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

2010/0251(COD) - 14/03/2012 - Final act

PURPOSE: to lay down a common regulatory framework with regard to the requirements and powers relating to short selling and credit default swaps in order to ensure a high level of consumer and investor protection.

LEGISLATIVE ACT: Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps

CONTENT: following an agreement negotiated in first reading, the European Parliament and Council adopted a Regulation on short selling and certain aspects of credit default swaps which introduces **common EU transparency requirements and harmonises the powers that regulators may use in exceptional situations** where there is a serious threat to financial stability. The United Kingdom delegation abstained.

At the height of the financial crisis in 2008, several Member States adopted emergency measures to restrict or ban short selling in some or all securities in order to counter a downward spiral in the prices of shares that could create systemic risks. "Uncovered" or "naked" short selling is a practice where the seller has not made arrangements to borrow the security.

As the EU lacks a common regulatory framework for dealing with short selling, Member States adopted divergent measures. The current fragmented approach limits the effectiveness of the adopted measures and results in regulatory arbitrage. It may also create confusion in the markets and impose additional costs on market participants. The Regulation is intended to address these issues, whilst acknowledging the role of short selling in ensuring the proper functioning of financial markets, in particular in providing liquidity and contributing to efficient pricing.

The main points of the Regulation are as follows:

Scope: in order to provide for a preventive regulatory framework to be used in exceptional circumstances, the Regulation covers **all types of financial instruments but provides for a response proportionate to the potential risks** posed by the short selling of different instruments. It is only in the case of exceptional circumstances that competent authorities and ESMA are entitled to take measures concerning all types of financial instruments, going beyond the permanent measures that only apply to particular types of instruments where there are clearly identified risks that need to be addressed.

Transparency of significant net short positions: for **shares admitted to trading on a trading venue in the Union,** a **two-tier model** is introduced, that provides for greater transparency of significant net short positions in shares at the appropriate level: (i) at the lower threshold, notification of a position should be made privately to the regulators concerned; (ii) at the higher threshold, positions should be publicly disclosed to the market. 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.

A requirement to notify regulators of significant net short positions relating to sovereign debt in the Union should be introduced as such notification would provide important information to assist regulators in monitoring whether such positions are in fact creating systemic risks or being used for abusive purposes. Such a requirement should only include private disclosure to regulators as publication of information to

the market for such instruments could have a detrimental effect on sovereign debt markets where liquidity is already impaired.

For **sovereign debt**, on the other hand, significant net short positions relating to issuers in the EU will always require private disclosure to regulators. The proposed regime also provides for notification of significant positions in credit default swaps that relate to EU sovereign debt issuers.

Natural and legal persons that hold significant net short positions shall keep, **for a period of 5 years,** records of the gross positions which make a significant net short position.

The text states that 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 holds the relevant position.

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.

Restrictions on uncovered short selling in shares: to reduce the risks of uncovered short selling of shares, the Regulation provides that a natural or legal person may enter into a short sale of a share admitted to trading on a trading venue only where that person has: (i) **borrowed the share** or has made alternative provisions resulting in a similar legal effect; or (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 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 a reasonable expectation that settlement can be effected when it is due.

However, these restrictions don't apply to the short selling of sovereign debt if the transaction serves to hedge a long position in debt instruments of an issuer. Moreover, if the liquidity of sovereign debt falls below a specified threshold, the restrictions on uncovered short selling may be temporarily suspended by the competent authority.

Exceptional situations: in exceptional situations that threaten financial stability or market confidence in a Member State or the EU, the Regulation provides that competent authorities should have temporary powers to require greater transparency or to impose restrictions on short selling and credit default swap transactions or to limit individuals from entering into derivative transactions.

In such a situation, the European Securities Market Authority (ESMA) is given a key coordination role, to ensure consistency between competent authorities and to guarantee that such measures are only taken where they are necessary and proportionate. ESMA is also given the power to take measures where the situation has cross-border implications.

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.

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 the 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.

Review and report: by 30 June 2013, the Commission shall, in light of discussions with the competent authorities and ESMA, report on:(i) the appropriateness of the notification and disclosure thresholds; (ii) the impact of the individual disclosure, in particular with regard to the efficiency and volatility of financial markets; (iii) the appropriateness of direct, centralised reporting to ESMA; (iv) the operation of the restrictions and requirements in the Regulation (v) the appropriateness of the restrictions on the uncovered sovereign credit default swaps and (vi) the appropriateness of any other restrictions or conditions on short selling or credit default swaps.

ENTRY INTO FORCE: 25/03/2012.

APPLICATION: from 01/11/2012 (certain provisions will apply from 25/03/2012).

DELEGATED ACTS: the Commission is empowered to adopt delegated acts in respect of details concerning calculating short positions, where a natural or legal person has an uncovered position in a credit default swap, notification or disclosure thresholds and further specification of criteria and factors for determining in which cases an adverse event or development creates a serious threat to financial stability or to market confidence in a Member State or the Union.

The power to adopt delegated acts is conferred on the Commission for an indeterminate period of time. A delegated act shall enter into force only if no objection has been expressed either by the European Parliament or the Council within a period of two months of notification (which may be extended by two months). If the European Parliament or Council objects, the delegated act shall not enter into force.