

Insight: Capital Markets

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The EU Short Selling Regulation comes into force

Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (the "EU Short Selling Regulation")¹ – as well as a Commission Implementing Regulation and three Commission Delegated Regulations² – came into force on 1 November 2012. These instruments are directly applicable in Member States and do not require any implementation into national law.

The EU Short Selling Regulation applies, broadly speaking, in respect of shares admitted to trading on EU trading venues, sovereign debt issued by EU sovereign issuers and related credit default swaps. It does not matter where a person entering into a short sale in these instruments is located. Therefore, firms in third countries could be affected by the EU Short Selling Regulation.

The EU Short Selling Regulation sets out:

- transparency requirements in relation to short positions in shares or sovereign debt;
- restrictions on uncovered short sales in shares or sovereign debt or uncovered short positions in sovereign credit default swaps;
- buy-in procedures; and
- additional measures that may be taken in exceptional circumstances,

and provides for only limited exemptions.

The new requirements introduced by the EU Short Selling Regulation represent a step change from the previous UK disclosure regime applicable to short positions during rights issues and to short positions in UK financial sector companies.

This client alert provides an overview of the EU Short Selling Regulation.

Scope

The scope of the EU Short Selling Regulation is defined with reference to the financial instruments it applies to. These include shares which are admitted to trading on a trading venue in the EU, regardless of where they are traded, subject to an exemption for shares whose primary trading venue is outside the EU, as discussed below. Debt instruments issued by sovereign issuers in the EU and credit default swaps relating to such debt instruments are also covered. In addition, as explained below, the EU Short Selling Regulation recognises that, from an economic perspective, short positions in shares or debt may arise as a result of transactions in other financial instruments.

The EU Short Selling Regulation has wide geographical scope. It applies regardless of where a natural or legal person is domiciled or established or where that person enters into transactions as long as these transactions relate to financial instruments within the scope of the EU Short Selling Regulation.



Stuart Willey

Counsel, London
+ 44 20 7532 1508
swilley@whitecase.com

Carmen Reynolds

Of Counsel, London
+ 44 20 7532 1421
creynolds@whitecase.com

David Barwise

Partner, London & Singapore
+ 44 20 7532 1402 (London)
+ 65 6347 1345 (Singapore)
dbarwise@whitecase.com

Nick Wittek

Local Partner, Frankfurt
+ 49 69 29994 1164
nwittek@whitecase.com

Ingrid York

Counsel, London
+ 44 20 7532 1441
iyork@whitecase.com

Susanne Leitterstorf

Associate, London
+ 44 20 7532 1349
sleitterstorf@whitecase.com

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¹ Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF>.

² Available at http://ec.europa.eu/internal_market/securities/short_selling_en.htm.

Transparency requirements

Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (the "Transparency Directive") sets out EU transparency requirements in respect of long positions. The EU Short Selling Regulation introduces transparency requirements at EU level also for net short positions.

Calculating net short positions

Short positions relating to either issued share capital or issued sovereign debt include those resulting from:

- (a) a short sale of a share issued by a company or of a debt instrument issued by a sovereign issuer; or
- (b) entering into a transaction which creates or relates to another financial instrument with the effect of conferring a financial advantage in the event of a decrease in the price or value of the share or debt instrument.

Long positions are equally broadly defined as arising from:

- (a) holding a share issued by a company or a debt instrument issued by a sovereign issuer; or
- (b) entering into a transaction which creates or relates to another financial instrument with the effect of conferring a financial advantage in the event of an increase in the price or value of the share or debt instrument.

The EU Short Selling Regulation expressly provides that the calculation of a short or long position in sovereign debt includes any sovereign credit default swap that relates to the sovereign issuer. Further, short and long positions in either shares or sovereign debt may also be held indirectly, including through or by way of any index, basket of securities or any interest in any exchange-traded fund or similar entity.

Commission Delegated Regulation (EU) 918/2012 provides further details on the calculation of short and long positions. Specifically, it requires positions to be delta-adjusted where appropriate. It also provides for cash positions in sovereign debt to be duration adjusted but remains silent on whether or not derivative positions in sovereign debt may also be duration-adjusted.

A *net short position* in relation to the issued share capital of a company is the position remaining after deducting any long position in the issued share capital from any short position in that capital. A net short position in issued sovereign debt is the position remaining after deducting from any short position in the issued sovereign debt (a) any long position in the issued sovereign debt and (b) any long position in debt instruments of a sovereign issuer the pricing of which is highly correlated to the pricing of the given sovereign debt. In relation to (b), "high correlation" normally means a Pearson's correlation coefficient of at least 80%, calculated in accordance with Commission Delegated Regulation (EU) No 918/2012, subject to a provision for temporary falls in the level of correlation.

Thresholds and timeline for notification and disclosure of net short positions

Net short positions in shares must be notified to the relevant competent authority where they reach or fall below thresholds of 0.2% of the issued share capital of a company or each 0.1% above that. Further, net short positions in shares must be publicly disclosed where they reach or fall below thresholds of 0.5% of the issued share capital of a company or each 0.1% above that.

Net short positions in sovereign debt do not need to be publicly disclosed, but must be notified if they reach or fall below certain thresholds. Where the total amount of the outstanding issued sovereign debt is between EUR 0 and EUR 500 billion, the thresholds are 0.1% and each 0.05% above

that. Where the total amount of the outstanding issued sovereign debt is above EUR 500 billion or where there is a liquid futures market for the particular sovereign debt, the thresholds are 0.5% and each 0.25% above that. ESMA has published a list of the thresholds applicable to different sovereign issuers in each category.³

The relevant time for calculation of a net short position is midnight at the end of the trading day on which the position is held. The notification or disclosure must be made to the relevant competent authority no later than at 3.30pm on the following trading day. Any notification or disclosure must specify the person who holds the net short position, the size of the position, the issuer in relation to which it is held and the date on which it was created, changed or ceased to be held. Records of the gross positions which constitute a significant net short position must be kept for a period of 5 years.

Aggregation, netting and reporting at group level

Net short and long positions of the legal entities constituting a group as defined in Commission Delegated Regulation (EU) No 918/2012 must be aggregated and netted, with the exception of management entities carrying on management activities (see below). When a notification or disclosure threshold is reached or crossed only by a legal entity in the group but not at group level, then the legal entity (or on its behalf, the group it belongs to) must notify or disclose that net short position. However, if a threshold is reached or crossed at group level, then a legal entity designated for this purpose must notify or disclose the net short position at group level, regardless of whether thresholds are also reached or crossed at legal entity level.

³ Available at <http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers>.

Management entities

A 'management entity' is a legal person or entity that manages on a discretionary basis, funds or portfolios pursuant to a mandate. 'Management activities' comprises the management of funds irrespective of their legal form and portfolio management in accordance with mandates given by clients on a discretionary client-by-client basis.

A management entity is excluded from group aggregation and netting to the extent that it engages in management activities. Instead, a management entity must aggregate the net short positions of the funds and portfolios under its management for which the same investment strategy is pursued in relation to a particular issuer. For this purpose, the management entity must take into account the positions of the funds and portfolios the management of which has been delegated by a third party, but may exclude the positions of the funds and portfolios the management of which it has delegated to a third party. The management entity must then report, and where required disclose, the resulting net short position at the relevant thresholds. To the extent that a management entity carries out non-management activities, it must follow the usual process for calculating its net short positions and for aggregation and netting at group level.

Restrictions on uncovered short sales

Uncovered short sales may increase the risk of settlement failure and volatility. The EU Short Selling Regulation therefore restricts uncovered short selling.

Restrictions on uncovered short sales of shares

A person may enter into a short sale of a share only if:

- a. the person has borrowed the share or made similar provisions;
- b. the person has entered into an agreement to borrow the share or has another enforceable claim with similar effect; or

- c. the person has made an arrangement with a third party that adequately ensures that the share will be available for settlement.

Commission Implementing Regulation (EU) No 827/2012 clarifies that agreements that satisfy b. must, broadly speaking, cover at least the number of shares proposed to be sold short, be entered into prior to or at the same time as the short sale and specify a delivery or an execution date that ensures settlement can be effected when due. Further, they must be provided in a durable medium.

Commission Implementing Regulation (EU) No 827/2012 lists the third parties with whom arrangements pursuant to c. may be made. They include investment firms, central counterparties, securities settlement systems, central banks, any other person subject to authorisation or registration requirements in accordance with EU law and persons established in a third country who are authorised or registered and subject to supervision by an authority in that third country, provided that the third country authority is a party to an appropriate cooperation arrangement concerning exchange of information with the relevant competent authority. Third parties in the investment firm, other authorised or registered persons or third country categories must also participate in the management of borrowing or purchasing of relevant shares, provide evidence of such participation and be able, on request, to provide evidence of their ability to deliver or process the delivery of shares or sovereign debt on the dates they commit to do so. The form of acceptable arrangements with third parties depends on the liquidity of shares and whether they are traded intraday. Commission Implementing Regulation (EU) No 827/2012 provides for easy to borrow or purchase arrangements for liquid shares, for standard same day locate arrangements for intraday short sales, and also, more generally, for standard locate arrangements. The specifications of these different arrangements are complex and, while considerable progress has already been made, it remains to be seen

whether all of them will be used in practice and to what extent the documentation used will converge towards an industry standard.

Restrictions on uncovered short sales of sovereign debt

A person may enter into a short sale of sovereign debt only if:

- a. the person has borrowed the sovereign debt or made similar provisions;
- b. the person has entered into an agreement to borrow the sovereign debt or has another enforceable claim with similar effect; or
- c. the person has made an appropriate arrangement with a third party that adequately ensures that the sovereign debt will be available for settlement.

These restrictions closely track those for short sales of shares. However, the restrictions do 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.

Also, the specifications of possible arrangements with third parties to adequately ensure that the sovereign debt will be available for settlement differs from those of possible arrangements to adequately ensure that shares are available for settlement. And eligible third parties include, in addition those listed above in connection with short sales of shares, the national debt management entities of the relevant sovereign debt issuers.

Restrictions on uncovered short positions in sovereign credit default swaps

Uncovered short positions in sovereign credit default swaps are prohibited. A person is considered to have an uncovered position in a sovereign credit default swap where the sovereign credit default swap does not serve to hedge against (a) the risk of default of an issuer where the 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 person holds assets or is subject to liabilities the value of which is correlated to the value of the sovereign debt.

Commission Delegated Regulation (EU) No 918/2012 further specifies the assets or liabilities which are eligible for hedging by a sovereign credit default swap. Particular care needs to be taken to ensure that assets or liabilities are eligible where the obligor is established or the asset or liability is located in more than one Member State.

Commission Delegated Regulation (EU) No 918/2012 also sets out a quantitative test and an alternative qualitative test for establishing correlation in connection with (b). The quantitative test is satisfied if the Pearson's correlation coefficient between the price of the hedged assets or liabilities and the price of the sovereign debt calculated on a historical basis using data for at least a period of 12 months of trading days immediately preceding the date when the sovereign credit default swap position is taken out is at least 70%. Broadly speaking, the qualitative test is met if there is "meaningful correlation" based on appropriate data which is not evidence of a merely temporary dependence and the Commission Delegated Regulation (EU) No 918/2012 sets out further details.

The sovereign credit default swap position must be proportionate to the size of the exposures hedged. However, the Commission Delegated Regulation (EU) No 918/2012 offers firms a degree of flexibility in meeting this requirement where certain conditions are met.

Buy-in procedures

Central counterparties that provide clearing services for shares must ensure that procedures are put in place to deal with settlement failure. In particular, where a person who sells shares is not able to deliver them for settlement within four business days after the day on which settlement is due, automatic buy-in of the shares must be triggered to secure delivery for settlement. Where the buy-in of the shares for delivery is not possible, an amount must be paid to the buyer based on the value of the shares to be delivered at the delivery date plus an amount for losses incurred by the buyer as a result of the settlement failure. The person who fails to settle has to reimburse all amounts paid in connection with buy-in or compensatory payments to the buyer. In addition, central counterparties must require such a person to pay a fine for each day that the failure continues which is sufficient to act as a deterrent.

Potential additional measures in exceptional circumstances

Competent authorities may impose additional transparency requirements, restrictions on short selling and similar transactions and on sovereign credit default swap transactions in exceptional circumstances. Specifically, there must be adverse circumstances which constitute a serious threat to financial stability or to market confidence and the measure must be necessary to address the threat and not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits. In addition, competent authorities have powers to restrict short selling of financial instruments temporarily in the case of a significant fall in price.

ESMA has a facilitation and coordination role in relation to measures taken by the competent authorities. It issues opinions on whether it considers measures proposed by competent authorities to be necessary to address exceptional circumstances. ESMA also has intervention powers of its own in exceptional circumstances.

Exemptions

Shares of a company admitted to trading on a trading venue in the EU whose principal trading venue is located in a third country are not covered by the transparency requirements, the restrictions on uncovered short sales or the buy-in procedures set out above. ESMA has published a list of such shares.⁴

The transparency requirements and the restrictions on uncovered short sales and uncovered short positions in sovereign credit default swaps do not apply to transactions performed due to market making activities. A third country entity may be able to rely on the exemption if the European Commission has adopted a decision confirming that a market authorised in that third country complies with certain requirements which are equivalent to those in the EU and which are subject to effective supervision and enforcement in that country. A person wishing to take advantage of the exemption must first notify the relevant competent authority of its intention to do so. ESMA has consulted on draft guidelines on the market making exemption,⁵ which are yet to be finalised. Controversial issues include whether the exemption should be applied on an instrument by instrument basis and whether or not the person seeking to use the exemption must be a member of the trading venue on which the relevant instrument is traded.

⁴ Available at <http://www.esma.europa.eu/page/List-exempted-shares>.

⁵ ESMA (2012) "Consultation Paper: Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps"; <http://www.esma.europa.eu/system/files/2012-580.pdf>.

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom
Tel: + 44 20 7532 1000
Fax: + 44 20 7532 1001

An exemption from the transparency requirements and the restrictions on uncovered short sales and uncovered short positions in sovereign credit default swaps is also available for authorised primary dealers acting pursuant to an agreement with a sovereign issuer who are dealing as principal in a financial instrument in relation to primary or secondary market operations relating to the sovereign debt. Again, a notification to the relevant competent authority is required before the exemption can be used.

Finally, certain provisions of the EU Short Selling Regulation do not apply to persons carrying out stabilisation in accordance with Commission Regulation (EC) No 2273/2003.

Timeline, transitional provisions and review

The EU Short Selling Regulation applies from 1 November 2012.

However, existing measures falling within the scope of the EU Short Selling Regulation, in force before 15 September 2010, may remain applicable until 1 July 2013 provided that they are notified to the European Commission by 24 April 2012. The previous UK disclosure regime for certain short positions, however, fell away on 1 November 2012.

Further, uncovered sovereign credit default swap positions that have been entered into before 25 March 2012 may be held until the maturity date of the credit default swap contract.

The European Commission will report to the European Parliament and the Council on the appropriateness of key provisions of the EU Short Selling Regulation by 30 June 2013.