

European Commission Publishes Proposed Regulation on Short Selling and CDSs

October 1, 2010

On September 15, 2010, the European Commission published a proposal (the **Proposal**) for a European Regulation on short selling and certain aspects of credit default swaps (**CDSs**). The Proposal aims at enhancing the regulatory framework for the financial markets as a consequence of the financial crisis of 2008/2009. The Proposal introduces a European legislative framework for short selling restrictions and is designed to harmonize the national regulations on this issue that some Member States (such as Germany,¹ France, Spain, Luxembourg, and Greece) have already enacted.

The Proposal is intended to become effective on July 1, 2012. Before it becomes effective, the Proposal must be adopted by the European Parliament and the Council.

Following are the key objectives of the Proposal:

- The restriction of uncovered short sales of shares to prevent negative price spirals and other risks associated with uncovered short selling
- The introduction of transparency requirements for (i) short selling in shares that reach certain thresholds, (ii) short selling in sovereign debt instruments that reach thresholds to be specified by the respective EU Member State or the Commission, and (iii) short selling in uncovered CDSs relating to EU sovereign debt issuers that serve to hedge underlying credit risks
- The granting of significant intervention powers to national financial regulatory authorities of EU Member States as well as the EU regulatory authority in the event of a threat of the financial markets (for example, the right to restrict short sales or similar transactions)
- The introduction of the requirement for market participants to flag short sell orders
- The obligation to execute settlement within fixed time periods to reduce settlement risks

1. In May 2010, Morgan Lewis reported about the German Stability Act, which is formally referred to as the “Act Aimed at Preventing Abusive Securities and Derivatives Trading Activities,” in the Morgan Lewis LawFlash “German Federal Government Proposes to Extend the Ban on Short Selling in Germany” (May 27, 2010), available at http://www.morganlewis.com/pubs/IM_ShortSellingInGermany_LF_27may10.pdf. Additional information about the German Stability Act can be found in the Morgan Lewis LawFlash, “German Short Selling Legislation Expected to Become Effective in July 2010” (July 13, 2010), available at http://www.morganlewis.com/pubs/IM_GermanShortSelling_LF_13jul10.pdf.

Application

The Proposal covers (i) financial instruments admitted to trading on a trading venue in the EU, including such financial instruments when traded over the counter (**OTC**); (ii) derivatives that relate to such financial instruments or an issuer of such financial instruments, including such derivatives when traded OTC; and (iii) debt instruments issued by an EU Member State or the EU and derivatives that relate to such debt instruments of an EU Member State or the EU.

Under the Proposal, a trading venue (**Trading Venue**) is defined as a regulated market or a multilateral trading facility (**MTF**) within the EU. The Proposal further defines an MTF as a trading facility that (i) is not a regulated market, (ii) is operated by an investment firm or a market operator, and (iii) brings together multiple third-party buying and selling interests in financial instruments in accordance with non-discretionary rules in a way that results in a contract pursuant to the provisions of EU Directive 2004/39/EC. (Examples of MTFs are Chi-X Europe, Turquoise, Equidact Berlin, and Vega-Chi MTF). MTFs are regulated by the relevant financial regulatory authority of the respective EU Member States. In Germany, the German Federal Financial Supervisory Authority (**BaFin**) is the competent supervisory authority for MTFs. Exchange-regulated multilateral trading facilities, such as the Open Market of the Frankfurt Stock Exchange (**Freiverkehr**) or the Alternative Investment Market of the London Stock Exchange, are not considered Trading Venues under the Proposal. Therefore, financial instruments that are traded on such exchange-regulated multilateral trading facilities are not covered by the Proposal.

Transparency Requirements

The Proposal introduces transparency requirements with regard to net short positions in relation to shares traded on a Trading Venue as well as in relation to issued sovereign debt of an EU Member State or of the EU, and certain CDSs. Pursuant to the Proposal, the notification and disclosure requirements apply to investors regardless of whether they reside or are established within or outside the EU.

Transparency Requirements for Short Selling in Shares

The Proposal imposes an obligation on investors to disclose net short positions in relation to shares traded on a Trading Venue. The Proposal defines a **short sale** in relation to a share as a sale of a share that the seller does not own, including sales where the seller has borrowed or agreed to borrow the share for delivery at the time of settlement. A **short position** in relation to a share is defined as a position resulting from a short sale of a share issued by a company. A **long position** in relation to a share, in contrast, is referred to as the holding of a share issued by a company. Pursuant to the Proposal, a **net short position** in shares of an issuer would be the position remaining after deducting any long position that an investor holds in shares of this issuer from any short position that such investor holds in the same shares.

The Proposal provides for a two-tier model of transparency. As soon as the net short position that an investor holds with respect to the issued share capital of the company concerned equals 0.2% (and at each additional 0.1% increment) a notification of such net short position must be made to the competent national financial regulatory authority. If the net short position that an investor holds with respect to the issued share capital of the company concerned equals 0.5% (and at each 0.1% increment above 0.5%) the concerned net short position must be disclosed to the market. The transparency obligations are designed to put market participants in the position to monitor which securities are being traded short and to detect risks that may result from such activities. Technical details, such as the calculation of individual positions, will be regulated by the Commission.

So far it remains unclear whether or to what extent net short positions held by different entities of the same corporate group or by funds managed by the same asset manager have to be aggregated for the purpose of calculating the relevant net short position. In Germany, the BaFin determined in connection with the transparency requirements for net short positions that positions that are held within a group of companies are not to be aggregated, so that transparency requirements will apply individually to each entity. In adopting that approach, the risk remains that investors may avoid transparency requirements by holding short positions below the relevant thresholds in shares traded on a Trading Venue through different legal entities. In addition, the Proposal also does not specify how net short positions in the same security that an investor holds in different EU Member States will be effectively disclosed since the notification requirements apply only on a national level.

Transparency Requirements for Sovereign Debt and CDSs

Under the Proposal, an obligation to notify the national financial regulatory authority of the respective EU Member State also exists if a position reaches or falls below a relevant notification threshold specified by the respective EU Member State or a threshold specified by the EU Commission with regard to either of the following:

- A net short position relating to issued sovereign debt of an EU Member State or of the EU
- An uncovered position in a CDS relating to an obligation of an EU Member State or the EU

Under the Proposal, a **sovereign debt** is defined as a debt instrument issued by the EU or an EU Member State, including debt instruments issued by any ministry, department, central bank, agency, or instrumentality of an EU Member State. The Proposal defines a **net short position in a sovereign debt** of an EU Member State or the EU as the short position remaining after deduction of any long position an investor holds in relation to the issued sovereign debt of the EU Member State or the EU from any short position that such investor holds in relation to the same debt. Technical details for the calculation of individual net short sovereign debt positions are left to be developed by the Commission.

An **uncovered position** in a CDS is referred to under the Proposal as a position in a CDS relating to an obligation of an EU Member State or the EU to the extent that such CDS is not hedging the risk of default of the issuer to which the protection buyer under the CDS is exposed to because of another investment. However, the Proposal clarifies that the protection seller in such situation is not considered to hold an uncovered position in such CDS because of its obligation to compensate the protection buyer in case of a credit event relating to the reference entity. The EU Commission shall provide specifications on cases in which the CDS is considered to be hedging against a default risk and the method for calculating uncovered positions in a CDS.

Notification and Disclosure Procedures

Any notification to the competent national financial regulatory authority of net short positions in shares, sovereign debt, or uncovered CDS positions, or disclosure to the public in relation to shares shall set out the following information:

- Details of the identity of the investor holding the relevant position
- The size of the relevant position
- The issuer in relation to which the relevant position is held
- The date on which the relevant position was created or ceased to be held

The Proposal considers 12:00 p.m. of a trading day as the relevant time for the calculation of a net short position held by an investor. In this context, the wording of the Proposal refers to net short positions only, but should also include uncovered CDS positions, as these positions are also subject to notification requirements under the Proposal. Notifications and disclosures with respect to that trading day shall be made until 3:30 p.m. on the respective next trading day. Since notification requirements refer to short positions with respect to financial instruments traded on a Trading Venue, the time specifications in the Proposal are likely referring to the relevant time zone of the respective Trading Venue.

In addition, pursuant to the Proposal, the European Securities and Markets Authority (**ESMA**)² shall develop drafts of the regulatory technical standards of the information to be provided. Where a public disclosure is required in relation to net short positions in shares, such disclosure shall be made public in a manner ensuring fast access to information on a nondiscriminatory basis and in accordance with officially appointed mechanisms of the home Member State (the home Member State has to be determined pursuant to Directive 2004/109/EC) of the issuer of the shares.

In addition, national financial regulatory authorities are obligated to notify ESMA on a quarterly basis of net short positions relating to shares or sovereign debt, and uncovered CDS positions for which the respective authority received notifications.

Requirements for Trading Venues/Flagging of Short Sales in Shares

Under the Proposal, natural or legal persons executing orders with respect to shares on a Trading Venue are obligated to flag sell orders as short orders if the seller is entering into a short sale of the share. Under the Proposal, the respective Trading Venue is required to publish at least once per day a summary of the volume of orders marked as short orders. The requirement for marking short sale orders will additionally increase transparency by providing additional information about the volume of short sales executed on a particular Trading Venue.

The Proposal, however, does not specify how Trading Venues and market participants are supposed to implement this requirement. Market participants, when they act as brokers, usually do not have the information necessary to determine whether a transaction constitutes a short sale for a particular customer. This requirement is, therefore, likely to result in a time-consuming information-request process—and the information obtained through such process will be difficult to verify.

In addition, Trading Venues where shares or sovereign debt instruments are admitted to trading are required to implement procedures that ensure settlement within four trading days after the day on which the trade takes place, or within six trading days after the day on which the trade takes place in case of market-making activities. In addition, such Trading Venues will have to introduce adequate arrangements that allow imposing sanctions in cases of late settlements of short sales.

2. ESMA shall be established and operational by January 1, 2011 in Paris as the new European financial supervisory authority. The EU Commission wishes to establish a European System of Financial Supervisors, comprising ESMA, a European Banking Authority, a European Insurance and Occupational Pensions Authority, and a European Systemic Risk Board. ESMA will replace the existing Committee of European Securities Regulators (**CESR**). In the future, ESMA will have authority (i) to develop legally binding technical standards, (ii) to ensure a consistent application of European rules by national supervisory authorities, (iii) to settle disagreements between national supervisory authorities, (iv) to safeguard the stability of financial markets in emergency situations based on special powers for specific actions, and (v) to authorize and monitor rating agencies and central counterparties, which act as neutral counterparties between contract parties in any derivative transaction. Unlike CESR, ESMA will have the power to address binding individual decisions to financial market participants.

Restrictions on Uncovered Short Sales

The Proposal bans uncovered short sales of (i) shares admitted to trading on a Trading Venue or (ii) sovereign debt instruments. Pursuant to the Proposal, a short sale of shares or sovereign debt instruments is only admitted if the seller has taken one of the following actions:

- Borrowed the share or sovereign debt instrument
- Entered into an agreement to borrow the share or sovereign debt instrument
- Ensured the share or sovereign debt instrument can be borrowed so that settlement can be effected when it is due

The scope of the Proposal's ban on uncovered short sales is not totally clear. Whereas the Proposal includes a provision on the application of the transparency requirements to investors outside the EU, no such provision is included in the Proposal with respect to uncovered short sales. However, since the Proposal applies to financial instruments admitted to trading on a Trading Venue, the ban on uncovered short sales is likely to also apply to investors residing outside the EU when trading with shares admitted to trading on a Trading Venue or with EU sovereign bonds.

Exemptions

The Proposal includes several exemptions with regard to transparency requirements and short selling restrictions. For example, exempted from the scope of the Proposal are shares of companies admitted to trading on a regulated market in the EU where the principal venue for the trading of the shares is located in a country outside the EU.

Also exempted from the transparency requirements and the short selling restrictions are certain market-making activities by market members of a market in a third country whose legal and supervisory framework has been approved by the EU Commission as being equivalent to EU law and who are subject to effective supervision and enforcement in such third country. The EU Commission still has to determine which third countries' supervisory frameworks it will refer to as equivalent to EU law. At present, it is not even clear whether the United States of America or other countries with similar regulatory requirements will be covered by the exemption.

In addition, exemptions exist for authorized primary dealers who are trading on the basis of an agreement with an issuer of sovereign debt as principal in a financial instrument in relation to primary or secondary market operations relating to the sovereign debt.

The competent national authorities shall notify the ESMA of any market makers and authorized primary dealers who are making use of the exemption and of any market makers and authorized primary dealers who are no longer making use of the exemption. The ESMA shall publish on its website a list of such market makers and authorized primary dealers and keep it up to date.

Intervention Powers of National Financial Regulators

The Proposal grants national financial regulatory authorities significant latitude to take measures in exceptional situations. An **exceptional situation** is defined as a situation that constitutes a serious threat to financial stability or to market confidence in the respective Member State. The measure taken by the national financial regulatory authority has to be necessary to circumvent the threat. It remains unclear, however, how a national financial regulatory authority would determine that such exceptional situation exists. The Proposal grants powers to the Commission to further define criteria for exceptional situations.

Under the Proposal, the financial regulatory authority of a Member State may temporarily implement additional transparency requirements or restrict short selling or other transactions that have similar effect in any financial instrument regardless whether such transactions are covered or uncovered. In exceptional situations, a financial regulatory authority may also restrict investors from entering into certain CDS transactions or CDS transactions of a specific class relating to an obligation of an EU Member State or of the EU itself. Financial regulatory authorities may in exceptional situations also limit the value of uncovered CDS positions that relate to an obligation of an EU Member State or the EU that may be entered into by investors.

National financial regulatory authorities are required to publish measures taken in such exceptional situations on their websites. Each such measure shall be initially limited to a period not exceeding three months from the date of its publication, but may be renewed for further periods not exceeding three months at a time.

In addition, national financial regulatory authorities are authorized to impose restrictions on short selling transactions in a financial instrument if the price of a financial instrument on a regulated market has fallen by 10% or more during a single trading day in case of a share. For other financial instruments the EU Commission may specify such amounts by separate announcement. Such measures shall, however, apply only for a period until the end of the trading day following the trading day on which the fall in price occurs.

Intervention Powers of the ESMA

The Proposal gives ESMA a central role in coordinating actions taken in exceptional situations and ensuring that such powers are exercised only when necessary. At least 24 hours before imposing any restriction, a national financial regulatory authority is obligated to notify ESMA and the national financial regulatory authorities of the EU Member States of the respective measures they intend to propose. Pursuant to the Proposal, ESMA will then issue an opinion within 24 hours on whether the respective measure is appropriate to address the threat and whether measures by other national financial regulators are necessary.

ESMA may even adopt measures itself which directly restrict or prohibit short selling in case of exceptional situations if no measures have been taken by the relevant national financial regulatory authorities, or if such measures are not sufficient to address the issue. ESMA may issue the same measures that a national financial regulatory authority would be empowered to issue. An ESMA measure will overrule any measure previously taken by the national financial regulatory authority of the affected EU Member State.

Obligation to Cooperate

The Proposal requires the national financial regulatory authorities of the EU Member States to cooperate and to assist each other, in particular with regard to on-site inspections or investigations. In cross-border cases, ESMA shall coordinate any such investigations or inspections. Under the Proposal, financial regulatory authorities shall also make arrangements with competent authorities in third countries for the exchange of information or the enforcement of measures.

Comparison to Bans/Requirements under National Law

The scope of uncovered short selling restrictions and transparency requirements under the Proposal diverges from corresponding national laws that have been enacted by some EU Member States to some extent. This is, for example, the case with regard to the German Stability Act, which came into effect in July this year and was aimed at preventing abusive securities and derivatives trading activities (**German Stability Act**).

Under the German Stability Act, the definition of uncovered short sales does not include short selling transactions if prior to the end of the respective trading day the seller of the securities becomes the owner of the securities or the owner of an absolutely enforceable claim to acquire title in a corresponding number of securities of the same class. Under the Proposal, in contrast, a natural or legal person may not enter into any short sale if no arrangements for a due settlement have been made at the time. It remains unclear, however, which level of surety has to be achieved so that settlement would be deemed as ensured under the Proposal.

In addition, whereas the short selling ban under the Proposal refers to shares and sovereign debt instruments traded on a Trading Venue, the scope of the trading ban under the German Stability Act is wider and also bans certain CDS transactions, including those embedded in a credit-linked note or a total return swap, if their reference obligation includes an obligation of an EU Member State and if the transaction is not intended to create an effective hedging position. For example, the ban under the Proposal covers transactions on MTFs within the EU, in addition to uncovered short sales of shares and debt instruments traded on regulated markets of the EU. The German Stability Act, on the other hand, does not cover trading on either MTFs or exchange-regulated markets, such as the Open Market of the Frankfurt Stock Exchange.

With regard to transparency requirements, the German Stability Act applies the same threshold in relation to shares as the Proposal. However, the German Stability Act, in contrast to the Proposal, does not impose an obligation on market participants to mark short sales in shares. The German Stability Act uses a different definition of the term “net short position in shares” than the Proposal. Under the Proposal, a net short position in shares of an issuer would be the position remaining after deducting any long position that an investor holds in shares of this issuer from any short position that such investor holds in the same shares. The German Stability Act, in contrast, includes in the definition of net short positions in shares other positions in financial instruments of an issuer that from an economic perspective result in a short position in shares of the respective issuer (including, for example, futures, put options, contracts of difference, and swaps). As a consequence, the scope of the transparency requirements under German Stability Act might be wider than under the Proposal.

Once the Proposal takes effect, market participants will still have to comply with the national regulations governing their transactions, to the extent that these national laws are more restrictive than the Proposal. For example, when executing activities in Germany or in connection with financial instruments traded on a German stock exchange, market participants will still have to comply with the German Stability Act because the Proposal will not automatically rescind the German regulation.

Outlook/Summary

The Proposal not only restricts short sales of shares, sovereign debt traded on a Trading Venue, and CDSs relating to an obligation of an EU Member State or the EU, but also imposes additional transparency requirements. The Proposal also provides for strong powers of ESMA and the national financial regulatory authorities of the EU Member States. ESMA or a national financial regulatory authority of an

EU Member State may, in exceptional situations, restrict short sales or similar transactions, whether covered or uncovered, with regard to any kind of financial instruments and may also impose additional transparency obligations. The exact scope of such powers in such exceptional situations is currently unclear and will have to be determined in practice.

The Commission regards the adoption of the Proposal as means to increase in the convergence of the EU's regulatory framework with the framework employed by the United States of America. In addition, a harmonization of short selling restrictions by EU Member States is intended to reduce compliance costs for market participants, which currently arise from the divergence of national rules. It remains questionable, however, whether the Proposal will achieve this aim, as market participants still have to comply with national rules where such national rules are more restrictive than the Proposal. As a consequence, market participants will have to comply with and monitor national *and* European provisions when approaching the EU or dealing with financial instruments traded on a regulated market within the EU or a European MTF, unless the EU Member States abandon their national rules.

We will keep you updated about further developments. If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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