Schulte Roth&Zabel

Alert

New European Rules on Short Selling — Effective 1 November 2012

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The EU *Regulation No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps* (the "Regulation")[1] and the subsidiary legislation made under it take effect in all 27 countries of the EU on 1 November 2012 and will replace all existing rules on short selling activities in EU countries.

With respect to almost all securities listed on exchanges in the EU,[2] the Regulation will require disclosure, both to the regulator of the relevant EU country on whose market(s) the particular securities are listed and (in certain circumstances) to the public, of any net short positions[3] in excess of 0.2 percent held by any persons, anywhere in the world. With regard to short positions in EU sovereign debt or credit default swaps ("CDS")[4] referable to EU sovereign debt, a private disclosure will also be required to be made to the regulator of the EU country whose debt forms the subject of the CDS, although for CDS there is no requirement for disclosure to the public.

The Regulation also introduces an EU "locate rule" which requires that persons short selling EU securities or EU sovereign debt must have covered their short position(s) and, unless a very narrow exemption is applicable (see below), CDS positions referable to EU sovereign debt must also be covered. Existing uncovered positions which cannot be covered before 1 November 2012 may need to be unwound to be in compliance with the Regulation.

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[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

[2] See "Territorial Effect" below for more information on the limited exception.

[3] Article 2(1)(b) of the Regulation defines a "short sale" as any sale of the share or debt instrument which the seller does not "own" at the time of entering into the agreement to sell, including such a sale where at the time of entering into the agreement to sell, the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement, not including: (i) a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price; (ii) a transfer of securities under a securities lending agreement; or (iii) entry into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a future date. "Ownership" means legal or beneficial ownership in accordance with the civil law or securities law applicable in the jurisdiction of the sale. The definition of a short sale excludes the selling of financial instruments: (a) transferred under a securities lending or repurchase (repo) agreement, if the securities will either be returned or the transferor recalls them so that settlement can be effected when it is due, (b) by a person who has purchased the instrument prior to the sale but has not taken delivery of it at the time of the sale, and (c) by a person who has exercised an option or similar claim on them, if the securities will be delivered so that settlement can be effected when due (Article 3 of the Delegated Regulation).

[4] Article 2(1)(c) of the Regulation defines a "credit default swap" as a derivative contract in which one party pays a fee to another party in return for a payment or other benefit in the case of a credit event relating to a reference entity and of any other default, relating to that derivative contract, which has a similar economic effect.

Background
For more information regarding the background to the Regulation please refer to our 21 October 2010 *Alert*.[5]

EU Short-Selling Rules
The key provisions of the Regulation and its delegated measures are:

Instruments covered by the rules. The Regulation covers shares and other financial instruments admitted to trading on an EU market[6] ("Relevant Financial Instruments") and derivatives relating to such Relevant Financial Instruments (even where the Relevant Financial Instruments or derivatives are traded outside an EU market), as well as EU sovereign debt and CDS referencing EU sovereign debt.[7] The Regulation seeks to provide for a proportionate response to the risks that short selling of different instruments may represent. CDS referable to EU sovereign debt are covered, since buying CDS without having a long position in underlying sovereign debt may be considered to be, economically speaking, equivalent to taking a short position on the underlying debt instrument.

Territorial effect. The Regulation and the disclosure rules will apply to any person (whether a natural person or a legal person) anywhere in the world who has a net short position in Relevant Financial Instruments traded on an EU market, or a short position in EU sovereign debt or who effectively shorts EU sovereign debt using CDS. However, Relevant Financial Instruments for which the "principal trading venue" is outside the EU are excluded from the disclosure requirements.[8]

Disclosure of net short positions. The Regulation requires that disclosures are made by persons with significant net short positions relating to Relevant Financial Instruments and by persons with significant net short positions in EU sovereign debt (including positions in CDS referencing EU sovereign debt), as follows:

- For companies that have Relevant Financial Instruments admitted to trading on an EU market, the Regulation provides for a two-tier disclosure model for significant net short positions in Relevant Financial Instruments:
    1. At a threshold of 0.2 percent (of the value of the issued share capital of the company concerned), 0.3 percent and 0.4 percent, disclosure* must be made privately to the regulator;[9] and
    2. At 0.5 percent and each 0.1 percent above that, disclosure* must be made both to the regulator and publicly.[10]
- For EU sovereign debt, the Regulation provides that disclosure* of net short positions in EU sovereign debt and CDS positions referable to EU sovereign debt must be made privately to the relevant EU regulator at:
    1. 0.1 percent, where the total amount of the outstanding issued sovereign debt is less than Euros 500 billion, with incremental thresholds every 0.05 percent (i.e., at 0.15 percent, 0.20 percent, 0.25 percent, etc.); and
    2. 0.5 percent, where the total amount of the outstanding issued sovereign debt is Euros 500 billion or greater (or where there is a liquid futures market for the particular sovereign debt),

[5] http://www.srz.com/102110_proposed_new_pan_european_rules_on_short_selling/.

[6] An EU regulated market or an EU multilateral trading facility.

[7] Sovereign debt instruments issued by any EU member state, the EU itself, the European Financial Stability Facility and the European Investment Bank are covered by the Regulation.

[8] Article 16 of the Regulation specifies that those Relevant Financial Instruments that are admitted to trading in the EU but for which the principal trading venue is outside the EU are exempt from the disclosure requirements. The principal trading venue will be that which has the largest volume of trading over the previous 24 months. A list of the exempted instruments is available online at: http://www.esma.europa.eu/page/List-exempted-shares.

[9] Article 5 of the Regulation.

[10] Article 6 of the Regulation.

with incremental thresholds every 0.25 percent (i.e., at 0.75 percent, 1.00 percent, 1.25 percent, etc.).[11]

- For net short positions in Relevant Financial Instruments and short positions and CDS positions relating to EU sovereign debt issuers, the disclosures* must be made when position size is either increasing or decreasing through the relevant thresholds.

* *Please see "Method of notification and disclosure" for more information regarding the mechanics of making the disclosures.*

Calculating a net short position. The calculation of a short or long position should take into account *any* form of economic interest which a person has in relation to the issued share capital of a company or the issued sovereign debt of an EU country. Holdings and short positions in different share classes must be consolidated; the disclosable net short position thresholds relate to the issuer as a whole, not to any specific class of relevant Financial Instruments. Calculations should take into account any interest obtained directly or indirectly through the use of derivatives (including options, futures, contracts for differences and spread bets) relating to Relevant Financial Instruments or sovereign debt. No distinction is drawn between short positions which are hedges and those that are investment positions. In the case of positions relating to sovereign debt, calculations should also take into account credit default swaps relating to sovereign debt issuers. The method for calculating a net short position has been clarified by the European Securities and Markets Authority ("ESMA") in a subordinate regulation under the Regulation itself (known in the EU as the "Delegated Regulation")[12] as follows:

- *Relevant Financial Instruments.* With regard to calculating a long or a short position, the Delegated Regulation states that the holding of a Relevant Financial Instruments through an indirect interest in a basket of Relevant Financial Instruments which contains the relevant share must be taken into account to the extent that the share is represented in the basket; exposure through a derivative instrument which confers a financial advantage/disadvantage in the event of an increase/decrease in the price of the relevant share must also be taken into account. Also, the Delegated Regulation confirms that it is irrelevant whether cash settlement or physical delivery of the underlying assets have been agreed when determining net short positions — the position must still be included in a firm's calculations.[13]
- *Sovereign Debt*. Under the Regulation, a long position in debt instruments of an EU sovereign issuer must be taken into account when calculating a net short position if the pricing of such debt instruments is "highly correlated" (see below) to the pricing of the sovereign debt. The Delegated Regulation clarifies that "pricing" means the yield, but where there is no yield or where this would be an inappropriate comparator, "pricing" means the price. Also, as with Relevant Financial Instruments, holding a position in EU sovereign debt through a long position in a basket of debt instruments will be taken into account as a long position to the extent that the sovereign debt is represented in the basket. In addition, a debt instrument and an issued sovereign debt are considered highly correlated where the correlation is at 80 percent between the pricing of the debt instrument of another sovereign issuer and the pricing of the given sovereign debt for the relevant period. However, where a position ceases to meet the high correlation test over a 12-month period, the sovereign debt of the issuer can no longer be taken into account when calculating a long position. Nevertheless, temporary fluctuations are permitted, provided the correlation remains at least 60 percent and dips below the 80 percent threshold standard for no longer than three months.[14]
- For both Relevant Financial Instruments and sovereign debt, a delta adjusted method must be used when calculating whether the holder has a net short position.[15] For Relevant Financial Instruments, the calculation must take into account transactions in all financial instruments conferring an advantage in the event of a change in price or value, whether traded on or outside a trading venue,

[11] Article 21 of the Delegated Regulation.

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

[13] Articles 5, 6, 7 & 10 of the Delegated Regulation.

[14] Articles 8, 9 & 11 of the Delegated Regulation.

[15] Set forth in Annex II of the Delegated Regulation.

and for sovereign debt positions must be calculated for every sovereign issuer in which the person holds a short position.

- The Delegated Regulation sets forth an aggregation procedure in relation to funds or managed accounts and in relation to positions held by different entities within a corporate group. For fund managers, net short positions must first be calculated for each individual fund or managed account under management. However, individual net short positions for funds or managed accounts pursuing the same investment strategy with respect to a particular issuer must then be aggregated when determining whether or not a disclosable net short position is held. Where a fund manager delegates management to a third party, that delegate must calculate and report any disclosable net short positions in relation to the delegated fund or portfolio; the fund manager will not be required to aggregate the delegated fund's or portfolio's positions with the net short positions for those funds or portfolios for which the fund manager is required to report net short positions. Where various entities within a corporate group have net short positions in Relevant Financial Instruments or EU sovereign debt, the Delegated Regulation requires that each entity within the group must calculate and report its net short positions separately (assuming the aggregate net short position exceeds the disclosure threshold). In addition, all positions are required to be aggregated and reported at group level.[16]

As the foregoing makes clear, calculating whether or not a disclosable net short position exists is likely to present an operational challenge for many market participants, all of whom will need to ensure that they have systems for monitoring EU sovereign debt positions and any positions in Relevant Financial Instruments in order to be able to comply with the Regulation's requirements.

Content of disclosures. The relevant disclosures must cover, at a minimum, the identity of the person who has the relevant disclosable net short position, the size of the position, the issuer in relation to which the position is held and the date on which the position was created, changed or ceased to be held.[17] A subordinate regulation that sets forth the content requirements for disclosures[18] expands on these principles and prescribes a format that all short selling disclosures and CDS disclosures must follow (so that all EU countries have a harmonised form of disclosure). The information must include:

- The name of the fund (i.e., the person holding the net short position);
- The BIC code, if the fund has one;
- Country (where the fund is established);
- The fund's registered address;
- The name, address and contact details for the investment manager/investment adviser that is reporting on the fund's behalf;
- The reporting date;
- Name of the issuer (including ISIN code);
- The date that the applicable net short position was reached;
- The net short position after crossing the relevant threshold (expressed as the number of shares and the percentage of the issued share capital); and
- The date of any previous notification made by the investment adviser on the fund's behalf.

Timing of disclosure. Disclosure must be made by not later than 3.30 pm (local time for the relevant market) on the next trading day after which the person first has the disclosable position or passes through the relevant incremental threshold(s).[19]

[16] Articles 12 & 13 of the Delegated Regulation.

[17] Article 9(1) of the Regulation.

[18] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-regulatory_en.pdf.

[19] Article 9(2) of the Regulation.

Method of notification and disclosure. The notification of information to the relevant regulator will need to be made in accordance with the prescribed requirements of each EU regulator. It is generally believed that regulators will either implement new online disclosure systems or will require that disclosures are made using the electronic notification systems currently used for the notification of substantial shareholdings in listed companies. Before 1 November 2012, ESMA will publish a list of electronic links to central websites operated or supervised by EU regulators where the public disclosure of net short positions may be posted. The links will appear on ESMA's short selling website.[20]

Penalties for failure to notify regulator. The Regulation requires that EU countries must establish rules on penalties for those persons who fail to comply with the disclosure rules. The Regulation gives ESMA the power to issue harmonising guidelines, if necessary, to ensure that a consistent approach to penalties is taken by regulators across the EU.[21] At the time of writing this *Alert*, ESMA had not used this power and therefore the penalty for failing to comply with the short selling disclosure rules will be those enforced by each EU regulator. ESMA will publish a list of each EU country's short selling penalties on its short selling website before 1 November 2012.[22]

Prohibition of uncovered shorts and new EU "locate" rule. Investment advisers entering into short sales of Relevant Financial Instruments, or short positions or CDS positions relating to EU sovereign debt issuers, must at the time the short sale is entered into have either borrowed the instruments or have another enforceable claim under contract or property law to be transferred ownership of the instruments, entered into an agreement to borrow the instruments or made other arrangements which ensure that they can be borrowed so that settlement can be effected when it is due.[23] The requirement permits legitimate arrangements that are currently used to enter into covered short selling and which ensure that securities will be available for settlement.[24] The prohibition on uncovered short sales also extends to CDS on EU sovereign debt and the Regulation contains a "locate" rule requirement for EU sovereign debt.[25]

For Relevant Financial Instruments, a further delegated regulation under the Regulation (known as the "Implementing Regulation")[26] sets forth two broad types of "locate" arrangements, as follows:

- The standard "locate" arrangement must consist of:
  - A confirmation provided by a third party prior to the short sale that it considers that it can make the shares available for settlement and indicating a period for which the shares are located (a "locate" confirmation); and
  - A confirmation that the third party has at least put on hold the requested number of shares (a "put on hold" confirmation).
- The standard same day "locate" and "easy to borrow or purchase" arrangements must include a "locate" confirmation from a third party (as above) and a confirmation that the share is easy to borrow or purchase or, in the absence of such confirmation, a "put on hold" confirmation.[27]

[20] http://www.esma.europa.eu/page/Short-selling.

[21] Article 41 of the Regulation.

[22] Please see footnote 20.

[23] Article 12 of the Regulation.

[24] These arrangements include futures, options and repurchase agreements.

[25] Article 13 of the Regulation.

[26] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-technical-standards_en.pdf.

[27] Articles 5 & 6 of the Implementing Regulation.

For sovereign debt, the Delegated Regulation sets forth four different types of locate arrangements:

- A "standard" locate, which is a confirmation from a third party that it considers that it can make the sovereign debt available for settlement in due time in the amount requested taking into account market conditions and indicating the period for which the sovereign debt is located;
- A "time limited" confirmation, which is similar to the "same day locate" for Relevant Financial Instruments;
- An "unconditional repo confirmation", which relies upon the third party's participation in a central bank or other repo arrangement that provides unconditional access to the sovereign debt in question; and
- An "easy to purchase" confirmation, which is similar to the "easy to borrow or purchase" confirmation for Relevant Financial Instruments.[28]

The Implementing Regulation specifies[29] the types of third parties from whom the "locate" confirmations may be obtained. They include:

(1) Counterparties within the EU

- Regulated investment firms or other regulated financial institutions which participate in the "management of borrowing" or purchasing of relevant shares or sovereign debt;
- Central counterparties;
- Securities settlement systems;
- Central banks; or
- National debt management entities (in relation to sovereign debt only).

(2) Where the third parties are non-EU entities, the Implementing Regulation requires that they must be subject to supervision by a regulatory authority with appropriate cooperation arrangements with the relevant EU regulator.

"Hedging" exemption for EU sovereign debt CDS. Even though the Delegated Regulation sets forth various options to locate arrangements in connection with the relevant sovereign debt instruments which must be in place at the time that the CDS is entered into, the Regulation does contain a very limited exception to the locate rule for CDS relating to EU sovereign debt. The Regulation notes that a CDS position is not deemed to be uncovered if it serves to hedge against (a) the risk of default of the issuer where the person has a long position in the sovereign debt of that issuer to which the sovereign CDS 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, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is highly correlated to the value of the sovereign debt.[30]

In the Delegated Regulation[31] clarification is provided as to when a sovereign CDS transaction is considered to be hedging against a default risk or the risk of a decline in the value of the sovereign debt — meaning that it is not an uncovered CDS position. To qualify, a sovereign CDS position must meet the following conditions:

- It must serve to hedge against either or both risk of default and risk of a decline in value;
- There must be a consistent significant correlation between the value of the asset or liability being hedged and the value of the sovereign debt referenced;

[28] Article 7 of the Implementing Regulation.

[29] Article 8 of the Implementing Regulation.

[30] Article 4(1) of the Regulation.

[31] Article 14 of the Delegated Regulation.

- A sovereign CDS position referencing an EU country may be used to hedge any assets or liabilities meeting the correlation test above — provided that the obligor of (or counterparty to) the asset or liability is located in the same EU country as the country referenced for the CDS; and
- The CDS position must be proportionate to the risks it is hedging.[32]

On the basis of the prohibition on uncovered CDS, all CDS referable to EU sovereign debt will fall into one of three classes and position holders should be aware that they may need to take action to avoid the CDS being an unlawful transaction.

1. Those entered into before 25 March 2012: These may be held until maturity (whenever that may be), even if they would result in an uncovered position after 1 November 2012.
2. Those entered into between 25 March and 1 November 2012: These are still permitted, but have to be unwound before 1 November 2012, unless they fall within the hedging exemption above.
3. Those entered into after 1 November 2012: Any new CDS referable to EU sovereign debt will not be permitted, unless it falls within the hedging exemption above.

New powers for EU regulators. The Regulation provides[33] that in the case of "adverse developments which constitute a serious threat to financial stability or to market confidence" in one or more EU countries,[34] EU regulators may require persons to disclose their short positions in any EU issuer, or may prohibit or restrict short selling activities that would otherwise be legitimate or pose minimal risks. In addition, in "exceptional circumstances" (where there are adverse events or developments which constitute a serious threat to financial stability or to market confidence) EU regulators will have the power to prohibit or restrict CDS referable to that country's sovereign debt. The power of intervention for regulators only contemplates temporary action/ bans for up to three months, with possible extensions of up to three months at a time, but this must be fully justified as well as being notified to and confirmed by ESMA.[35]

In highly exceptional circumstances, where two conditions are fulfilled, ESMA may itself take action and impose a pan-European ban on short selling. These conditions are: (1) there is a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU (and there are cross-border implications) and (2) measures have not been taken by EU regulators, or such measures are not deemed to be sufficient, to address the threat.[36]

Effective date. The new EU rules on short selling come into effect in each of the 27 EU countries on 1 November 2012.

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If you have any questions concerning this *Alert*, please contact one of the authors or your attorney at Schulte Roth & Zabel.

[32] Limited over-provisioning shall be permissible where the relevant party can justify (to the relevant regulator) why an exact match was not possible and can justify that a larger CDS position was necessary to match a measure of risk associated with the reference portfolio taking into account (1) the size of the nominal position, (2) the sensitivity ratio of the exposures to the obligations of the sovereign which are which scope of the CDS, and (3) whether the hedging strategy being used is static or dynamic. (Article 19 of the Delegated Regulation).

[33] Articles 18 to 26 of the Regulation.

[34] Article 24 of the Delegated Regulation includes (1) serious financial, monetary or budgetary problems; (2) a rating action or default by a Member State or a bank and other financial institutions deemed important to the global financial system; (3) substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks or other financial institutions deemed important to the global financial system; (4) any relevant damage to the physical structures of important financial issuers, market infrastructures, clearing and settlement systems, and supervisors which may adversely affect markets where such damage results from a natural disaster or terrorist attack; and/ or (5) any relevant disruption to any payment system or settlement process.

[35] Articles 24 and 26 of the Regulation.

[36] Article 28 of the Regulation.

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