



European Commission Public Consultation on Short Selling

On 14 June 2010, the European Commission (the “Commission”) published a public consultation to aid the finalisation of proposals on stand alone legislation dealing with short selling (the “Consultation”).¹ The Consultation aims to: 1) consider policy options in respect of rules that will increase the transparency of short sales, 2) reduce the risks of uncovered (naked) short selling, and 3) provide emergency powers for competent authorities to impose temporary short selling restrictions. It also gives some consideration to the role that the European Securities and Markets Authority (“ESMA”) may play in this regard.

Increased Transparency

The Consultation closely follows the publication of a March 2010 report and feedback statement by the Committee of European Securities Regulators (“CESR”) that set out proposals for a pan-European model for the disclosure of short positions in EU shares (the “CESR Report”).² The contents of the CESR Report (and technical details in respect thereof) are outlined in our updates on 9 March 2010³ and 2 June 2010.⁴ In summary, CESR’s model (the “Model”) proposes a two tiered disclosure system, whereby short sellers first make private disclosure to their relevant national regulator, at the end of each trading day where their net short position reaches 0.2% of an issuer’s issued share capital. Each further movement of 0.1% of issued share capital (upwards or downwards above the 0.2% threshold) will then trigger further disclosure obligations to the regulator. However, once their net short position is greater than 0.5% of the issuer’s issued share capital, the short seller will have to make a second public disclosure of its position to the market as a whole.

The policy options of the Commission are closely predicated upon CESR’s Model, which is proposed to apply to EEA issuers with short positions that create an economic exposure to any share admitted to trading on an EEA-regulated market and/or an EEA Multilateral Trading Facility (“MTF”). This might include economic net short positions in shares created by the use of derivatives such as options, futures, and CFDs. However, the Commission has asked in the Consultation, whether the future legislation should follow CESR’s suggestions as outlined above, or apply the regime only to EU shares and EU sovereign bonds. On the basis of the latter approach, the Commission has suggested following CESR’s two tiered disclosure regime in respect of EU shares. However, in respect of EU sovereign bonds, they propose to introduce a regime that only requires notification to regulators (following the relevant net short position reaching, exceeding or falling below a particular notification

¹ The European Commission, “Public Consultation on Short Selling”:

http://ec.europa.eu/internal_market/consultations/docs/2010/short_selling/consultation_paper_en.pdf.

² Committee for European Securities Regulators, “Model for a pan-European short selling disclosure regime,” CESR/10-088, March 2010:

http://www.cesr.eu/data/document/10_088.pdf.

³ MoFo, “CESR Proposals for a Pan-European Short Selling Regime”: <http://www.mofo.com/files/Uploads/Images/100409CESR.pdf>.

⁴ MoFo, “CESR Releases Technical Details of the Pan-European Short Selling Disclosure Regime”:

<http://www.mofo.com/files/Uploads/Images/100602CESR.pdf>.

threshold). This is on the basis that the potential impact of public disclosure on sovereign bond markets still needs to be assessed.

The Consultation also sets out further details in respect of the mechanics of notification. It is suggested that the relevant time for calculating a net short position should be at midnight at the end of each trading day, and that disclosure would need to be made no later than 3:30 p.m. on the next trading day. The same method for reporting transactions under the Markets in Financial Instruments Directive (MiFID) is proposed to be used to make the relevant notifications. The Commission highlights that a further policy option might include a requirement for each competent authority to provide summary information to ESMA on a quarterly basis. ESMA would also be able to request further information if required.

Uncovered Short Sales

“Uncovered” or “naked” short selling arises where a short seller has not borrowed the securities that are the subject of the short sale (or ensured that such securities can be borrowed). If the seller does not manage to obtain the required shares within the relevant time frame, this is likely to result in settlement failure, and consequently the potential for price volatility is increased. A similar concept exists in relation to naked credit default swaps (“CDS”). The purchase of a CDS in circumstances where the protection buyer does not own the underlying reference obligation can, economically speaking, be the same as taking a naked short position with respect to such reference obligation.

Although the concepts of naked short selling and naked CDS were given little more than passing mention in the CESR Report, the Consultation seeks views in respect of suggested solutions to the risks that these practices generate. This may be in part due to the increased impetus given to such issues following the unexpected actions of Germany in unilaterally banning naked short sales and naked CDS of sovereign Eurozone bonds.

The Commission proposes placing conditions on short selling, such that a person would only be permitted to enter into a short sale contract if they have either borrowed the referenced share in question, or have an agreement in place to borrow it by the time of settlement. The second requires that trading venues (EEA-regulated markets and/or an MTF), will be required to ensure that if there is settlement failure in respect of any uncovered short sales, then procedures are triggered to buy the relevant shares for settlement.

It is not entirely clear from the Consultation whether the Commission intended equivalent rules to apply to naked CDS transactions. Given that investors will often use an imperfect hedge to offset their risk, determining what is and what is not a naked CDS may be difficult. These issues do, however, invite comments on whether there should be a ban or limitations on parties entering into naked CDS transactions.

Exemptions

With regard to any possible exceptions from future legislation on short selling, the Commission considers that the recommendations in the CESR Report are appropriate. Specifically, market makers who are genuinely acting in their capacity as providers of liquidity in the market should be exempt from disclosure obligations. The Commission has invited views on whether such exemptions should apply to rules governing uncovered as well as covered short sales.

Powers of Competent Authorities

The proposed European legislation on short selling is also likely to provide competent authorities with certain powers to impose temporary restrictions on short selling and CDS transactions, in circumstances where there is a serious threat to financial stability in either a Member State or the European Union. It is proposed that in respect of short sales, the competent authority will be able to impose conditions which restrict their use. With regard to

credit default swaps, the relevant competent authority will be able to restrict or prohibit the purposes for which persons may enter into such transactions.

It is further suggested in the Consultation, that ESMA will perform a facilitation and co-ordination role in relation to any action taken under these emergency powers. The aim is that ESMA can ensure a consistent approach to the nature of the measures taken, as well as the commencement and duration. In this regard, a competent authority will be required to notify ESMA and every other competent authority before any action is taken. Such notice should be provided at least 24 hours before it is intended to take effect, unless there are exceptional circumstances which prevent this provision. In response, ESMA would issue advice over the action that is proposed to be taken. To the extent that the competent authority opts to act contrary to ESMA's advice, such competent authority would have to publish a notice setting out its rationale for doing so.

It is worth noting, however, that it is envisaged ESMA will retain its emergency powers under Article 10 of the Regulation Establishing a European Securities and Markets Authority.⁵

Enforcement

The Commission has suggested that competent authorities may also be given new powers to enforce provisions of the proposed legislation. This may include the ability to seek further information from a person regarding the purposes for which they have entered into a particular credit default transaction.

Responses

The fund industry, in particular, has previously expressed concern regarding the public disclosure of short positions, on the basis that such actions may harm liquidity and increase costs. In addition, the recent German action in relation to banning naked short selling and CDS has been viewed with considerable skepticism. This is in part on the basis that there is little or no evidence to suggest that the recent Greek sovereign debt crisis had been greatly exacerbated by the use of naked short selling or naked CDS. Further, it is widely acknowledged that a substantial proportion of CDS activity takes place outside of Europe in New York. Consequently, any European restrictions may be capable of being avoided by investors moving their activities outside the EU. We therefore expect that there will be a number of vigorous responses to the Consultation, which remains open for comments until 10 July 2010.

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⁵ 2009/0144 (COD).

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