EU AGREES ON NEW RULES ON SHORT SELLING AND CREDIT DEFAULT SWAPS

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To Our Clients and Friends:

Last night, the European Parliament, Council and Commission agreed on new rules on short selling of EU shares and sovereign bonds as well as sovereign credit default swaps (CDSs).

The proposed regulation still needs to be formally adopted by the European Parliament and the Council. It is expected to enter into force in November 2012.

PRINCIPLES

In a nutshell, the proposed regulation:

- introduces new reporting requirements on significant short positions;
- gives emergency powers to national regulators and to the European Securities and Markets Authority (ESMA) in exceptional situations to impose temporary measures, such as to require further transparency or to restrict short selling and CDS transactions;
- restricts naked short selling of shares and sovereign bonds as well as sovereign CDSs when they are not used to hedge correlating exposure; and
- allows Member States to suspend the ban on naked sovereign CDSs under certain circumstances.

REPORTING REQUIREMENTS

For shares, short positions in excess of 0.2% of the issued share capital will have to be disclosed only to the competent national regulator, while short positions in excess of 0.5% will also have to be disclosed to the market.

For sovereign bonds, significant net short positions will have to be disclosed only to the regulator. This includes notification of significant CDS positions relating to sovereign debt issuers. Disclosure to the market is not foreseen, as it could have negative consequences for the operation of sovereign bond markets, notably in terms of liquidity.

In order to avoid any circumvention through off-exchange derivative transactions, the reporting requirements also cover the use of derivatives to obtain a net short position relating to the shares or bonds.

EMERGENCY POWERS

In distressed markets when short selling can amplify a downward price spiral, these reporting requirements may not be sufficient. The national regulators will then have emergency powers to impose temporary measures, such as to require further transparency or to restrict short selling and CDS transactions. ESMA is given a central role in coordinating action in such situations and ensuring that powers are only exercised where necessary.

ESMA may itself take action under certain circumstances. In the case of an emergency situation related to sovereign debt or sovereign CDS, ESMA may only act when the Council declares an emergency situation.

RESTRICTIONS

Certain restrictions on short selling are introduced to reduce the risks of settlement failures and increased price volatility.

In order to enter a short sale, an investor must have borrowed the shares or sovereign bonds concerned, entered into an agreement to borrow them, or have an arrangement with a third party under which that third party has confirmed that the instruments have been located and have a reasonable expectation that settlement can be effected when it is due.

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.

The proposed regulation also bans naked sovereign CDSs. This ban addresses concerns that the instruments can destabilize the sovereign debt markets in a similar way to short selling. The buyer of the CDS is "naked" 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.

EXCEPTIONS

The proposed regulation contains exceptions for market-making activities, for primary market operations and for shares whose principal market is outside the EU. Market making includes providing price quotes for financial instruments to provide liquidity to the market or to fulfill client orders. Primary market operations are transactions performed by dealers to provide liquidity to issuers of sovereign debt and for the purposes of stabilization schemes (*i.e.*, share issues intended to stabilize a share price).

In order to address concerns that a ban on naked sovereign CDSs could negatively affect the liquidity of sovereign debt markets, a Member State may temporarily suspend the restrictions if it believes that its sovereign debt market is not functioning properly and that such ban might increase its cost of borrowing or affect its ability to issue new debt. ESMA has to approve such suspension.

BACKGROUND

During the financial crisis and more recently in the context of market volatility in euro-denominated sovereign bonds, EU Member States reacted differently to the issues raised by short selling and CDSs.

Germany, for example, banned naked short selling of certain shares and sovereign debt of euro-zone countries as well as of euro-zone sovereign debt CDSs in 2010. Yet, it was not clear how this ban could be enforced unless other countries followed suit, in particular given that most European trading in CDSs takes place in the United Kingdom.

The proposed regulation aims to end this fragmented approach which limited the effectiveness of the measures imposed, led to regulatory arbitrage and created additional compliance costs for investors. Whether it will ultimately be adopted in its current form remains to be seen.

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Please feel free to contact us with any questions.

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