Financial markets: short selling and certain aspects of credit default swaps

2010/0251(COD) - 15/11/2011 - Text adopted by Parliament, 1st reading/single reading

The European Parliament adopted by 507 votes to 25, with 109 abstentions, a legislative resolution on theproposal for a regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps.

The vote had been postponed from the 5 July session.

Parliament adopted its position at first reading under the ordinary legislative procedure. The amendments adopted in plenary are the result of a compromise negotiated between the European Parliament and the Council. They amend the Commission's proposal as follows:

Purpose: to ensure the proper functioning of the internal market and to improve the conditions of its functioning, in particular with regard to the financial markets, and to ensure a high level of consumer and investor protection, it is therefore appropriate to lay down a common regulatory framework with regard to the requirements and powers relating to short selling and credit default swaps and to ensure greater coordination and consistency between Member States where measures have to be taken in exceptional situations.

It is recalled that while in certain situations it may have adverse effects, under normal market conditions short selling plays an important role in ensuring the proper functioning of financial markets, in particular in the context of market liquidity and efficient price formation.

Transparency of net short positions: a natural or legal person who has a net short position in relation to the issued share capital of a company that has shares admitted to trading on a trading venue shall disclose details of that position to the public whenever the position reaches or falls below a relevant publication threshold referred to in the Regulation. 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.

The European Supervisory Authority (European Securities and Markets Authority – ESMA) may issue an opinion to the Commission on adjusting the thresholds referred to in the regulation, taking into account the developments in financial markets.

In addition, a natural or legal person who has a net short position **relating to the issued sovereign debt of a sovereign issuer** shall notify the relevant competent authority whenever such position reaches or falls below the relevant notification thresholds for the Member State concerned or the Union. **ESMA shall publish on its website** the notification thresholds for each Member State.

Natural and legal persons that hold significant net short positions **shall keep, for a period of five years**, records of the gross positions which make a significant net short position.

The text stipulates 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 has the relevant position. It shall apply to all transactions irrespective of the means of trading used, including transactions executed through either manual or automated trading, and irrespective of whether the transactions have taken place during normal trading hours.

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. This information shall be posted on a central website operated or supervised by the relevant competent authority. The competent authorities shall communicate the address of this website to ESMA, which, in turn, shall put a link to all such central websites on its own website.

The competent authority shall provide the requested information to ESMA at the latest within seven calendar days. **Where there are adverse events or developments** which constitute a serious threat to financial stability or to market confidence in the Member State concerned or in another Member State, the competent authority shall provide ESMA with any available information based on the notification requirements outlined in the Regulation within 24 hours.

In order to ensure **consistent application of these provisions**, ESMA shall develop draft regulatory technical standards specifying the details of the information to be provided. ESMA shall submit drafts for those regulatory technical standards to the Commission by 31 March 2012.

Uncovered Short Sales: uncovered short selling of shares and sovereign debt is sometimes viewed as increasing the potential risk of settlement failure and volatility. To reduce such risks it is appropriate to place **proportionate restrictions** on uncovered short selling of such instruments.

- Restrictions on uncovered short sales in shares and in sovereign debt:

A natural or legal person may only enter into a short sale of a share admitted to trading on a trading venue where one of the following conditions is fulfilled:

(a) the natural or legal person has borrowed the share; or has made alternative provisions resulting in a similar legal effect ;

(b) the natural or legal person has 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 ;

(c) the natural or legal person has 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 reasonable expectation that settlement can be effected when it is due.

Where the liquidity of sovereign debt falls below the threshold determined in accordance with the methodology referred to in paragraph 4, the restrictions referred to in paragraph 1 may be **temporarily suspended** by the relevant competent authority. Before suspending these restrictions, the relevant competent authority shall notify ESMA and other competent authorities about the proposed suspension.

The suspension shall be valid for an initial period not exceeding six months from the date of its publication on the website of the relevant competent authority. Such a suspension may be renewed for further periods not exceeding six months at a time if the grounds for the suspension continue to be applicable. If the suspension is not renewed after that six-month period, it shall automatically expire.

ESMA shall **within 24 hours after the notification by the relevant competent authority** issue an opinion based on paragraph 4 on any notified suspension or renewal of a suspension. The opinion shall be published on ESMA's web site.

ESMA shall, in particular, take into account the need to preserve liquidity of markets, especially sovereign bond markets and sovereign bond repurchase markets (repo markets).

- Restrictions on uncovered credit default swaps in sovereign debt: since entering into a sovereign credit default swap without underlying exposure to the risk of a decline in the value of the sovereign debt instrument may have an adverse impact on the stability of sovereign debt markets, natural or legal persons **should be prohibited from entering into such uncovered credit default swap position**s. However, at the first initial signals that the sovereign debt market is not functioning properly, the competent authority should be empowered to **suspend temporarily such a restriction**. Such a suspension should be based on the belief of the competent authority based on objective elements consisting of the analysis of certain indicators set out in this Regulation. However, competent authorities should be empowered to use additional indicators.

The suspension shall be valid for an initial period not exceeding twelve months from the date of its publication on the website of the relevant competent authority. Such a suspension may be renewed for further periods not exceeding six months at a time. ESMA shall within 24 hours after the notification by the relevant competent authority issue an opinion on the intended suspension or on the renewal of that suspension. The opinion shall be published on ESMA's web site.

- Buy-in procedure: the new Regulation also imposes requirements on central counterparties relating to buy-in procedures and fines for failed settlement of transactions in those shares.

Notification by lenders in exceptional situations: the new Regulation provides that the competent authority of a Member State may require natural or legal persons who have net short positions in relation to a specific financial instrument or class of financial instruments to notify it or to disclose to the public details of the position whenever the position reaches or falls below a notification threshold fixed by the competent authority, where all the following conditions are fulfilled:

(a) there are adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State concerned or in one or more other Member States;

(b) the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits.

Power to temporarily restrict short selling of financial instruments in case of a significant fall in price: where the price of a financial instrument on a trading venue has significantly fallen during a single trading day in relation to the closing price on that venue on the previous trading day, the competent authority of the home Member State for that venue shall consider whether it is appropriate to prohibit or restrict natural or legal persons from engaging in short selling of the financial instrument on that trading venue or otherwise limit transactions in that financial instrument on that trading venue in order to prevent a disorderly decline in the price of the financial instrument.

A competent authority shall notify ESMA about any decision of this nature so that ESMA can immediately inform the competent authorities of the home Member States of venues which trade the same financial instrument and, if necessary, assist those authorities in reaching an agreement in accordance with Article 19 of Regulation (EU) No 1095/2010.

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. ESMA shall publish a report setting out its findings and any recommendations relating to the issue or practice within three months as from the end of the inquiry.

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 this 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.

Delegated acts: power to adopt acts in accordance with Article 290 TFEU is delegated to the Commission in respect of details concerning calculating short positions, when a natural or legal person has an uncovered position in a credit default swap, and notification or disclosure thresholds. ESMA should play a central role in the drafting of delegated acts by delivering advice to the Commission.