in which the company is invested – hedging an exposure to the company by taking a CDS referenced to the EEA member state in which the company is invested, provided the company is established in both Member States.

In terms of correlation, the Commission has taken a less flexible approach than that recommended by ESMA. The Level 2 measures require correlation to be demonstrated through the application of either a quantitative test (70% correlation coefficient over the immediately preceding 12 months) or a qualitative test that must demonstrate a "meaningful correlation" over a different time period, which may be forward looking. There are three cases given where correlation can be assumed. These cover state owned or state guaranteed enterprises, local governments or certain government funded projects. The Level 2 measures also require that the credit protection must be "proportionate" to the assets that constitute the hedge. Sensitivity ratios (beta) can be taken into account in

conducting the proportionality analysis. Unlike the correlation test (which appears to be a one off analysis when the CDS is entered into), the Level 2 measures impose an obligation on investors to keep the proportionality analysis under review. The Level 2 measures provide that holders of sovereign CDS positions need to be able to justify their correlation and proportionality analysis to the relevant EEA regulator. It is clear from the text that in order to enter into a sovereign CDS position, an investor needs to earmark a specific long asset or assets as the relevant hedge and make a record in respect of each such asset of the correlation and proportionality analysis that has been conducted.

As already mentioned, all CDS positions on EEA sovereign debt must be included in the sovereign debt net position calculation for disclosure purposes. Whilst there is considerable flexibility in terms of the long positions recognised for hedging purposes in the context of avoiding the ban on naked CDS, it should be noted that for short position disclosure purposes, the calculation takes a very much narrower approach, as described above.

The Regulation provides for the possibility of a member state's national regulator temporarily suspending the prohibition where it believes that its sovereign debt market is not functioning properly and that the prohibition might have a negative impact on the sovereign CDS market, especially by increasing the cost of borrowing for sovereign issuers or affecting their ability to issue new debt. Where the prohibition is lifted temporarily in this way, naked CDS positions must be included in the net short position calculation for EEA sovereign debt and are disclosable as part of the more general disclosure relating to short positions in EEA sovereign debt. An additional disclosure specifically in respect of naked CDS positions exceeding the relevant thresholds in their own right will also be necessary.

Buy in procedures/late settlement fines

The Regulation contains a number of provisions designed to minimise the risk of settlement failure caused by short sales of shares. These oblige an EEA based central counterparty providing clearing services in respect of shares to ensure that procedures are in place:

- to buy in shares where the seller is not able to deliver them for settlement within four business days after the day on which settlement is due, in order to ensure settlement
- to pay cash compensation to the buyer where it is not possible to buy in the shares, and
- to impose daily fines on sellers who fail to settle on the due date.

The buy in provisions, surprisingly, appear to cover all settlement failures, not just those caused by short selling. We would question whether the Regulation is an appropriate place for such a requirement to be introduced, especially as Recital 23 to the Regulation contemplates separate, more generally applicable, legislation addressing the wider aspects of settlement discipline. There are no official statistics as to the percentage of settlement failures on different markets that are caused by short selling but, clearly, there are a number of other common reasons why settlement failures occur (eg operational errors). The automatic fines on sellers may lead to behaviour whereby market participants seek to engage in greater pre borrowing activity to reduce the risk of fines, which could have liquidity implications.

The scope of the buy in provisions also appears potentially to extend beyond EEA listed shares, in that they are expressed to apply in respect of all shares for which an EEA based central counterparty provides clearing services (which would cover services provided in relation to shares listed on non EEA trading venues) but only where the principal venue for trading is in the EEA.

Exemptions

The Regulation contains exemptions for those holding short positions in their capacity as a market maker or an authorised primary market dealer, or in the context of stabilisation activity in accordance with the Market Abuse Directive.

It is important to note that the exemptions for market makers and authorised primary market dealers only apply where the person seeking to rely on the exemption notifies the relevant regulator of its intention to do so at least 30 days before relying on the exemption. The relevant regulator may block use of the exemption if it considers that the conditions for the exemption to apply have not been satisfied. On 17 September 2012 ESMA published a consultation paper on proposed guidelines on a common approach to these exemptions which focus on: (i) the content of the written notification required to be sent to the relevant regulator; (ii) the process for submitting the notification; (iii) assessing the eligibility of the notifier to benefit from the exemption in question; and (iv) monitoring the conditions of eligibility once the exemption is used. The deadline for comments was 05 October 2012 and ESMA is expected to issue

its final guidelines shortly. On 24 September 2012 the FSA published guidelines on the process for making notifications to it in this context.

The Level 2 provisions also provide for the definition of the term “short sale” specifically to exclude:

- the sale of financial instruments already transferred under a stock lending or repurchase agreement, provided they will be returned to the transferor or recalled by the transferor so that settlement can be effected when it falls due;
- the selling of financial instruments by a person who has purchased them prior to the sale but has not yet taken delivery of them at the time of the sale; and
- the selling of financial instruments by a person who has exercised an option or similar claim on them, provided they will be delivered so that settlement can be effected when it falls due.

Emergency powers

The Regulation provides for the possibility of additional emergency measures being taken by the relevant national regulator or even directly by ESMA.

The emergency powers contemplate, in particular, the possibility of additional disclosure requirements for financial instruments other than EEA listed shares and EEA sovereign debt, total bans on short selling activity, wider restrictions on credit default swaps and temporary “circuit breakers” prohibiting short selling in relation to particular shares or financial instruments which fall in value during a given period by 10% or more (in the case of liquid shares) and by an amount to be specified by the EU Commission (in the case of illiquid shares and other financial instruments). In each case, these powers can only be exercised where there are adverse events or developments which constitute a serious threat to financial stability or market confidence and the relevant measure is necessary to address that threat.

The Regulation provides for limits on the length of time for which emergency measures can be imposed as well as procedures designed to ensure that powers are exercised consistently and appropriately. In particular, where an individual member state intends to impose a trading restriction or additional disclosure requirements, ESMA has to be notified about the proposal at least 24 hours before the measure is intended to take effect (although in exceptional circumstances, the period can be shorter). ESMA is required to publish an opinion on whether the proposed measure is necessary to address the relevant emergency and whether the measure is appropriate and proportionate.

The Regulation contains a provision which appears to prohibit individual member states from imposing their own disclosure requirements relating to EEA listed shares or EEA sovereign debt over and above the requirements set out in the Regulation (although the drafting of this particular provision could benefit from being made clearer). If that is the correct interpretation, then the Regulation represents a “maximum” harmonisation regime, which is to be welcomed, as it will prevent individual European regulators from taking unilateral action to impose their own gold plated disclosure regimes. Subject to any emergency measures imposed by national regulators pursuant to the provisions just described, it therefore seems that, in relation to EEA listed shares and sovereign debt, the Regulation should enable market participants to run a single calculation engine to calculate their net short positions for each member state in the EEA (which represents a considerable improvement on the previous “patchwork” landscape).

The role of ESMA

As well as having an important role to play in the production of the Level 2 legislation providing further details of the regime, the Regulation envisages that ESMA will play a significant role in ensuring that the regime is applied consistently across all EEA member states.

The emergency powers granted to ESMA to take direct action which would be binding on market participants mark another step towards the creation of a pan European regulator.

More information

See our Short Selling Regulation Tracker, which provides access to the papers being produced in the UK and internationally on short selling, including all of our other elexica materials on this topic.

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