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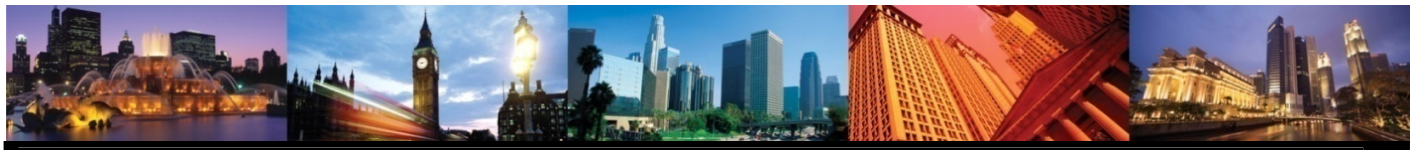

INVESTMENT FUNDS, ADVISORS AND DERIVATIVES UPDATE

EU Short Selling and CDS Regulation – Analysis of "Level 2" Measures

Introduction

In our previous Update – *Analysis of Final EU Short Selling and CDS Regulation*[1] – we provided an overview and analysis of the final text of the European Union ("**EU**") Regulation on Short Selling and Certain Aspects of Credit Default Swaps (the "**SSR**").[2]

To recapitulate briefly, with effect from 1 November 2012 the SSR will impose:

- notification and disclosure requirements on net short positions in EU-listed[3] shares and EU sovereign debt;[4]
- restrictions on uncovered short sales of such shares and sovereign debt; and
- restrictions on uncovered transactions in credit default swaps ("**CDS**") on EU sovereign issuers.

As with most EU financial services legislation, the SSR provides that the European Commission (the "**Commission**") is to adopt subsidiary legislation (that is, "Level 2" measures) in order to provide greater detail on certain provisions of the SSR.

The Commission has now adopted its Level 2 measures in the form of three "Delegated Regulations" and one "Implementing Regulation" (collectively, the "**Level 2 Regulations**").[5] The Level 2

[1] http://www.sidley.com/sidleyupdates/Detail.aspx?news=5140.

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

[3] To be precise, the SSR applies to shares of a company which are admitted to trading on a trading venue in the EU; however, it does not apply where the principal trading venue for the trading of such shares is outside the EU.

[4] As noted in our previous Update, "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 agencies or ministries), a consortium of EU Member States and the European Investment Bank. It does not cover corporate bonds.

[5] The four Level 2 Regulations are available from the Commission's website (http://ec.europa.eu/internal_market/securities/short_selling_en.htm).

Regulations are based on draft technical standards and technical advice produced by the European Securities and Markets Authority ("**ESMA**") following a consultation process.[6]

Jurisdictional scope of the SSR

The text of the SSR expressly provides that the notification and public disclosure provisions (as described below) apply to natural or legal persons domiciled or established within the EU or outside the EU. However, the SSR is silent on the territorial scope of the restrictions on uncovered short sales and sovereign CDS.

Notification and disclosure requirements

Calculation of net short positions

The Level 2 Regulations set out the method for calculation and netting of short positions in shares and sovereign debt for the purposes of the notification and public disclosure obligations under the SSR.

Calculation of net short positions must be performed on a delta-adjusted basis. Any positions held indirectly (*via* derivatives, baskets, indices or ETFs) must be included in the calculation. However, positions in convertible bonds, subscription rights and other comparable instruments should not be counted in the calculation of a person's net short position.

"High correlation" for sovereign debt

The SSR provides that, in determining a person's long position in the sovereign debt of a particular sovereign issuer, that person is to include any net long position it has in the sovereign debt of any other sovereign issuer, the pricing of which is "highly correlated" to that of the first issuer.

Firms that are active in short selling EU sovereign debt will thus need to ensure that their internal systems can track cases where "high correlation" may occur. In demonstrating "high correlation", the Level 2 Regulations require a Pearson's correlation coefficient of at least 80% to be shown, based on historical data over a 12 month period preceding the position. For temporary fluctuations in correlation after the position has been taken out, a minimum correlation of 60% for no more than three months must be shown.

Notification and disclosure thresholds

Under the SSR, net short positions in shares of 0.2% (and each 0.1% increment above that) must be notified to the relevant EU regulator. Positions of 0.5% (and each 0.1% above that) must be disclosed publicly.

The SSR does not specify the notification thresholds for sovereign debt. Instead, ESMA will publish on its website the relevant thresholds (in a monetary amount) for each sovereign issuer. The initial notification thresholds will be calculated as a percentage of the total amount of outstanding sovereign debt as follows:

- 0.1% if the outstanding issued sovereign debt is between EUR 0 and EUR 500 billion; and

[6] See: (i) ESMA's Final Report on Technical Advice on Possible Delegated Acts concerning the SSR (http://www.esma.europa.eu/system/files/2012-esma-263_-_final_report_on_technical_advice_on_short_selling.pdf); and (ii) ESMA's Final Report on Draft Technical Standards on the SSR: (http://www.esma.europa.eu/system/files/2012-228_0.pdf).

- 0.5% if the outstanding issued sovereign debt is above EUR 500 billion or if there is a liquid futures market for such debt.

The additional incremental notification thresholds for sovereign debt are calculated as 50% of the initial thresholds (*i.e.* 0.05% if the initial threshold is 0.1% and 0.25% if the initial threshold is 0.5%).

Notifications of net short positions must be made through the reporting mechanism designated by the relevant EU regulator. Public disclosures of net short positions in shares will be made on the website maintained by the relevant regulator. There is no requirement for public disclosure of sovereign debt positions.

Fund management activities and groups

The Level 2 Regulations specify the aggregation procedure in relation to funds or managed accounts and in relation to positions held by different entities within a corporate group.

In relation to fund management activities, net short positions must first be calculated for each individual fund or managed account. Individual net short positions for funds or managed accounts for which the same "investment strategy" with respect to a particular issuer is pursued must then be aggregated and reported (provided that they reach the relevant threshold).

If a fund manager delegates management of a fund or portfolio to a third party, that delegate will be responsible for calculating and reporting net short positions in relation to the delegated fund or portfolio and the fund manager will not be required to include positions of the delegated fund/portfolio in its own calculations and reporting of net short positions.

For groups, each entity within the group must calculate and report its net short positions separately. In addition, all positions must be aggregated and reported at group level.

Restriction on uncovered short sales of shares and sovereign debt

As noted in our previous Update, the SSR provides that a person may not enter into a short sale of shares or sovereign debt, unless that person:

- has borrowed the share or sovereign debt;
- has entered into an "agreement" to borrow the share or sovereign debt; or
- has an arrangement with a third party confirming that the share or sovereign debt has been "located".[7]

Agreements to borrow

The Level 2 Regulations set out a list of "agreements" for the purposes of the second limb of the short sale restriction above. The list includes futures, swaps, options, repos, standing agreements or rolling facilities with respect to a predefined amount of shares or sovereign debt and other "claims or agreements leading to delivery" of shares or sovereign debt. In formulating its draft technical standards, ESMA indicated that, although securities lending and prime brokerage agreements are contemplated under the heading of "claims or agreements leading to delivery", such agreements would need to be

[7] The locate provisions for shares and sovereign debt are drafted in slightly different forms within the SSR, with the locate provision for sovereign debt being more flexible than that for shares.

supplemented with a specific confirmation or term sheet containing the number of specific securities and specific execution or delivery date.

"Locate" arrangements

The third limb of the short sale restriction above (commonly known as the "locate" arrangement) was the subject of significant industry attention during ESMA's consultation on its technical standards and technical advice. Industry participants argued that the framework proposed by ESMA (most of which now appears in the final text of the Level 2 Regulations) was artificially complex and more restrictive than existing market practice.

Specifically, the Level 2 Regulations contemplate three different types of locate arrangements, as follows:

- the "standard locate" arrangement must consist of: first, a confirmation provided by a "third party" prior to the short sale that it considers that it can make the shares available for settlement and indicating a period for which the shares are located (a "locate" confirmation); and second, a confirmation that the third party has at least put on hold the requested number of shares (a "put on hold" confirmation); and
- the "standard same day locate" and "easy to borrow or purchase" arrangements must include a "locate" confirmation from a third party (as above) and a confirmation that the share is easy to borrow/purchase or, in the absence of such confirmation, a "put on hold" confirmation.

For sovereign debt, four types of arrangements are permitted, giving a slightly more flexible approach than that for shares:

- a "standard" locate, which is a confirmation from a third party that it considers that it can make the sovereign debt available for settlement in due time in the amount requested taking into account market conditions and indicating the period for which the sovereign debt is located;
- a "time limited" confirmation, which is similar to the "same day locate" for shares;
- an "unconditional repo confirmation", which relies upon the third party's participation in a central bank or other repo arrangement that provides unconditional access to the sovereign debt in question; and
- an "easy to purchase" confirmation, which is similar to the "easy to borrow or purchase" confirmation for shares.

"Locate" providers

A list of "third parties" which provide "locate" confirmations is set out in the Level 2 Regulations; they include: (i) a regulated investment firm or other regulated financial institution which participates in the "management of borrowing or purchasing of relevant shares or sovereign debt"; (ii) a central counterparty; (iii) a securities settlement system; (iv) a central bank; or (v) a national debt management entity (in relation to sovereign debt only).

In the case of a "third party" which is established outside the EU, such third party must be subject to supervision by a regulatory authority with appropriate cooperation arrangements with the relevant EU regulator.

Restrictions on uncovered sovereign CDS positions

The SSR prohibits "uncovered" transactions in EU sovereign CDS. That is, any sovereign CDS transaction must serve to hedge a long position in the relevant sovereign debt or an exposure to assets or liabilities the value of which is "correlated" to the value of the relevant sovereign debt.

Correlation and proportionality for sovereign CDS

Where a sovereign CDS position purports to hedge a "correlated" exposure, an investor must be able to demonstrate that the correlation test as set out in the Level 2 Regulations was met at the time the CDS contract was entered into. The Level 2 Regulations specify that correlation must be demonstrated by either showing:

- quantitative correlation of at least 70%, using data for a period of 12 months of trading days preceding the transaction; or
- qualitative correlation by showing a "meaningful" correlation based on appropriate historical data.

Because of the presence of the quantitative correlation test of 70% (which was not in ESMA's technical advice), it remains to be seen what Member State regulators will require in relation to the qualitative correlation test; for example, will there be an expectation that the position holder must have a comfort level similar to that achieved under the quantitative test? If so, how would the position holder demonstrate such a comfort level?

Separately, the sovereign CDS position must be proportionate to the size of the exposure hedged. As a practical matter this means that the position holder cannot be hedged only on the date that the transaction is entered into, but must have a continuously hedged position, proportionate to the size of the exposure. Where an exact hedge is not possible, a limited over-provision is permitted provided that the position holder can demonstrate that such over-provision is necessary to match the relevant measure of risk associated with the reference portfolio.

Cross-border correlation

As a general principle, cross-border hedging with sovereign CDS (*i.e.* where the exposure is to EU Member State A, but the CDS references EU Member State B) is not recognised under the Level 2 Regulations. However, the Level 2 Regulations recognise cross-border hedging in certain limited circumstances, for example, where the exposure is to a group of companies and a parent company (in EU Member State B) provides credit support to a subsidiary issuer in EU Member State A, or where the issuer of a security is in EU Member State A but the relevant assets and revenues are in the issuer's subsidiary in EU Member State B. Under certain limited conditions, the Level 2 Regulations also permit a person to hedge an exposure to an entity in EU Member State A, which is heavily invested in the sovereign debt of EU Member State B, by buying CDS referenced to EU Member State B.

As a result of the above restrictions, from 1 November 2012 it will no longer be possible to utilise sovereign CDS for certain risk mitigation techniques. For example, where a person has sovereign debt exposure to EU Member State A, it will generally not be possible to buy CDS protection on EU Member State B even if it is commercially sensible to do so (*e.g.* where Member State B's CDS is 50% cheaper than that of Member State A while providing 90% of the protection needed on Member State A). Separately, the Level 2 Regulations permit hedging with an index or a basket of appropriately selected sovereign CDS but only in cases where the position holder has an exposure to the EU, EU

Member State or a company with operations across the EU. Finally, it appears that it will generally not be possible to use EU sovereign CDS to hedge tail risk events, such as severe market turmoil.

Other provisions of the Level 2 Regulations

Other aspects of the SSR covered in the Level 2 Regulations include:

- the triggers for the exercise of emergency powers by EU Member State regulators and ESMA in relation to short selling and sovereign CDS;
- the method for calculating turnover for the purposes of the exemption from the notification and disclosure requirement for shares whose principal trading venue is outside the EU; and
- the method for calculating the liquidity thresholds for suspending restrictions on short sales of sovereign debt.

Next steps

The SSR and the Level 2 Regulations become directly applicable in all EU Member States on 1 November 2012. The SSR provides a transitional period for short selling measures that were adopted by certain EU Member States prior to 15 September 2010; such local measures will remain in force until 1 July 2013 provided the relevant EU Member State has notified the Commission by 24 April 2012 that such measures should remain in force. It appears that the only Member State which gave such a notification is Austria. Short selling measures that were put in place by Member States after 15 September 2010 will lapse on 1 November 2012.

Conclusion

With the 1 November 2012 deadline looming, market participants will need to reassess their investment strategies that utilise short sales of EU-listed shares and EU sovereign debt. Separately, strategies involving EU sovereign CDS will need to be reviewed; indeed, non-compliant positions entered into from 25 March 2012 may need to be covered or otherwise unwound by 1 November 2012.

The preparation for the SSR will involve significant enhancements to both operational and risk management processes relating to short sales and sovereign CDS transactions. Operations teams will need to put in place procedures for calculating and reporting net short positions, record-keeping with respect to netting and correlation and monitoring changes in delta and correlation. Further, agreements and operational protocols relating to securities borrowing may require updating. Finally, risk managers will need to implement appropriate procedures and controls to ensure that any sovereign CDS positions are covered in compliance with the SSR.

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