

EU Commission consults on short selling and credit default swaps

The European Commission has published a consultation paper on possible measures on short selling and credit default swaps (CDS), focusing on new transparency rules, restrictions on naked short sales to address settlement risk and emergency powers. The paper makes specific proposals to introduce the two-tier disclosure regime proposed by the Committee of European Securities Regulators (CESR) in relation to net short positions in EU shares, but extending this to require private (but not public) disclosure to regulators of net short positions in EU government bonds. It also proposes a general ban on naked short selling of EU shares and required buy-in procedures for unsettled short sales in those shares. In addition, it proposes giving national regulators new emergency powers to ban or restrict short selling of EU shares and bonds and EU sovereign linked CDS, subject to co-ordination by the proposed new European Securities and Markets Authority (ESMA). The deadline for responses to the consultation is 10 July 2010 and the Commission expects to submit its legislative proposal to the Council of Ministers and the European Parliament in September 2010.

Background

The Commission's consultation follows a period of renewed, intense focus in Europe on short selling and the use of credit default swaps, both in relation to equities and sovereign bonds.

In common with regulators around the world, many EU member states responded to the intensifying crisis in late 2008 by introducing restrictions or disclosure obligations on short selling of equities. Many of these measures focused on stocks of financial issuers that were perceived to be particularly vulnerable to losses of confidence triggered by falling share prices. There was much criticism of the uncoordinated and disparate approaches adopted by regulators during the crisis and the difficulties that this presented for market participants.

During 2009, regulators in Europe and around the world consulted with a view to developing a more coordinated response to the policy issues presented by short selling. In March 2010, CESR published its proposals for a pan-European disclosure regime for significant net short positions in EU shares (followed by a supplemental paper on the technical details for the proposed regime). Other regulators have been developing different approaches, including proposals in the same month by the US Securities and Exchange Commission (SEC) for the introduction of a circuit breaker to restrict short selling where there is a significant fall in share prices and by the Hong Kong Securities and Futures Commission (SFC) for a new transparency regime for short positions, albeit on a more limited and less intrusive basis than proposed by CESR. The incoming Commissioner for the Internal Market, Michel Barnier, identified the issue of short selling, including the treatment of credit default swaps, as a priority for EU action, with the aim of consulting before the summer and putting forward a legislative proposal towards the end of 2010.

Key Issues

Commission's consultation focuses on increased transparency, restrictions on naked short sales and emergency powers for regulators

Proposal to implement CESR's two-tier disclosure regime for EU shares, plus private disclosure to national regulators of significant net short positions in EU government bonds

Proposed ban on naked short selling of EU shares and/or required buy-in procedures for unsettled short sales in those shares

Exemptions from transparency rules and restrictions on naked short selling for market makers

National regulators to be given new emergency powers to ban or restrict short selling of EU shares and bonds and EU sovereign linked CDS, subject to co-ordination by ESMA

Deadline for consultation responses is 10 July 2010

Commission to submit its legislative proposal in September 2010

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But these more measured responses have been somewhat overtaken by the market volatility in European public debt markets resulting from the fiscal pressures on some member states. The Greek regulator reintroduced its ban on short selling of Greek financial stocks in April 2010.

The German regulator first introduced new disclosure requirements for short positions in specified financial stocks in March, followed in May by an immediate ban on naked short selling of financial stocks and eurozone sovereign bonds and restrictions on entering into uncovered CDS linked to eurozone sovereign credits. The German Ministry of Finance has now published legislative proposals to ban naked short sales of shares and eurozone public sector bonds, to ban uncovered CDS on eurozone public sector obligations and to impose transparency requirements on net short positions in German shares. The Spanish regulator has implemented the CESR disclosure regime with very limited prior notice, while Portugal is consulting on similar proposals.

Meanwhile, there have been public calls by the heads of government of France and Germany for the European Commission to act more quickly in this area. The haste of the Commission's response is reflected in the lack of detail in the consultation paper published by the Commission services. The paper also lacks any draft cost-benefit analysis or impact assessment for its proposals, although it calls for stakeholders to provide comments on the possible costs and benefits of regulating in this area.

Scope of Commission proposals

It seems likely that the Commission's preferred approach will be to develop specific rules for different types of instrument admitted to trading on EU trading venues, such as shares (and derivatives linked to those shares), sovereign bonds (and derivatives related to those bonds) and CDS relating to EU sovereign issuers. However, the Commission does ask whether there should be rules that apply uniformly to every kind of instrument admitted to trading on EU trading venues that can be the subject of short selling, although the practical and policy issues of such an approach would clearly be more formidable.

It also seems that the Commission is minded to consider applying any rules to all recognised EU trading venues, i.e. both regulated markets and multilateral trading facilities (MTFs). This goes beyond the current scope of the market abuse directive and obligations under other directives. However, the EU regulatory pipeline includes reviews of those directives which may lead to the extension of the scope of obligations under those directives to match the current proposals.

The Commission makes clear that at least some obligations, such as notification and disclosure rules in relation to net short positions, would have to apply extraterritorially to market participants outside the EU. However, the Commission does not discuss whether its proposed ban on naked short sales of shares or any measures taken under emergency powers should apply extra-territorially.

While the Commission's paper discusses the need for harmonisation it does not make clear whether its proposals would remove member states' authority to introduce more stringent or extensive measures (i.e. whether its measures would involve "maximum harmonisation" of national law). It also does not discuss whether the legislative proposal will take the form of a regulation which takes effect across the EU automatically or a directive that would require member states to transpose the proposals into national law. However, it does propose a role for ESMA in setting technical standards for the measures adopted which would reduce the extent of national divergence with respect to any measures adopted.

Transparency

The Commission asks for views on two main options for increasing transparency on short selling.

The first option is to apply the approach suggested by CESR to all types of financial instruments admitted to EU trading venues (other than those that cannot be the subject of short selling). This would clearly require significant adaptation of the CESR regime and the paper does not discuss this option in any detail.

The second option is to apply the approach suggested by CESR only to EU shares and to EU sovereign bonds (the paper does not mention the German proposal to apply requirements to other public sector debt or the treatment of bonds issued by the EU itself). For EU shares, the Commission asks for views on CESR's two-tier disclosure regime that would require:

- notification to regulators of a market participant's net short positions in EU shares, where the position reaches, exceeds or falls below a notification threshold (0.2% of issued share capital and 0.1% thresholds above that level);
- public disclosure of any market participant's net short position where the position reaches, exceeds or falls below higher notification thresholds (such as 0.5% of issued share capital and 0.1% thresholds above that level).

Notifications and disclosures would be on T+1 basis (by 3.30pm on the next trading day) and public disclosure would identify the investor and be required to use the officially appointed mechanism of the issuer's home member state for dissemination of market information.

For EU sovereign bonds, the Commission only discusses proposals that would require private disclosure to regulators (not public disclosure on an individual basis) where net short positions reach, exceed or fall below a specified notification threshold. The Commission does not propose a specific threshold but suggests that it be fixed by reference to the scale of outstanding issuance and the average size of market participants' positions. National regulators would then report summary information to ESMA on a regular basis.

Naked short selling

The Commission specifically envisages two possible measures to address the settlement risks resulting from naked short selling of shares:

- a ban on a person entering into a short sale of shares admitted to trading on an EU trading venue unless the person has borrowed the share, agreed to borrow the share or has evidence of other arrangements which will ensure that it is able to borrow the share at the time of settlement (this may not be as flexible as the SEC's rules which require firms to "locate" stock before trading short but not necessarily to have arrangements that "ensure" the ability to borrow); and/or
- a requirement that trading venues (or their central counterparties or settlement systems) have rules to trigger a buy-in of shares if a person who has entered into a short sale is not able to deliver the shares within a specified period following the day of trading (and the Commission adds a supplemental question as to whether there should be a requirement to mark orders for shares that are short sales, which would probably be necessary if the buy-in obligation was restricted to short orders).

The Commission does ask whether there are risks in relation to naked or uncovered short sales of other instruments, such as government bonds, that would justify extending these measures to those instruments. It also specifically asks whether there is evidence that would justify permanent limitations or a ban on unhedged credit default swaps. However, the Commission does not set out any specific proposals in this respect.

Exemptions

The Commission suggests that market makers should benefit from exemptions from both the proposed new transparency requirements and the proposed restrictions on naked short sales of shares (including possible additional flexibility in the buy-in process). The Commission's paper endorses CESR's proposal which extended the exemption to firms that are members of exchanges or MTFs that post firm two-way quotes of comparable size and at competitive prices (thus providing liquidity on a regular and ongoing basis) or as part of their usual business fulfil orders initiated by clients or in response to clients' requests to trade and hedge resulting positions. However, the Commission does ask specific questions as to how to deal with market participants and markets outside the EU.

Emergency powers

The Commission proposes that national regulators should be given specific powers to ban or restrict short sales in emergency situations (defined as "adverse developments which constitute a serious threat to financial stability or market confidence in a member state"). In particular, it proposes that national regulators should have powers to ban or restrict (covered or naked) short sales of shares or bonds admitted to trading on trading venues for which they are the home member state (as well as transactions whose effect is to confer a financial advantage on a person in the event of a decrease in the price of such a share or bond, which should catch equivalent synthetic transactions – the wording is borrowed from recent UK legislation on short selling). In addition, national regulators would be able to ban or restrict CDS transactions linked to a member state's default (or the default of the EU itself).

The national regulator would be required to publish its measures on its website (together with its reasoning) and any measures would only remain in force for three months (absent exceptional circumstances justifying an extension). In addition, the national regulator would be required to give ESMA and other member state regulators at least 24 hours of its proposed action and other member state regulators would be able to take similar action in support of the notifying regulator (following equivalent notice) even if the emergency situation has not arisen in their state.

The Commission envisages that ESMA would play a coordinating role and that, if a national regulator acted contrary to its advice, that regulator would have to publish its reasons for so acting. In addition, the proposed legislation establishing ESMA (which is not yet finalised) envisages that ESMA would have other powers in emergencies to require national regulators to take action (and decisions binding on market participants) that would take precedence over these specific powers.

In addition, the Commission asks whether national regulators should have other powers such as powers to impose very short term restrictions on short selling in the event of significant (e.g. 10%) price falls (which echoes the SEC's circuit breaker proposals).

Other powers

Finally, the Commission suggests that national regulators be given powers to seek additional information from market participants about the reasons for entering into CDS. It also asks whether ESMA should be given a general power to investigate issues or practices with respect to short selling and to publish a report on the issue.

Links:

The Commission's consultation paper and related FAQs are available [here](#).

Follow these links for our briefings on the [CESR proposed disclosure regime](#) and [related technical details](#).

Our Online Services portal also has a dedicated Short Selling Update page covering recent developments in short selling rules, available to users of our Online Services. If you are a registered user and would like to access regular updates, please go to: <https://onlineservices.cliffordchance.com>. The Short Selling Update is available from the Current Topics tab. If you are not currently a registered user, please contact our Online Services team at onlineservices@cliffordchance.com or + 44 20 7006 4444.

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