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INVESTMENT FUNDS, ADVISERS & DERIVATIVES UPDATE

Analysis of Final EU Short Selling and CDS Regulation

Introduction

On 24 March 2012 the final text of the EU Regulation on Short Selling and Certain Aspects of Credit Default Swaps (the "**Regulation**") was published in the Official Journal of the European Union.[1]

The Regulation seeks to create a harmonised framework for coordinated action at European level. It sets out notification requirements and restrictions relating to short positions in shares and sovereign debt and, separately, a prohibition on uncovered sovereign credit default swaps ("**CDS**"). It also grants powers to Member State regulators and the European Securities and Markets Association ("**ESMA**") to restrict or prohibit short selling activities and CDS transactions in certain situations.

Timing

The Regulation will become directly applicable[2] throughout the EU on 1 November 2012. Uncovered sovereign CDS transactions which were concluded before 25 March 2012 are grandfathered and may be held until the maturity date of the contract.

In mid-2012, the Commission will be publishing certain "Level 2" implementing measures to address certain details arising from the "Level 1" text of the Regulation. ESMA, which is advising the Commission on the contents of these Level 2 measures, has undertaken two consultations,[3] addressing certain specific aspects of the Regulation. The consultation papers give an indication of ESMA's approach to the detail of the Regulation.

Certain existing Member State short selling rules may also be grandfathered, as discussed in "Grandfathering of Existing Member State Rules" below.

Instruments covered

The Regulation covers "shares" and "sovereign debt". "Sovereign debt" in this context refers to debt issued by a "sovereign issuer", which is widely defined and includes the EU, any EU Member State (including Member State

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[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

[2] That is, unlike an EU Directive, the Regulation becomes law in each Member State, without having to be transposed into national law.

[3] See http://www.esma.europa.eu/content/Draft-technical-standards-Regulation-EU-xxxx2012-European-Parliament-and-Council-short-selli and http://www.esma.europa.eu/node/56557.

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agencies or ministries), a consortium of EU Member States and the European Investment Bank. It does not cover corporate bonds.

Note, however, that Member State regulators and ESMA have broad powers to impose restrictions on any kind of financial instrument, in certain circumstances. See "New powers for ESMA and Member State regulators" below.

What is "short selling" under the Regulation?

Article 2(1)(r) of the Regulation defines short selling as "any sale of a 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." It does not, however, include sales under repurchase agreements, transfers of securities under securities lending agreements, or futures contracts relating to the relevant share or debt instrument.

Notification and disclosure requirements

Notification and disclosure of net short positions in shares

The Regulation provides that investors must notify Member State regulators and publicly disclose their net short positions in the issued share capital of companies which have shares admitted to trading on an EU regulated market or multilateral trading facility ("**MTF**"). However, this requirement will not apply where the "principal trading venue" for the shares is located outside of the EU. Net short positions must be notified to Member State regulators when they reach (or fall below) 0.2% of the company's issued share capital, and at each 0.1% movement above that. The threshold for public disclosure is 0.5%, and each 0.1% movement above that.

An investor's net short position is calculated by deducting any long position that he holds in the company's share capital from his short position.[4] Long positions include holdings in shares issued by the relevant company, or arrangements which confer a financial advantage in the event of an increase in the share's value. Positions in indices, baskets and ETFs must also be taken into account. Although ESMA has proposed a range of derivative contracts which would be classed as long positions, it has stated in its draft technical advice that subscription rights and convertible bonds may not be taken into account. This is significant because many investors see convertible bonds as a legitimate means of exposure to the company's share capital, particularly where the trigger for conversion from debt to equity is automatic (*e.g.* in the case of contingent convertibles).

Notification of net short positions in sovereign debt

For sovereign debt, as for shares, long positions must be deducted from short positions leaving a reportable net short position.[5]

Unlike shares, however, short positions in sovereign debt only need to be notified to Member State regulators and not to the public. The Regulation allows short sellers of sovereign debt to take into account long positions in the debt instruments of another EU sovereign issuer, the pricing of which is "highly correlated" with the pricing of the sovereign debt in question.[6] The sale of a sovereign CDS would be regarded as being a long position and the purchase of a sovereign CDS would be a short position.

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[4] This calculation would be delta adjusted to more accurately reflect the investor's economic exposure to the underlying shares.

[5] ESMA has proposed two different methods for calculating a net short position in sovereign debt: the "nominal method", which is similar to the calculation that would be used in relation to shares; and the "sensitivity adjusted method", which would take into account the duration of the sovereign debt.

[6] ESMA has proposed that such high correlation be determined for these purposes using historic data over a 24 month period with a 90% correlation coefficient, or a proxy for more illiquid debt.

The notification thresholds for the reporting of positions in sovereign debt will be set out by the Commission in its Level 2 measures. ESMA has proposed, in its draft advice to the Commission, that these thresholds should vary according to the liquidity of the sovereign debt, with more liquid debt being subject to a higher notification threshold (*e.g.* 0.5% for illiquid debt vs. 0.1% for very illiquid debt).

How notifications and disclosures are to be made

Net short positions in the relevant instrument must be determined by midnight at the end of each trading day, and disclosures must be made by 15:30 on the next trading day. ESMA is proposing that the disclosure forms be standardised across jurisdictions. Such harmonisation will reduce the administrative burden on investors and is therefore likely to be welcomed, particularly by firms which trade across numerous markets. Public disclosure of positions in shares will be made on the website of the relevant Member State regulator.

ESMA proposes that, for positions in sovereign debt, notification should be made in the jurisdiction of the issuer, whereas for shares, notification must be made to the Member State regulator of the "most relevant market in terms of liquidity" for that share.

Restrictions on uncovered short sales and sovereign CDS positions

Restrictions on uncovered short sales in shares

The Regulation effectively prohibits uncovered short sales in shares which have been admitted to trading on an EU regulated market or MTF. Article 12 of the Regulation provides that an investor may only therefore enter into a short sale agreement where one of the following conditions is met:

(a) he has borrowed the share;

(b) he has entered into an agreement to borrow the share; or

(c) he has "an arrangement with a third party under which that third party has confirmed that the share has been located and has taken measures vis-à-vis third parties necessary for the natural or legal person to have a reasonable expectation that settlement can be effected when it is due."

The principal concern from an industry perspective lies with how the third limb (generally referred to as the "locate" arrangement) will be interpreted. ESMA consulted on the issue, proposing three different regimes – for "liquid" shares, for shares which are not "liquid" shares, and for intra-day trading. In general, industry has disagreed with the strict interpretation given by ESMA to the provision. Hedge funds in particular would argue that existing "locate" practices are sufficient. However ESMA is concerned that a broad "locate" arrangement may not be sufficient to cover the different liquidity profiles of shares; hence the proposal for the three regimes to take different liquidity profiles into account.

Restrictions on uncovered short sales in sovereign debt

Article 13(1) of the Regulation provides that an investor may only enter into a short sale of sovereign debt where:

(a) he has borrowed the sovereign debt;

(b) he has entered into an agreement to borrow the sovereign debt; or

(c) he has "an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or otherwise has a reasonable expectation that settlement can be effected when it is due."

The restriction does not apply 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.

Interestingly, the language in Article 13(1) is: "located ***or*** has reasonable expectation that settlement can be effected when due" (Emphasis added). This compares with Article 12(1) on shares where the word "and" is used, indicating that a lower "locate" standard is required for sovereign debt.

Prohibition on uncovered sovereign CDS positions

Under the Regulation, investors may only enter into sovereign CDS transactions where the CDS does not lead to an "uncovered position in a credit default swap" under Article 4. Article 4 of the Regulation provides that a sovereign CDS will be "uncovered" where it does not serve to hedge:

(a) "the risk of default of the issuer where the natural or legal person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates" or

(b) "the risk of a decline of the value of the sovereign debt where the natural or legal person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is correlated to the value of the sovereign debt."

Recital (21) of the Regulation gives examples of when a hedge may be considered to be correlated (so that the CDS would not be "uncovered"). The effect of the examples in Recital (21) is that, a person could buy Italian CDS if he held Italian sovereign debt. But he would also be able to buy Italian CDS if he had an exposure to some other entity in Italy which he could demonstrate was correlated to the value of Italian sovereign debt. What is less clear is whether a person could buy protection on Member State A where he has an exposure in Member State B. The Regulation does not appear to prohibit such an arrangement; however, ESMA proposed in its consultation paper that hedging/correlation could only be on an intra-Member State basis. Given that it is demonstrable that an exposure in Member State A can be more closely correlated to the sovereign risk of Member State B, a restriction on such cross-border hedging may prove to be problematic in practice. The status of tail-risk hedging – for which historical correlation may be difficult, if not impossible, to demonstrate – is also unclear.

Finally, a Member State regulator may suspend the restriction on uncovered sovereign CDS for 12 months (followed by further 6 month periods) where it believes that the sovereign debt market is not functioning properly.

Exemptions

As noted above, the notification requirements and restrictions on short sales of shares do not apply where the principal trading venue for those shares is outside of the EU. There is also an exemption for market making activities and stabilisation activities carried out in connection with the issuance of securities. This exemption applies to all notification requirements and restrictions imposed by the Regulation.

Finally, authorised primary dealers of sovereign debt will not be subject to the sovereign debt notification requirements or to the restrictions on uncovered short sales of sovereign debt and sovereign CDS positions.

New powers For ESMA and Member State regulators

The Regulation grants Member State regulators broad powers to impose temporary measures for a period of 3 months (which can be extended) where there is a "serious threat to financial stability or to market confidence", including (in relation to *any* financial instruments):

(a) requiring notification or disclosure of net short positions;

(b) requiring securities lenders to notify the regulator of any change in securities lending fees;

(c) prohibiting short selling; and

(d) limiting persons from entering into sovereign CDS or imposing a limit on the value of sovereign CDS that may be entered into.

Although this power could result in different measures being put in place throughout the EU – which is at odds with the Regulation's goal of harmonising short selling restrictions – ESMA is to play a coordinating role and may opine that other Member States should take similar measures (if they do not, ESMA may impose the relevant restriction itself). ESMA has also proposed setting out a list of events which would give grounds for action by Member State regulators (or ESMA itself), including unsubstantiated rumours of a ratings downgrade or natural disasters and terrorist attacks on market infrastructure. Such a list would give the market greater clarity on when such powers may be used, but it should be noted that regulators are not required to give any prior notice of temporary bans or restrictions, which could cause market disruption.

Under Article 23 of the Regulation, Member State regulators will also be able to prohibit or restrict short selling in any financial instruments which have suffered a "significant fall in value" compared to the previous day's closing price.

The Regulation gives ESMA the power independently to impose requirements for the notification or disclosure of net short positions in financial instruments, and to prohibit the short selling of shares. ESMA will take these actions where it believes that there is a cross-border threat to the orderly functioning of the financial markets or to the stability of the financial system.

Finally, ESMA may take emergency actions on sovereign debt and sovereign CDS, but this power is subject to the stricter rules on emergency measures in the ESMA Regulation.[7] ESMA's significant role in oversight of EU financial markets has been a consistent theme across recent regulatory proposals such as the AIFM Directive, EMIR and MiFID II.

Grandfathering of existing Member State rules

Many Member States brought in short selling restrictions and/or notification requirements as a response to the market turbulence associated with the financial crisis, and while some of these short selling rules have lapsed, others are still in place. The Regulation grandfathers existing short selling rules which were in force prior to 15 September 2010 (and which are still in place); these grandfathered rules may remain applicable until 1 July 2013. Member State measures put in place after 15 September 2010 will, on the other hand, lapse on 1 November 2012.

Conclusion

Unlike the short selling rules implemented by some Member States since the onset of the financial crisis and which typically relate to a limited group of companies (usually financial institutions), the short selling rules in the Regulation will apply to all shares which have been admitted to trade on an EU regulated market or MTF. This means that the reporting burden for such positions will be exponentially greater than is the case under the current regime. Firms will need to ensure that they have systems in place which are able to handle the increased requirements for calculating net short positions, particularly given the need to calculate "highly correlated" sovereign debt positions in time for notification on a T+1 basis. Firms should also consider the way that they currently structure locate arrangements and ensure that existing arrangements give sufficient comfort that settlement can be effected when due. Finally, firms will

[7] Regulation no. 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority).

need to consider carefully any sovereign CDS entered into, as they will have to demonstrate that such CDS is not "uncovered".

If you have any questions regarding this Update, please contact the author of this Update or your regular Sidley contact.

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