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January 2012

Regulation on short selling and certain aspects of credit default swaps

As a result of the financial crisis 2008, a number of EU member states adopted emergency measures to restrict or ban short selling in some or all securities. As a result, different measures were adopted across the EU. In order to harmonise the rules, the European Commission adopted a proposal in September 2010 for a regulation on short selling and certain aspects of credit default swaps (CDS). The main objectives of the proposal are to create a harmonised framework for coordinated action at the European level, to increase transparency and to reduce risks. The Commission states that the new framework will result in regulators – both national and European – having clear powers to act when necessary, while preventing market fragmentation and ensuring the smooth functioning of the internal market.

Enhanced transparency of short selling

For shares admitted to trading on a trading venue in the EU, a two-tier model is introduced that provides for greater transparency of significant net short positions in shares. Investors will have to notify regulators about significant net short positions in shares at a threshold of 0.2% of the issued share capital and each 0.1% above that, and disclose to the market significant net short positions in shares at a threshold of 0.5% of the share capital and each 0.1% above that. The notification and disclosure requirements shall also apply whenever the position falls below the relevant thresholds.

The notification or disclosure shall set out the details of the identity of the natural or legal person that has the relevant position, the size of the relevant position, the issuer in relation to which the relevant position is held and the date on which the relevant position was created, changed or ceased to be held.

The proposed transparency requirements for significant net short positions relating to sovereign debt issuers in the EU and uncovered CDS relating to EU sovereign debt issuers, include disclosure to regulators whenever such position reaches or falls below the relevant notification thresholds. Such thresholds are not yet defined.

Reducing the risks of naked short selling

Uncovered (or naked) short selling potentially increases the risk of settlement failure. The proposal requires that in order to enter into a short sale, an investor must have borrowed the instruments concerned, entered into an agreement to borrow them, or have an arrangement with a third party to locate and reserve them for lending so that they are delivered by the settlement date. The specific conditions

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will be presented by the European Securities and Market Authority (ESMA) in the form of technical standards. In addition, trading venues shall ensure that they, or the central counterparty that provides clearing services for the trading venue, ensure that there are adequate arrangements in place for buy-in of shares or sovereign debt in the event there is a failure to settle a transaction. In case of non-settlement, daily fines will be imposed. Trading venues will also be able to forbid a natural or legal person who has failed to settle a trade to enter into further short sales.

Powers of intervention of competent authorities and of ESMA

The proposal gives national regulators clear powers in exceptional situations to temporarily restrict or ban short selling in financial instruments, subject to coordination by ESMA. ESMA is also given the power to issue opinions to competent authorities when they intervene in exceptional situations. In line with the new supervisory framework, ESMA will have the possibility when certain conditions are fulfilled to adopt temporary measures restricting or prohibiting short selling.

In addition, if the price of a financial instrument falls by a significant amount, national regulators will have the power to restrict short selling in that instrument. These measures will help regulators take the necessary action in a coordinated way to slow or halt price declines which can be amplified by short selling in distressed markets. They will also reduce compliance costs for market participants which currently arise from the divergence of national rules.

Exemptions

The proposal provides for certain exemptions to permit legitimate activities that are considered beneficial to the efficiency and quality of European markets to continue. For example, shares where the principal market for the shares is outside the EU are exempted, since it would be potentially onerous for market participants and would create unnecessary complexity. There are also exemptions for market making and for primary market operations performed by dealers to assist issuers of sovereign debt or for the purpose of stabilisation.

Next steps

The proposal has passed to the European Parliament and the Council for negotiation and adoption. Once adopted, the regulation would apply from 1 November 2012.

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