The European Regulation on short selling and CDS

The European Regulation on short selling and certain aspects of credit default swaps¹ (the Regulation) was published in the Official Journal on 24 March 2012 and will take effect on 1 November 2012.

As this measure has been enacted as an EU Regulation, it will, once in force, have direct effect across all member states of the EEA² and will not require any further transposition into national law. For the first time, therefore, the rules on short selling will become harmonised across the region.

The Regulation is complemented by a package of four delegated or implementing measures which flesh out some of the more technical aspects of the rules. On 29 June 2012, the Commission published a Delegated Regulation setting out regulatory technical standards on the notification and disclosure requirements for net short positions. The European Parliament and the Council have one month (subject to extension by a further month) from the date of publication to object, after which it will enter into force, provided that neither co-legislator objects, the day following its publication in the Official Journal. Published on the same date was the provisional text for an Implementing Regulation of implementing technical standards. The Implementing Regulation is not subject to a right of objection and will apply from 1 November 2012.

On 5 July 2012, the Commission published the provisional text for two further Delegated Regulations. The explanatory memorandum for the first, and longer, of these refers to the measure as a Delegated Act and is subject to a three month objection period; the second encompasses regulatory technical standards on the calculation method for a fall in value prescribed by the Regulation³.

This paper does not contain a summary of all of the national short selling regimes in force across Europe, which have differed quite significantly, but nevertheless draws comparisons where relevant with the short selling regime presently in force in the UK.

We describe the key elements of the regime to be introduced by the Regulation and then go on to suggest answers to a number of practical questions which are likely to arise for those firms which are required to comply with the new provisions.

For an explanation of the background to the creation of a harmonised short selling regime in Europe, please refer to our earlier briefing titled The European Commission’s proposal for the regulation of short selling which was published in October 2010 and can be found on our website⁴.

¹ Regulation (EU) No 236/2012.
² The EEA comprises all member states of the European Union plus Norway, Iceland and Liechtenstein.
³ Delegated and Implementing measures all available at: http://ec.europa.eu/internal_market/securities/short_selling_en.htm. Where relevant we refer to the provisional text of these measures in this paper.
⁴ Search at www.slaughterandmay.com
1. TRANSPARENCY

The Regulation requires firms to disclose short positions in relation to shares and EU sovereign debt. The regime applies differently to the two categories.

1.1 Shares

The Regulation provides for a two tier model of private and public reporting at initial and incremental thresholds, triggered by the size of a net short position in shares:

- A net short position of 0.2% or more in the issued share capital of a company admitted to trading on a regulated market or MTF must be reported privately to the regulator that is the home member state competent authority of the relevant issuer for the purposes of the Transparency Directive;

- Additional reports must be made if the short position reaches each 0.1% threshold thereafter (i.e. at 0.3%, 0.4%, 0.5% etc). A report must also be made when the firm’s net short position falls below the relevant thresholds.

- On reaching 0.5% of the issued share capital, and at each 0.1% threshold thereafter, the net short position must also be reported to the market.

A requirement proposed in an earlier draft of the Regulation for firms to “flag” short orders has been dropped.

For firms already subject to the FSA’s short selling regime (set out in the Financial Stability and Market Confidence sourcebook, known as FINMAR), this represents an expansion of existing disclosure requirements, which apply only to net short positions in shares that are the subject of a rights issue and shares in UK financial sector companies.

Concerns have been raised that the increased public visibility of shorts (including disclosure of individual short positions) provided for by the Regulation might lead to more frequent squeezes on those firms carrying short positions, the undermining of legitimate investment strategies carried on by a broad range of investors, including institutional money managers, and artificial commercial limits on short selling in the market. There is certainly some evidence to suggest that public disclosure of short positions probably does act as a constraint on short selling activity and could therefore have a negative effect on liquidity.

Similar fears were expressed during the consultation on the FSA’s FINMAR rules and earlier temporary short selling measures. The FSA eventually opted for public disclosure at 0.25% on the basis that private disclosure would not constrain perceived negative effects of short selling, which were said to include the threat of market abuse and disorderly markets. Public disclosure regimes for short positions in shares already apply in many European jurisdictions, albeit at different thresholds to those provided for in the Regulation.

1.2 Sovereign debt

The Regulation provides a requirement to report to regulators certain net short positions in EU sovereign debt, including positions in CDS referencing an EU sovereign debt obligation. Sovereign debt instruments issued by any member state (including any ministry, agency or special purpose vehicle of a member state), the EU itself, the European Financial Stability Facility and the European Investment Bank are covered.

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5 Directive 2004/109/EC.
Rather than setting a single notification threshold for all sovereign issuers or individual thresholds for each sovereign issuer, they have been grouped into two categories (taking into account the size of the outstanding issued sovereign debt and the liquidity of the sovereign debt market measured in terms of total turnover).

- An initial reporting threshold of 0.1% (and 0.05% intervals thereafter) applies for the first category of member states, where the total amount of the outstanding issued sovereign debt is up to €500 billion.

- A reporting threshold of 0.5% (and 0.25% intervals) applies if the total amount of the outstanding issued sovereign debt is more than €500 billion or if there is a “liquid futures market” for the particular sovereign debt.7

The monetary amounts implied by the relevant percentage thresholds for each sovereign issuer will be published by ESMA on a quarterly basis.

2. RESTRICTIONS ON UNCOVERED POSITIONS

From November, a firm that wishes to take an uncovered, or ‘naked’, short position in particular shares will be required either:

(a) to have borrowed sufficient shares to settle the short trade;

(b) to have entered into a binding agreement to borrow those shares; or

(c) to have “an arrangement with a third party under which that third party has confirmed that the [shares have] been located” and to have “taken measures vis-à-vis third parties necessary for [the firm] to have a reasonable expectation that settlement can be effected when it is due”.

The types of agreements contemplated under (b) are listed in the Implementing Regulation and include, among others, futures, options and repurchase agreements. Prime brokerage agreements are thought to be capable of falling within the list of agreements under (b), but only if they are specific as to the number of shares or sovereign debt securities proposed to be sold short and as to a delivery or execution date. A standard form master lending agreement covering a long timeframe and wide range of possible securities would not in itself ensure that otherwise naked shorting of a share is regarded as covered.

The Implementing Regulation also elaborates on the sorts of arrangements that may be acceptable in terms of ‘locating’ a share and the sorts of measures that could legitimately give rise to a ‘reasonable expectation’ that settlement can be effected when due for the purposes of (c). The volume and liquidity of intra-day trading of the particular shares are key factors to be taken into account in this context. A share will be considered to be ‘liquid’ for these purposes if it is included in the MiFID list of liquid shares8 or if it is “included on a main national equity index [and is] the underlying financial instrument of a derivative contract admitted to trading on a trading venue”.9

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8 ESMA publishes a consolidated list of all shares admitted to trading on EEA regulated markets (http://mifiddatabase.esma.europa.eu/) which enables firms to identify those shares deemed to be liquid under Article 22 of the MiFID implementing Regulation (No 1287/2006).

9 Article 6(4) of Implementing Regulation (provisional text).
It is clear that, at a minimum, a locate confirmation (i.e. a confirmation from the third party that it can lend, or otherwise make available, the shares in the amount requested by the seller so as to allow settlement in due time) is required before a share can be shorted. For liquid shares or intra-day short selling, an additional confirmation needs to be obtained to the effect that the share concerned is easy to borrow or to purchase. If the short position is in relation to an illiquid share and for longer than an intra-day period, shares will need to have been "put on hold" by the third party (understood to mean that sufficient shares should have been identified and allocated).

ESMA remarked in the draft technical standards, on which the Implementing Regulation is based, that the "third party" from whom a locate confirmation may be obtained should be a distinct legal entity from the firm entering into the short sale. The suggestion therefore is that a trading desk cannot obtain cover for short trades from an in-house stock lending desk for the purposes of covering a short sale under (c) (notwithstanding the fact that at an institutional level there is no short sale on an aggregate basis)\(^\text{10}\).

**Going naked on sovereign debt or CDS**

The Regulation is marginally less prescriptive in relation to uncovered short/CDS positions in sovereign debt than in relation to shares, in that if such a position is being used for permitted hedging purposes the firm concerned is not required to have borrowed, or be able to borrow, securities in order to ensure settlement of that position.

An uncovered short position in sovereign debt is permitted if it is being used to hedge a long position in the debt instruments of an issuer, the pricing of which has a 'high correlation' with the pricing of the sovereign debt. This is a different, and arguably more commercially unrealistic, standard to the simple correlation prescribed for sovereign CDS, as explained below. Some firms will therefore need to consider carefully the extent to which they can use hedges for their risk exposures to sovereign debt without breaching the Regulation.

In contrast, firms are not permitted to enter into an uncovered, or ‘naked’, CDS on sovereign debt unless, according to the recitals of the Regulation, there is an "insurable interest" in the underlying sovereign debt position\(^\text{11}\). (The choice of words presumably reflects a policy intention rather than an intention to muddy the waters between the legal status of a CDS and that of a contract of insurance). A firm is considered to have a naked position in a sovereign CDS when the CDS does not serve to hedge against:

> "the risk of default of the issuer where the … person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates, or the risk of a decline of the value of the sovereign debt where the 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 sovereign debt”.

In other words, the buyer of the CDS is uncovered if it does not have an exposure which it is seeking to hedge either to the sovereign debt itself, or to assets or liabilities whose value is correlated to the sovereign debt. It will be reassuring to many firms to note that correlation in this context can be judged quantitatively (with a required co-efficient of at least 70%) or qualitatively\(^\text{12}\). A wide range of exposures are covered, including indirect exposures

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\(^{10}\) ESMA has concluded, as a matter of legal and technical interpretation, that an eligible third party means a different legal entity.

\(^{11}\) The usefulness of these restriction might be questioned in light of the message in IOSCO’s June 2012 report (search at http://www.iosco.org/), prepared in response to a mandate from the G20, that “there is no conclusive evidence on whether taking short positions on credit risk through naked CDS is harmful for distressed firms or high-yield sovereign bonds”.

\(^{12}\) The Delegated Act presupposes that correlation would be demonstrated on a historical basis using data from the most recent 12 months (see Article 18). There is a question as to whether forward-looking correlation would be permitted; the text of the Delegated Act is ambiguous in this respect but does not appear expressly to exclude the possibility.
obtained through indices, funds or special purpose vehicles. Involuntary uncovered CDS positions accepted by general clearing members of central counterparties are not treated as uncovered for these purposes.

Illustrative examples of when sovereign CDS might be considered to be a valid hedging tool are described in the Delegated Act. The use of sovereign CDS to hedge cross-border risks (i.e. where a position referencing one sovereign issuer is used to hedge exposures in a sovereign issuer in a different member state) is not considered eligible. This general rule is subject to certain very limited exceptions prescribed in the Delegated Act and the firm concerned being able to demonstrate that the value of an exposure located in more than one member state being hedged is correlated and broadly proportionate to the value of the obligations of the sovereigns which are within the scope of the CDS. In principle, an uncovered position in a sovereign CDS index is also permitted to hedge a pan-EU or pan-Eurozone exposure.

If exposures being hedged by the CDS position are liquidated or redeemed such that the position can be considered to have become (partially) uncovered, they must either be replaced by equivalents, or the CDS position must be reduced proportionally. The attempt to ensure appropriate supervision on the question of correlation and proportionality could presumably have the potential to increase volatility in the sovereign CDS market.

National regulators have been granted a power by the Regulation to lift temporarily the restrictions on uncovered short sales in sovereign debt if liquidity in the market for that debt falls below a pre-determined threshold, based on readily available trading venue and OTC market data\(^\text{13}\).

### 3. SETTLEMENT PROVISIONS

Under the Regulation central counterparties are required to have automatic buy-in arrangements which will be triggered if short-sold shares are not delivered within four business days after the due date for settlement. Where buy-in is not possible, the Regulation provides that the short seller must instead pay an amount to the purchaser based on the value of the shares plus an amount for losses incurred by the purchaser as a result of settlement failure. The short seller is also required to reimburse the central counterparty for the cost of effecting any such buy-in or cash compensation.

The buy-in requirements apply only in relation to the short sale of shares but not (as under the Commission’s initial proposal) to the short sale of sovereign debt instruments.

The Regulation also mandates that settlement failures on short sale transactions should attract daily fines, to be imposed by central counterparties, that are sufficiently high to act as a deterrent to traders failing to settle. It is not yet clear how the level of these fines will be set and how they will be enforced if the relevant short seller does not have operations in the jurisdiction concerned.

These measures might lead to an unwillingness by exchange members to take on business where they perceive a risk of settlement failure; one can see how this might itself temper the amount of uncovered short selling in the market. Central counterparties are likely to need to impose additional margining or other default requirements to address the risk that they may otherwise fail to recover amounts imposed in respect of settlement failures from short selling clearing members.

\(^{13}\) When the turnover of a given month falls below the 5th percentile based on the monthly volume traded in the previous 12 months. Article 22(3) of the Delegated Act.
4. HARMONISATION AND THE SHADOW OF ESMA

Short sales have thus far received varied regulatory treatment across EU member states, raising difficult practical issues for those firms trading in securities admitted to trading on regulated markets throughout the region. The Regulation is in this respect a welcome move towards harmonisation of those disparate regimes, including as to the powers that regulators may exercise in exceptional situations where there is perceived to be a serious threat to financial stability.

Financial regulators have been granted powers by the Regulation to take certain measures in exceptional circumstances, including to require further transparency or impose temporary bans on short selling and credit default swap transactions in their respective jurisdictions, for an initial three month period. The Delegated Act sets out a non-exhaustive list of criteria and factors for determining when exceptional circumstances might be considered to arise, acknowledging the potential disruption of self-fulfilling market phenomena. In the case of a significant fall in the price of a financial instrument on a trading venue, national regulators have the ability to restrict short selling of the financial instrument on relevant venues within their own jurisdiction until the end of the next trading day. The measure can be extended for a further two trading days if there is a further significant fall in value of the financial instrument.

Where these powers are applied in isolation by a national regulator, they will be of limited use for preventing short selling of those securities elsewhere in the EU. Accordingly, the Regulation entrusts ESMA with a facilitation and coordination role to be exercised when a national regulator intends to introduce or renew one of the temporary measures in exceptional circumstances. ESMA is required, within 24 hours of notification that a measure is to be imposed or renewed, to issue an opinion assessing its necessity, appropriateness and proportionality as well as whether any measure should also be taken by other financial regulators.

In relation to financial instruments other than sovereign debt or sovereign CDS, ESMA may itself intervene if it considers there to be a threat to the orderly functioning or stability of the markets, or other 'cross-border implications' which are unaddressed, or insufficiently addressed, by national measures. A measure taken by ESMA in this context would prevail over any previous measures taken by a national regulator.

This means ESMA could seek to take direct control of the regulation of short selling in individual member state markets, even in circumstances where the national regulator does not agree that a ban is necessary (and may even be of the view that a ban would be counter-productive).

Last month, in a move which has potentially important implications for the challenge of the balance of powers within the EU, the UK filed an action for annulment of Article 28 of the Regulation – the basis for ESMA's rights of intervention – suggesting a contradiction with the principle set out in the judgment of the European Court of Justice in Meroni. We might expect any intervention by ESMA in national markets to continue to be a potential political flashpoint in due course.

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14 Article 24.
16 Meroni v. High Authority [1957 – 58] ECR 133. See also statement made after the first reading of the Regulation at the Council of the EU (6216/12 – Revised Addendum) by the British and Czech governments that they cannot support the text in Article 28 and “will be considering how best to ensure legal certainty is provided”.
Questions and Answers

SCOPE OF THE REGULATION

1. **What is a 'short sale' for the purposes of the Regulation?**
   A 'short sale' is defined in the Regulation 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 where the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement. The definition excludes sales under a repurchase agreement, transfers of securities under a securities lending agreement and futures contracts.

2. **Do market participants domiciled outside the EU need to comply with the disclosure requirements prescribed under the Regulation?**
   Yes, the requirements apply regardless of where the person effecting the short sale is domiciled or established, including outside the EU.

3. **Are there any exemptions?**
   Yes, for market making activities, primary market operations in respect of sovereign debt and stabilisation schemes under the Market Abuse Directive.

   Also, the main provisions of the Regulation do not apply to shares whose principal trading venue (i.e. a regulated market or a multilateral trading facility) is located outside the EU. ESMA will publish a list of exempted shares every 2 years. 'Principal venue' refers to the venue for the trading of that share with the highest turnover.

CALCULATING A SHORT POSITION

4. **What is the method for calculating a disclosable net short position in shares?**
   Put simply, a net short position is calculated by netting long and short positions in a given issuer using a delta-adjusted model.

   A long position includes holding the instrument itself or entering into a transaction in instruments which confer a financial advantage in the event of an increase in the price of the share whose value depends on the value of the share. All economic interests are taken into account, including instruments or transactions held on trading venues or in exchange-traded and over the counter derivatives.

   A net short position is calculated as a percentage of the total 'issued share capital' of an issuer. 'Issued share capital' for this purpose includes ordinary and preference shares, but not convertible debt securities.

5. **How should I calculate a long position in sovereign debt?**
   A long position in a sovereign debt instrument is calculated by including any long position in relation to the issued sovereign debt of a sovereign issuer and any net long position in debt instruments of a sovereign issuer the pricing of which is 'highly correlated' to the pricing of the given sovereign debt. Derivative positions are also taken into account.

   For sovereign debt with liquid market prices, correlation is measured on a historic basis using daily accumulated weighted data for the 12 months prior to the date on which the position is taken out. To be regarded as high, the correlation over this period must be at least 80% (not 70% as proposed by ESMA in its advice). Temporary
fluctuations are permitted provided the correlation is at least 60% for a buffer period of no longer than 3 months.

Where there is no liquid market price or an insufficiently long price history for the sovereign debt, a proxy instrument of a similar duration may be used to measure correlation.

6. How are baskets of shares or indices treated?
Any position held in shares or sovereign debt by a person indirectly – including through an index or basket of securities or ETF – must be included in the calculation of short and long positions. This includes derivative products relating to an index. There is no de minimis threshold even for broad-based indices.

Market participants should have regard to ‘publicly available information’, obtained free of charge, as to the composition of an index/basket or interests held by an ETF. Real-time information is not required.

7. How is a short position calculated for fund management activities relating to several funds?
This is addressed in the Delegated Act. To summarise, calculation of the net short position in a particular issuer is conducted at the level of each individual fund (regardless of legal form) and for each portfolio under management. A discretionary manager should aggregate net short positions of funds and portfolios “for which the same investment strategy is pursued in respect of a particular issuer”17. Where a single legal entity performs both management and non-management activities (such as proprietary trading) it should conduct two separate calculations. In some instances that entity may have to make two reports.

8. How is a short position calculated where different legal entities in a group have short or long positions?
Net short positions are calculated for each individual legal entity in a group. Where a relevant threshold is reached, the legal entity (or the group on its behalf) must report or disclose the position.

At group level, net short or net long positions in a particular issuer (excluding any positions resulting from discretionary management activities) held by all the legal entities constituting the group should also be aggregated and netted.

When an individual legal entity belonging to the group reaches a relevant threshold but the group does not, the legal entity makes a report. Where a threshold is crossed both by a single entity belonging to a group and at group level, the group reports the position. The group also reports the position if the group alone has a disclosable position.

The definition of group for the purposes of the notification and disclosure requirements is the same as the definition in the Transparency Directive18.

9. What is the process for calculating and reporting a disclosable net short position?
Calculations of short position must be made on a net basis at midnight at the end of the trading day. Disclosure must then be made by 15:30 on the next trading day. All times are calculated according to the time in the member state of the relevant national regulator to whom the relevant position must be notified. The notification should be presented in form set out in Annex II of the Delegated Regulation.

Records of gross positions which make significant net short positions must be kept for a period of five years.

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17 Article 12(3), Delegated Act.
10. When would there be a significant fall in the price of an instrument potentially triggering a “circuit breaker”?

For liquid shares, a significant fall is 10%, calculated in accordance with the most recently published regulatory technical standards.

For illiquid shares, a significant fall in value is considered to be:

- if the share is admitted to trading on a main national equity index and is the underlying financial instrument for a derivative contract admitted to trading on a regulated market or MTF, otherwise termed a “semi-liquid” share, a fall in value of 10% or more in relation to the closing price of the share on that venue on the previous trading day;

- if the share price is EUR 0.50 or higher (or the equivalent in the local currency), a fall in value of 20% or more in relation to the closing price of the share on that venue on the previous trading day;

- if the share price is less than EUR 0.50 (or the equivalent in the local currency), a fall in value of 40% or more in relation to the closing price of the share on that venue on the previous trading day.

There are different criteria for other financial instruments such as corporate and sovereign bonds, money-market instruments and ETF, all of which are set out in the Delegated Act.

11. Can uncovered sovereign CDS be held to maturity?

The transitional provisions of the Regulation provide that a CDS resulting in an uncovered position in a sovereign CDS that has been concluded before the entering into force of the Regulation (25 March 2012) or during a suspension of the restrictions may be held until the maturity date of the CDS. The suggestion is that uncovered sovereign CDS entered into after the entering into force of the Regulation will have to be covered or unwound by 1 November 2012.