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SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS

Reference text: European regulation 2010/0251 (COD)
Link:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:01:EN:HTML

Date of application:
1st November 2012

Presentation:
This regulation stems from two events that marked the financial world: the financial crisis in 2008, followed by the strong movements on sovereign debts. The financial crisis which followed the collapse of Lehman Brothers obliged regulators, more or less everywhere in the world, to take measures aiming to restrict short selling. These initial measures were taken as a matter of urgency without any real global coordination or coherence.

The objective of this regulation is to construct a preventative framework (comprising permanent measures, alongside temporary measures that can be activated by the competent authorities in exceptional situations), that is reasoned (the project does not undermine the benefits that short selling can entail under normal market conditions and exempts certain activities) and harmonised, aiming to govern short selling of shares and sovereign debts and the use of CDSs on sovereign debts. Such a framework is only fully effective of course if it is accompanied by a reinforcement of the powers granted to the local competent authorities and the ESMA, and an increase in the transparency necessary to exercise their function. The text thus specifies the role of the various competent authorities and stresses the need for cooperation among them.

Mainly targeted at investors (corporate entities and private individuals), the text covers short selling according to two themes:

- an obligation for declaration to the authorities (possibly accompanied by a public version),
- the obligation to have taken all necessary measures to enable settlement of the sale on the intended date. Concerning CDSs, it prohibits them from negotiating “naked”, i.e. without having a long position to hedge over the debt itself.

It should be noted that the text also imposes on Clearing Houses the establishment of penalties for late settlement and a harmonised buy-in procedure (activated 4 trading days after the intended settlement date) in line with what seems set out in the proposed regulation on central securities depositories. It is furthermore not the only case of connection between the proposed texts of the EC: the marking of short selling orders, once envisaged in this regulation, has been finally abandoned to the benefit of marking of transactions through the Transaction Reporting as set out in the future MiFIR. However as the Transaction Reporting is to be done by the entity executing the order, it is no more than a marking of orders since the seller will have to flag the order when sending it for execution. The only difference is that only executed orders will be declared.

The main points of the Regulation:

Scope: in order to provide for a preventive regulatory framework to be used in exceptional circumstances, the Regulation covers all types of financial instruments but provides for a response proportionate to the potential risks posed by the short selling of different instruments. It is only in the case of exceptional circumstances that competent authorities and ESMA are entitled to take measures concerning all types of financial instruments, going beyond the permanent measures that only apply to particular types of instruments where there are clearly identified risks that need to be addressed.

Transparency of significant net short positions: for shares admitted to trading on a trading venue in the Union, a two-tier model is introduced, that provides for greater transparency of significant net short positions in shares at the appropriate level: (i) at the lower threshold, notification of a position should be made privately to the regulators concerned; (ii) at the higher threshold, positions should be publicly

disclosed to the market. A relevant publication threshold is a percentage that equals 0.5 % of the issued share capital of the company concerned and each 0.1 % above that.
A requirement to notify regulators of significant net short positions relating to sovereign debt in the Union should be introduced as such notification would provide important information to assist regulators in monitoring whether such positions are in fact creating systemic risks or being used for abusive purposes. Such a requirement should only include private disclosure to regulators as publication of information to the market for such instruments could have a detrimental effect on sovereign debt markets where liquidity is already impaired.

For sovereign debt, on the other hand, significant net short positions relating to issuers in the EU will always require private disclosure to regulators. The proposed regime also provides for notification of significant positions in credit default swaps that relate to EU sovereign debt issuers.
Natural and legal persons that hold significant net short positions shall keep, for a period of 5 years, records of the gross positions which make a significant net short position.
The text states that the relevant time for calculation of a net short position shall be at midnight at the end of the trading day on which the natural or legal person holds the relevant position.
The notification of information to a relevant competent authority shall ensure the confidentiality of the information and incorporate mechanisms for authenticating the source of the notification.

Restrictions on uncovered short selling in shares: to reduce the risks of uncovered short selling of shares, the Regulation provides that a natural or legal person may enter into a short sale of a share admitted to trading on a trading venue only where that person has: (i) borrowed the share or has made alternative provisions resulting in a similar legal effect; or (ii) entered into an agreement to borrow the share or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due or (iii) an arrangement with a third party under which that third party has confirmed that the share has been located and has taken measures vis-à-vis third parties necessary for the natural or legal person to have a reasonable expectation that settlement can be effected when it is due.
However, these restrictions don't apply to the short selling of sovereign debt if the transaction serves to hedge a long position in debt instruments of an issuer. Moreover, if the liquidity of sovereign debt falls below a specified threshold, the restrictions on uncovered short selling may be temporarily suspended by the competent authority.

Exceptional situations: in exceptional situations that threaten financial stability or market confidence in a Member State or the EU, the Regulation provides that competent authorities should have temporary powers to require greater transparency or to impose restrictions on short selling and credit default swap transactions or to limit individuals from entering into derivative transactions.
In such a situation, the European Securities Market Authority (ESMA) is given a key coordination role, to ensure consistency between competent authorities and to guarantee that such measures are only taken where they are necessary and proportionate. ESMA is also given the power to take measures where the situation has cross-border implications.

ESMA inquiries: ESMA may, on the request of one or more competent authorities, the European Parliament, the Council or the Commission or on its own initiative conduct an inquiry into a particular issue or practice relating to short selling or relating to the use of credit default swaps to assess whether that issue or practice poses any potential threat to financial stability or market confidence in the Union.

Cooperation with third countries: the competent authorities of Member States shall wherever possible conclude cooperation arrangements with competent authorities of third countries concerning the exchange of information with competent authorities in third countries, the enforcement of obligations arising under the Regulation in third countries and the taking of similar measures in third countries by their competent authorities.

Penalties: the measures, sanctions and penalties provided for shall be effective, proportionate and dissuasive. In accordance with Regulation (EU) No 1095/2010, ESMA may adopt guidelines to ensure a consistent approach is taken concerning the measures, sanctions and penalties to be established by Members States. ESMA shall publish on its website and update regularly a list of existing administrative measures, sanctions and penalties per Member State.

Current situation:

Entered into force

Main steps:

The text was adopted by European Parliament on 14 March 2012 and published in the JO on 24 March 2012.
The ESMA published its proposal concerning technical standards (28 March 2012) and its opinion on level 2 measures (19 April 2012).
On 5 July 2012, the European Commission adopted delegated acts and technical standards proposed by the ESMA. Technical standards have been published on the EU JO on the 18 September.
On 17 September ESMA issued a consultation regarding exemptions linked the market making activity. Answers were expected for the 5 October at the latest.
In the meantime, buy-in procedures have been modified by CCPs in order to comply with this new regulation, going beyond the initial scope of the Regulation (shares and sovereign debts).
On 10 October: first update of the ESMA's Q&A (first version dated 13th of September).
On 22 October: publication of the list of "Links to national websites for the purpose of the notification of net short positions"
1 November 2012: Implementation
9th of November: publication of the list of exempted shares (those whom principal trading venue is located in a third country)
Publication of the table of the net short notification thresholds for sovereign issuers
10th of December: mandate given to ESMA for technical advice on the evaluation of this regulation (deadline 31st of May 2013)
January 2013: second update of the ESMA's Q&A (previous one dated 10th of October)
1st February: publication of ESMA's guidelines on market making and primary market exemptions
12th February: ESMA published a "call for evidence" in order to prepare its technical advice on the evaluation of the regulation; answers expected for the 15th of March.
3rd of June 2013 ESMA published its technical advice on the evaluation of the regulation (expected on the 31st of May); ESMA has found that it has had some positive impacts and has suggested some improvements such as on the method to calculate the net positions or on the threshold used for the notification, on the exemption regarding market making activity …
12th of June: ESMA published the Guidelines compliance table regarding exemption for market making activities and primary market operations (to be noted: the AMF answered that it intends to comply only when the guidelines will be fully applied throughout the EU).
12th of September: in the case "UK against Council and Parliament" in the Court of Justice of the EU, advocate general found that article 28 of the SSR should be annulled. Article 28 gives ESMA certain powers to "intervene, by way of legally binding acts, in the financial markets of EU Member States in the event of a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the EU". The advocate general's opinion is not binding on the Court of Justice. Deliberations should now begin.
23rd of September: ESMA to find its short-selling ban has not disrupted the market, as participants had warned it would.
13th of December 2013: the European Commission issued its conclusions based on the ESMA study. The Commission is on the opinion that no change should be made (even those proposed by ESMA) at this stage since (as admitted also by ESMA) it is a too short time period since the launch of the regulation to make any evaluation on its impacts. The Commission suggested such an exercise to be made in 2016.
The main caution point is on the settlement disciplines and particularly on the buy-in process as required for CCPs. Both ESMA's and the Commission's thoughts are to include such requirements in a more horizontal text as for example the future CSDR.

Next Step:

The review of the text was foreseen (in the regulation) to take place by June 2013. In its report issued on the 13.12.2013 the European Commission stated that it was 'too early, based on available evidence, to draw firm conclusions on the operation of the SSR framework which would warrant a revision of the legislation at this stage" and suggested that such evaluation should be conducted in the future.

The SSR has been amended by the CSDR where article 15 on the buy-in requirement has been removed. This requirement will be done through the CSDR.

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http://ec.europa.eu/internal_market/securities/docs/short_selling/20120705-regulation_en.pdf

http://ec.europa.eu/internal_market/securities/docs/short_selling/131213_report_en.pdf

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