Welcome
This Regulatory Spotlight will address the latest update on European Short Selling regulations and certain aspects of credit default swaps (CDSs).

Background
In the light of the financial crisis over the last years and the Eurozone debt crisis in 2010, where various EU 27 member states such as Germany and France took individual and uncoordinated emergency measures at national level such as the temporary restriction or ban on the short-selling of specific instruments, the European Commission decided that a pan-European legislative framework was required to address these aspects. It adopted a regulatory proposal on 15 September 2010 that also included certain provisions relating to (sovereign) CDSs and that aimed to ensure coordination at European level, equip member states with necessary intervention powers, increase transparency and reduce risk.

The proposals, even following a compromise text prepared this month, seek to impose wide-ranging duties on market participants (notwithstanding market maker exemptions). Items such as the public disclosure reporting requirements on individual short-selling positions and the inclusion of sovereign CDSs into the legislative framework have provoked much industry comment, so the political debate will continue through the first half of 2011. The final measures are expected to come into force in July 2012.

ESMA – the new European Securities Market Authority that came into existence in January 2011 and that replaces the former CESR authority (Committee of European Securities Regulators) – is equipped with enhanced supervisory powers to ensure greater consistency across all EU 27 member states. In the context of short selling, ESMA is empowered to provide opinions to local authorities in cases of emergency interventions and can even adopt temporary measures that are directly binding on the markets.

Timeline and next steps
September 2010
The European Commission adopts proposals for the regulation of short selling and certain aspects of CDSs.

As this legislation is designed as a regulation, it is directly applicable to industry participants once it comes into force and does not need to be transposed into national member state law like a directive does.
February 2011
The Hungarian EU Presidency publishes a draft compromise text that will form the basis of the political discussions in the coming months. The European Parliament is expected to vote on possible amendments to the draft regulations.

March 2011
EU finance ministers are scheduled to meet on 15 March 2011 when this regulatory draft is expected to be on the formal agenda.

Q2/Q3 2011
Agreement on the final version of the text is expected by mid 2011 at the latest with adoption in late 2011.

1 July 2012
Envisaged entry into force - law becomes directly applicable to the industry.

**Expected industry implications – some key aspects**

**Disclosure of net short-sale positions**
Policy makers acknowledge that short-selling techniques support market liquidity and efficient pricing. But in distressed markets, they also consider that the techniques can amplify fails and lead to disorderly markets and systemic risk. Enhanced transparency of net short positions in shares where the principal trading venue is inside the EU – to regulators at 0.2% and 0.1% increments thereafter, and publicly at 0.5% and each 0.1% above that – via notification to competent authorities would enable regulators to monitor for systemic risk and market abuse. Thresholds for reporting net short positions in sovereign debt and CDSs have not yet been indicated.

However, it remains a matter of some debate whether there is conclusive evidence to corroborate that short selling per se (not constituting a market abuse) – for shares and in particular for sovereign debt or sovereign CDSs – has damaging systemic effects and should be regulated at all by short-selling provisions.

**Uncovered short-selling**
Restricting so-called naked or uncovered short selling to limit potential risk of settlement failure is also envisaged. The latest proposal suggests that a seller must have borrowed the shares or sovereign debt it plans to short-sell, made arrangements with a third party either to locate the instruments or have another reasonable expectation that settlement can be made on contractual settlement date.

It is noteworthy that the previous proposal to both “locate and reserve” a security prior to its short-sale has been dropped from the February 2011 compromise text. This reservation requirement was widely viewed as an implicit ban on uncovered short selling and its proposed deletion is welcomed given the costs of setting aside securities for settlement, the increase in transaction costs and the likelihood of reduced market liquidity.

**Client impact**

**Disclosure to the market**
Asset managers may benefit from a harmonised framework and a consistent common regime for regulatory intervention measures across Europe and increased reporting requirements to the regulators may also support greater transparency. However, disclosures to the market regarding short-selling positions of individual stocks or short-selling bans could have an adverse effect on market efficiency.
Asset management companies are likely to be much more limited in the way they manage investment risk as the shorting of companies, sovereign debt and sovereign CDSs would become transparent to regulators and the market. It would potentially allow other market participants to take insights into each other’s trading strategies and views that are taken on the underlying entity, i.e. companies or specific countries in case of shorting sovereign debt or CDSs.

The provisions will furthermore have an impact on liquidity, the equity bid-ask spread will likely widen and short squeezes would probably intensify. This outlook is based on empirical analysis some firms have undertaken on the recent UK’s FSA public short-selling disclosure requirements, which showed a double-digit drop in trading volumes with a bid-ask spread widening almost 50%.

The public disclosure rules are expected to increase costs of hedging strategies or make them less effective if public data on short positions is used to distort price drivers in the market. Worst-case, this might result in a decreased demand for stock lending programmes.

These outlined adverse implications could be limited by either mandating the disclosure requirements to regulators only and not to the market or at least through limiting the disclosure reporting to the market of positions in aggregate and anonymised form (instead of individual stocks sold short) and/or increasing the disclosure threshold from 0.5% to for example 3.0%. Otherwise, asset managers may re-consider their equity capital allocation away from Europe and increase trading for example in Hong Kong or the US where short selling disclosure guidelines are in place that do not require the disclosure of individual shorting positions to the market.

Sales of long lent positions
A repo is proposed to be excluded explicitly from the definition of a short sale; however, the situation where an investor sells its lent position in a stock and then recalls for contractual settlement date is not. Discussions continue to clarify this position because, even though this would be a covered short sale (enforceable legal claim to meet the settlement date delivery obligation), the disclosure requirements would still need to be met.

Current regulatory position in example markets (short-selling of shares)
France
Effective 1 February 2011. The AMF implemented a new transparency system for net short positions on shares (as of this date, the exceptional measures taken by the AMF on 19 September 2008 on short-selling of financial stock are no longer applicable):

- Any natural or legal person holding a net short position that becomes equal to or greater than 0.2%, 0.3% or 0.4% of the capital of a company whose shares are admitting to trading on a regulated market or traded on an organised multilateral trading facility within the meaning of Article 524-1 shall report that position to the AMF within one trading day. The same reporting requirement shall apply if the net short position falls below one of these thresholds.
- Any natural or legal person holding a net short position that becomes equal to or greater than 0.5% of the capital of a company referred to in the above paragraph shall report that position within one trading day to the AMF, which will publish it. The same reporting requirement shall apply when any additional threshold set at increments of 0.1% is crossed upwards or when any threshold mentioned in this paragraph is crossed downwards.
• This article shall not apply to net short positions in shares for which the regulated market or organised multilateral trading facility in France is not the principal trading market.

Germany
27 July 2010. The “Abusive Securities and Derivatives Trade Preventions Act” entered into force. Under this law, new regulations relating to the prohibition of short selling came into effect, including a worldwide ban on naked short sales in German equities. The introduction of the new law further extends the ban previously introduced by BaFin to counteract the high volatility of government bonds in the Eurozone and financial sector-related stocks and also to reduce the spread of CDS for bonds of Eurozone countries, ensuring orderly trading in these asset classes. Exceptions have been provided for designated sponsors, liquidity providers, and as well as for lead brokers and specialists who are active in affected instruments.

After a planned transition period of 20 months, comprehensive reporting requirements for short-selling positions will be introduced. In the meantime, the BaFin’s General Decree of 4 March 2010 on the introduction of a transparency obligation for net short-selling positions remains in force.

Italy
4 December 2009. Consob issued a clarification notice on the residual short-selling restrictions applicable to shares of companies that announced a capital increase by close of business 30 November 2009 and to shares that are still in progress, as follows.

• Short selling is allowed on shares of companies that announce a capital increase from 1 December 2009 onwards;
• The prohibition of the short-selling of shares of companies that have announced a capital increase by close of business 30 November 2009 expires at the closing of the offering period;
• The short-selling of shares (including the new shares issued following a capital increase) of companies that have announced a capital increase up to 30 November 2009 is allowed from the first business day after the closing of the offering period, regardless of whether these shares were actually delivered or not.

The United Kingdom
1 June 2009. The Financial Services Authority extended its disclosure regime indefinitely. Under the rules, anyone with a short position equal to 0.25% of the outstanding stock in one of 30 prescribed companies must publicly disclose their holdings.

To discuss the matter please contact your client executive or email Natalie.Westerbarkey@Citi.com

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