

Short Selling and Credit Default Swaps - New EU Rules Enter into Force on 1 November 2012

The provisions of Regulation (EU) 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”) will come into force on 1 November 2012.

Impact

The Regulation focuses on shares admitted to trading on a trading venue in the EU and the sovereign debt of the EU Member States. It bans naked short sales of shares and sovereign debt in the EU, imposes a general ban on uncovered sovereign credit default swaps (“CDS”) and requires that certain net short positions are privately notified to the relevant national regulator² and, at higher levels, are publically disclosed. It contains various exemptions including for shares of a company admitted to trading on a trading venue in the EU where the principal venue for the trading of the shares is in a third country and in relation to transactions carried out in the performance of market-making activities and when acting as an authorised primary dealer. The Regulation also gives various emergency powers to curb short selling to national regulators and to ESMA. Although these provisions will apply in two days’ time, many questions still remain about how practically they will take effect.

Directly Applicable EU Law

The Regulation has direct effect in the law of all EU countries without there being any need for domestic implementing measures. All that is required of the EU countries is that they repeal any domestic provisions which are inconsistent with the Regulation or are no longer required and ensure that the Regulation is fully effective and enforceable in their jurisdictions by providing for an effective, proportionate and dissuasive penalty regime.

The UK already has in place a short selling regime: the FSA maintains a disclosure regime in relation to selected UK financial stocks and UK companies undertaking rights issues under which public disclosures are required of net short positions of 0.25% of the issued equity or above. This regime, set out in FINMAR 2, is superseded by the Regulation. Accordingly, it will be repealed from 1 November 2012 and FINMAR 2 will be amended to reflect the Regulation. It should be noted that positions reached under the existing domestic regime that trigger disclosures due by 3.30pm on 1 November 2012 will still need to be disclosed as per the ‘old’ domestic regime.

Some commentators have queried whether the restrictions on the short selling of shares and sovereign debt or on the taking of uncovered positions in CDS apply to persons located or domiciled outside the EU. ESMA has, however, stated that its view is that the Regulation applies in respect of the instruments within its scope regardless of the location of the short seller or the execution or booking of the transaction.³ It would not, therefore, be safe to assume that the Regulation does not have extraterritorial effect in this regard.

Key Provisions In the Regulation

(A) NAKED OR UNCOVERED SHORT SELLING OF SHARES AND SOVEREIGN DEBT

The Regulation states that short sales of a share or sovereign debt are only permitted where a person has:

- (i) borrowed the share or made alternative provisions resulting in a similar legal effect;
- (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 confirmed that the share has been located and has taken measures necessary for the person to have reasonable expectation that settlement can be effected when it is due.

A short sale in sovereign debt is, however, permitted where the transaction serves to hedge a long position in the debt instrument of an issuer, the pricing of which has a “high correlation” with that of the given sovereign debt. There is no definition or guidance on the meaning of “high correlation” in this context. Where the liquidity of sovereign debt falls below a certain threshold the national regulator may suspend the ban on uncovered short sales in sovereign debt.

The definition of a short sale in the Regulation specifically excludes:

- (a) sales 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;
- (b) lending agreement; or
- (c) entering into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a further date.

Accordingly, the ban does not extend to sales under a repo agreement, transfers of securities under a securities lending agreement and derivatives, such as futures, where it is agreed to sell securities at a specified price at a later date.

There is further detail on the types of agreements, arrangements and measures which adequately ensure that shares or sovereign debt instruments are available for settlement in Commission Implementing Regulation No 827/2012.

(B) UNCOVERED SOVEREIGN CDS POSITIONS

CDS resulting in an uncovered position concluded before 25 March 2012 may be held until maturity. Otherwise, from 1 November 2012 there is a general prohibition on taking uncovered sovereign CDS positions. It is, however, possible for a national regulator to suspend this ban temporarily (up to 12 months and then 6 months at a time) if it believes that its sovereign debt market is not functioning properly and the ban is impacting negatively on the sovereign CDS market. There has as yet been no indication that any country in the EU will suspend the general ban at the outset but commentators are already expressing

concern that the ban may jeopardise the rest of the sovereign CDS markets, erode liquidity in the markets and prevent investors having a reliable gauge of sovereign credit stress.

The Regulation provides a basic definition of an uncovered position as when the CDS does not serve to hedge against either:

- (i) the risk of default of the issuer where the person holds a long position in the sovereign debt of the issuer to which the CDS relates; or
- (ii) the risk of a decline in the value of the sovereign debt where the person holds assets or is subject to liabilities the value of which is ‘correlated’ to the value of the relevant sovereign debt.

Commission Delegated Regulation No 918/2012 contains further detail on the cases in which a sovereign CDS is considered to be legitimate hedging and therefore deemed ‘covered’ for the purposes of the ban on uncovered sovereign CDS. The rules are complex and, at this stage, there is general uncertainty as to what exactly they mean.

(C) NOTIFICATIONS AND DISCLOSURES

The Regulation aims to provide a regime which is proportionate to the potential risks posed by the short selling of different instruments. Accordingly, it imposes a two-tier disclosure regime consisting of:

- (i) private disclosure to national regulators of net short positions for sovereign debt and shares admitted to trading on a trading venue in the EU at certain thresholds; and
- (ii) public disclosure in respect of shares once a higher threshold has been passed.

As discussed above, there is a general prohibition on uncovered sovereign CDS but where that prohibition is lifted in a particular country, private disclosure to national regulators of uncovered positions is required at certain specified thresholds.

The thresholds for shares are as follows:

- (i) private disclosure to the relevant national regulator where a position reaches or falls below 0.2% of issued share capital;
- (ii) public disclosure via the relevant national regulator where a position reaches or falls below 0.5%;
- (iii) further notification or reporting is required at each 0.1% above the initial threshold.

The thresholds for sovereign debt (and uncovered CDS, where applicable) can be found on ESMA's website for each sovereign issuer. The initial list was published on 11 October but is incomplete. ESMA makes clear that the figures in the October version of the list are indicative only and are to assist investors in preparing for implementation. It has said that it will publish the definitive thresholds by 1 November 2012 and that those issuers which are not currently included in the list will be added as soon as it receives the necessary information from the national regulator. In these circumstances, ESMA recommends that interested persons who may hold notifiable short positions should check regularly the updates of the list in the coming days.

The Regulation provides that a net short position is obtained by deducting any long position that a person holds from any short position. A short position is defined as either:

- (i) a short sale of a share issued by the company or a debt instrument issued by a sovereign;
- (ii) entry into a transaction which creates or relates to a financial instrument other than the instruments at (a) where the effect is to confer a financial advantage on the person in the event of a decrease in the price or value of the share or debt instrument.

This means that, although the definition of a short sale excludes certain derivatives transactions, such as futures or forwards, those instruments will need to be included in the calculation of the net short position and will count towards the reporting and disclosure thresholds. Any sovereign CDS that relates to the sovereign issuer will also count towards the calculation of position relating to sovereign debt. Further detail on how net short positions are to be calculated and reported by fund managers managing several funds and by different entities within a corporate group has been promulgated in Commission Delegated Regulation No 918/2012.

Disclosures will need to be made direct to the relevant national regulator. In the UK, the FSA is working on a web-based solution for making these notifications and in the interim will have

disclosure forms available on its website. Notifications of short positions will need to follow the content and format set out in the Annexes to Commission Delegated Regulation No 826/2012. Although the contents of the form will be the same throughout the EU, each national regulator will have its own system of reporting.

Public disclosures need to be posted on a central website operated by or supervised by the relevant national regulator. The FSA intends to publish the disclosures on the FSA website.

On 19 October 2012 ESMA published links to the central websites operated or supervised by national regulators for the purpose of the notification of net short positions and where public disclosure of net short positions is posted. The lists of web links will be updated when ESMA receives new information from national regulators but, in the meantime, ESMA suggests that any specific queries on the links or the information contained on the national websites should be addressed to the relevant national regulator.

(D) EXEMPTIONS

The notification and disclosure requirements in respect of shares and the ban on uncovered short sales in shares do not apply to shares of a company admitted to trading on a trading venue in the EU where the principal venue for the trading of the shares is in a third country. The national regulator of the trading venue on which the company's shares are traded will determine whether the principal venue for the trading of its shares is in a third country and notify ESMA who shall publish a list on its website.

The initial list was published by ESMA on 4 October 2011 and can be found on its website but it is incomplete. ESMA has indicated that any queries regarding the content of the list should be directed to the relevant national regulator.

There are also exemptions relating to transactions carried out in the performance of market-making activities and when acting as an authorised primary dealers. The notification and disclosure requirements in respect of shares and sovereign debt, the ban on uncovered short sales in shares and sovereign debt and the ban on uncovered sovereign CDS do not apply to transactions carried out in the performance of market-making activities. Further, the notification in respect of sovereign debt, the ban on uncovered short sales in sovereign debt and the ban on uncovered sovereign CDS do not apply to the activities of a person acting as an authorised primary dealer. It is important to note that these exemptions only apply to the specific transactions not to all the activities carried out by the notifying person.

Those wishing to use either of the market making activities or primary market operations exemptions must notify the national regulator in writing that they intend to do so not less than 30 calendar days before

they first plan to use the exemption. The national regulator may prohibit the use of the exemption if it considers that the person does not satisfy the conditions of the exemption. The national regulator shall notify ESMA of the persons using the market making activities or primary market operations exemptions and ESMA shall publish a list on its website.

The list is yet to appear on the ESMA website, something which is not surprising given that ESMA guidelines on the exemptions have yet to be promulgated: ESMA's consultation on this issue only closed on 5 October 2012. The FSA has, however, issued guidance on its notification regime regarding the application of exemptions in respect of transactions carried out in performance of market-making activities and as authorised primary dealers⁴. The FSA website also contains exemption notification forms.

If you have any questions about any of the issues raised in this update, please contact one of the lawyers listed below.

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Endnotes

- 1 See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF>
- 2 The relevant national regulator is determined according to Article 2(i)(j) of the regulation. Essentially, the relevant national regulator is the regulator of sovereign issuer (for sovereign debt) and of the trading venue where the financial instrument was first admitted to trading (for shares) but see provision for further detail.
- 3 See question 1 of ESMA's updated Questions & Answers on the Implementation of the Regulation dated 10 October 2012.
- 4 The UK notification process for market-making activities and primary market operations (September 2012)

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