

Client Alert

Latham & Watkins
Corporate Department

Update: Pan-European Short Selling Regulation – The Implications for US Market Participants

Overview

This edition¹ of our update on the pan-European short selling Regulation² focuses on the implications of the Regulation for market participants in the United States (US). In particular, we focus on market participants whose trading activities are conducted in the US in financial instruments that have a nexus with the European Union (EU), such as a parallel EU listing of a financial instrument or an EU listing of the underlying financial instrument. Such activities, which may subject the market participant not only to the US short selling regime, but also to the Regulation,³ include short sales of (i) certain American Depositary Receipts (ADRs) of EU-listed issuers, and (ii) dual listed securities of issuers that are concurrently listed on one of the EU and US trading venues.

The Regulation applies only to those financial instruments (i) that are admitted to trading on a trading venue in the EU, and (ii) whose principal trading venue (defined below) is determined to be in the EU. The Regulation applies regardless of whether the financial instrument is traded on or off-exchange (*i.e.*, over-the-counter). The Regulation defines “financial instrument” broadly⁴ and includes all transferable securities and derivative contracts relating to securities that are traded on an EU trading venue.⁵

In this *Client Alert*, we discuss the application of some of the key provisions of the Regulation as they relate to (i) ADRs, and (ii) dual-listed securities that are traded in the US. We have also compared certain fundamental concepts and definitions in the Regulation with those found in the US regulatory regime in Regulation SHO (Reg SHO)⁶ under the US Securities Exchange Act of 1934, as amended (the Exchange Act).

Application of Articles 3, 5 and 12 of the Regulation to ADRs and Dual-Listed Securities Traded in the US

The Regulation’s definition of a “financial instrument” includes all transferable securities. Transferable securities, in turn, are defined as those classes of securities which are negotiable on the capital markets (with the exception of instruments of payment), such as shares in companies, partnerships or other entities, as well as

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*depository receipts in respect of shares, bonds or other forms of securitized debt, including depository receipts in respect of such securities, and any other securities giving the right to acquire or sell any such transferable securities.*⁷

Central to the Regulation is the concept of the “principal trading venue” for a financial instrument. This is determined based on the trading volume for the financial instrument on the relevant trading venues,⁸ calculated in accordance with the provisions of the Delegated Regulation.⁹ The Regulation requires the European Securities and Markets Authority (ESMA) to publish a list of shares whose principal trading venue is determined to be outside the EU (List of Exempted Shares).¹⁰ Thus, shares included on the List of Exempted Shares will not be subject to the Regulation when it becomes applicable on November 1, 2012.¹¹

There are currently 10,087 issuers included on the List of Exempted Shares published on October 4, 2012.¹² We understand that this List of Exempted Shares is a consolidation of the information provided by Member State competent authorities to ESMA.¹³ Each Member State competent authority was required to compile a list of shares admitted to trading in its respective jurisdiction, whose principal trading venue the competent authority determined to be located outside the EU. In compiling and providing their respective lists of exempted shares, it appears that several competent authorities included ADRs.¹⁴

ADRs

We have compared the List of Exempted Shares to a list of European issuers that have ADRs admitted to trading in the US, based on their International Securities Identification Number (ISIN). There are currently over a thousand European issuers listed on one or more of the EU trading venues whose ADRs are admitted to trading on either the New York Stock Exchange, NASDAQ or the American Stock Exchange. Our comparison of the two lists reflects at least 78 common issuers whose shares would be exempt from the Regulation.

Article 3 of the Regulation prescribes the manner in which short, net short and long positions are to be calculated, in respect of both “shares” and “financial instruments” other than shares. Article 5 of the Regulation addresses the transparency or reporting requirements, including the private and public notification thresholds further described in “Transparency Obligations” (below), in respect of net short positions *in relation to* the issued share capital of a company that has shares admitted to trading on an EU trading venue. The Delegated Regulation provides guidance on “in relation to” and states that a holding of shares, or any exposure through a financial instrument other than a share which confers a financial advantage in the event of an increase or decrease in the price or value of the share, must be taken into account when calculating the short and net short position in a relevant financial instrument.¹⁵ The financial instruments to be considered include options, futures, covered warrants, contracts for difference, units in ETFs, complex derivatives and global depository receipts.¹⁶ The inclusion of global depository receipts within the list of financial instruments that should be considered in calculating a short position suggests, by analogy, that ADRs may also be included in such calculations.

Based on the analysis above and the information provided by ESMA at this time, it thus appears possible that the ADRs that are not included in the List of Exempted Shares¹⁷ will be subject to the reporting obligations under the Regulation. We have included details in respect of the reporting obligations in the section on “Transparency Obligations” (below).

In contrast to the language of Articles 3 and 5 of the Regulation, Article 12, which addresses uncovered short sales and in particular restricts “uncovered short sales in shares,” makes no corresponding reference to financial instruments. Instead, the provisions of Article 12 appear to be limited to shares. We note that the List of Exempted Shares is not limited to “shares” whose principal trading venue is outside the EU, as a number of Member State competent authorities have also included ADRs. This suggests that at least some Member State competent authorities might view shares and ADRs as essentially fungible for these purposes. If this were the case, ADRs would also be subject to the Regulation’s ban on uncovered short sales. In the absence of clarification from ESMA, we believe it cannot be ruled out that ESMA might take the position that the ban on naked short sales also applies to ADRs.

Dual-Listed Securities

We have also compared the List of Exempted Shares with a list of EU issuers whose ordinary shares are concurrently admitted to trading on an EU trading venue and on one of the New York Stock Exchange, NASDAQ or the American Stock Exchange, on a name-by-name basis (as a comparison on an ISIN basis was not possible). Our comparison of the two lists identifies at least 31 issuers in common. Based on our understanding of the Regulation and absent further clarification from ESMA, we believe that US short selling activity in the shares of the remaining issuers admitted to trading in the US, but not included in the List of Exempted Shares, will be subject to the transparency requirements and the prohibition on naked short sales under the Regulation.

Analysis of Certain Key Concepts and Definitions of Reg SHO and the Regulation

Both the Regulation and Reg SHO seek to eliminate abusive short selling while preserving the ability to engage in legitimate short sales. However, as further described below, the EU and US regulatory regimes differ in the scope of activities and financial instruments subject to regulation and the availability of exemptions. Perhaps most significantly, the Regulation and Reg SHO place the obligation to locate the security sold short on different market participants. Under Reg SHO, the broker-dealer has to perform the locate. Under the Regulation, the locate obligation falls on the short seller.

The discussion below focuses on (A) the definitions of “short sale” and “ownership,” (B) the “locate” requirement, including the treatment of naked short sales, and (C) net short positions. For each of these topics, we briefly compare the treatment of these matters under each of the EU and the US regulatory regimes.

Definition of Short Sale and Ownership

The concepts of “ownership” and “holding” are similar across the Regulation and Reg SHO – the party bearing the eventual economic risk is generally deemed to “own” the applicable security.

Short Sale - Regulation

The Regulation defines a short sale of a share as any sale of the relevant share that the seller “does not own at the time of entering into the agreement to sell,” regardless of whether the seller has borrowed or agreed to borrow the share for

delivery at settlement. However, any short sale pursuant to a repurchase agreement, a transfer of securities under a securities lending agreement, a futures contract or other derivatives contract pursuant to which one party agrees to sell shares at a specified price at a future date is not deemed a short sale.¹⁸ We have examined the concept of ownership below.

Short Sale - Reg SHO

Under Reg SHO, a short sale is defined as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”¹⁹ Many of the substantive provisions of Reg SHO, including the locate requirement described below, are limited to equity securities.²⁰ The term “equity security” includes “any stock or similar security, certificate of interest or participation in any profit sharing agreement, reorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.”²¹ A security convertible into an equity security is an equity security. Thus, short sales of convertible bonds are subject to Reg SHO. As for any security, including structured products, to which the “equity” status may not be clear, the SEC will consider such status and the application of certain aspects of Reg SHO on a case-by-case basis.²²

Ownership – Regulation

The concepts of “ownership” and “holding” with respect to financial instruments are not uniformly defined or harmonized in the EU under the respective laws of the Member States. However, for the purposes of the short selling regime, “ownership” is defined in terms of ultimate beneficial ownership, regardless of who is the actual or apparent “holder” of the instrument. A beneficial owner is regarded as the “investor who assumes the economic risk of acquiring a financial instrument.”²³ A “holder” is one who either has (i) legal ownership of a share, or (ii) the possession of an enforceable claim to be transferred ownership of a share.²⁴

Unlike under Reg SHO, the Regulation provides for broad latitude with respect to securities futures contracts and repurchase agreements, with the seller effectively being deemed to own the relevant security. Reg SHO, in keeping with the more prescriptive nature of the US securities laws, defines ownership quite specifically (as further described below). With respect to futures contracts, for example, a holder will only be considered an owner where such holder has received notice that the contract will be physically settled and is irrevocably bound to receive the security.

Ownership – Reg SHO

Ownership is determined in accordance with Rules 200(a)-(f) of Reg SHO. Under Rules 200(b) and (c), a person will be deemed to own a security if (1) the person or his agent has title to it, (2) the person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it, (3) the person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange, (4) the person has an option to purchase or acquire it and has exercised such option, (5) the person has rights or warrants to subscribe to it and has exercised such rights or warrants,

or (6) the person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security, in each case only to the extent that such person has a net long position in such securities. In addition, in certain limited circumstances, brokers and/or dealers will be deemed to own a security even if they are not net long. In particular, a broker-dealer that engages in block positioning will be able to disregard economically neutral bona fide arbitrage, risk arbitrage and bona fide hedge positions involving short stock components in determining its net position in the block positioned security.²⁵

Obligation to Locate

Both the Regulation and Reg SHO include locate requirements designed to limit the occurrence of naked short selling,²⁶ which could otherwise result in fails to deliver on settlement date.²⁷ The two regimes, however, approach this locate requirement quite differently.

Regulation

The Regulation imposes an obligation on a short seller to ensure that the shares that are subject to the proposed short sale have been borrowed or “located” so that the short sale is covered.²⁸ Short sellers may satisfy this locate requirement by:

- Borrowing the shares or making alternative provisions resulting in a “similar legal effect”²⁹
- Entering into an agreement with a third party³⁰ (including investment firms) to borrow the shares, or entering into an agreement with an “absolutely enforceable claim” under contract or property law to have “ownership” of a corresponding number of securities of the same class transferred so that settlement can be effected when it is due, or
- Having an agreement with a third party under which the third party has confirmed that the shares have been “located” and there is a “reasonable expectation” that settlement can be effected when it is due.³¹ The Regulation regards “reasonable expectation” to constitute allocation of the share for borrowing or purchasing so that settlement can be effected when it is due. With regard to short sales proposed to be covered on a same-day basis, the third party must confirm that it considers the shares “easy to borrow or to purchase.” The Implementing Regulation³² specifies that in order to be deemed “easy to borrow or purchase,” the relevant shares must (i) meet certain liquidity requirements as set out in the MiFID implementing regulations,³³ or (ii) be shares that are included in the main national equity index of the relevant Member State, and which are also the underlying financial instrument for a derivative contract admitted to trading on a trading venue³⁴

ESMA has clarified that a naked short sale entered into by one legal entity within a corporate group will not be regarded as a “covered” short sale even if the relevant financial instrument is owned, held or subject to a locate agreement, by another legal entity within the same group.³⁵

The Regulation provides for a limited exemption from the general prohibition on naked short selling for bona-fide market making activities of market participants that satisfy certain prescribed criteria. Under the Regulation and ESMA’s consultation on the market making exemption, such criteria include: (i) membership in a trading venue, (ii) dealing as principal, (iii) holding oneself out as a market maker, and (iv) posting firm, simultaneous two-way quotes.³⁶ Further, a market maker is required to notify each Member State competent authority of the

jurisdiction in which such market maker will act, on an instrument-by-instrument basis, at least 30 calendar days before the intended first use of this exemption.

Reg SHO

Unlike the locate requirement of the Regulation, the obligations of Reg SHO rest with the broker-dealer. Rule 203(b) of Reg SHO requires a broker-dealer to (i) borrow the applicable security or enter into a bona-fide arrangement to borrow the applicable security, or (ii) have "reasonable grounds" to believe that the applicable security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security. This "locate" must be made and documented prior to effecting the short sale, regardless of whether the seller's short position may be closed out by purchasing securities on the same day.³⁷

"Reasonable grounds" is not specifically defined and is determined based on the facts and circumstances of a particular transaction. The SEC has stated that in the absence of countervailing factors, "easy to borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities. However, in order for it to be "reasonable" for a broker-dealer to rely on such lists, the information used to generate the "easy to borrow" list must be less than 24 hours old, and the securities on the list must be readily available such that it would be unlikely that a failure to deliver would occur. A broker-dealer may also satisfy the "reasonable grounds" standard under Rule 203(b)(1)(ii) if it obtains an assurance from a customer that such party can obtain securities from another identified source in time to settle the trade. However, where the broker-dealer knows or has reason to know that the customer's prior assurances resulted in failures to deliver, assurances from such customer would not provide the "reasonable grounds" required by the rule.³⁸

There are limited exceptions to the locate requirement, including with respect to (i) bona fide market making activities,³⁹ (ii) situations where another broker-dealer has accepted responsibility for compliance with Rule 203(b)(1),⁴⁰ (iii) situations where a broker-dealer has been reasonably informed that a person owns the relevant security and will deliver it as soon as all restrictions on delivery have been removed, and (iv) security futures.⁴¹

The market making exception allows market makers, as defined in Section 3(a)(38) of the Exchange Act,⁴² to fulfill their obligation to sell the applicable security on a regular and continuous basis at a publicly quoted price, even when there are shortages of that security in the market.⁴³ This market making exception, however, is limited and does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer or that is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.⁴⁴

We note that this indirect attempt to limit naked short sales by way of the locate requirement of Reg SHO is further supported by the following rules:

- Rule 204 under Reg SHO is intended to further the goals of reducing fails to deliver and addressing potentially abusive naked short selling in equity securities by requiring the delivery of securities by settlement date or, in connection with a short sale, the immediate purchase or borrow of such securities to close out a fail to deliver position by no later than the beginning of regular trading hours on the following settlement day.⁴⁵
- Rule 10b-21 under the Exchange Act specifies that it is unlawful for any person to submit an order to sell a security if that person deceives a broker-dealer,

participant of a registered clearing agency, or purchaser regarding his/her intention, or ability, to deliver the security by settlement date and that person fails to deliver the security by settlement date.⁴⁶

- Selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the security's price would run afoul of the anti-fraud and anti-manipulation rules under the Exchange Act.⁴⁷

Key Distinctions

The locate requirement is fundamental to both the Regulation and Reg SHO to ensure that settlement can be effected when due, with each regulatory regime providing that "reasonable" grounds or expectations, such as "easy to borrow" lists, are sufficient to satisfy this requirement. Key distinctions include:

- The Regulation and Reg SHO place the onus on different market participants. Under Reg SHO, the broker-dealer has to comply with the locate requirement and document such compliance. Under the Regulation, the short seller is required to ensure that the shares that are the subject of the proposed short sale have been located. We note, however, that the Regulation permits the seller to agree with an investment firm to borrow or locate the shares on the seller's behalf. Thus, as a practical matter, the market impact of each regime may be quite similar.
- The locate requirement under the Regulation is more restrictive than under Reg SHO, as the market maker exemption is the only such exemption under the EU regime. Reg SHO, on the other hand, takes a practical, operational approach to the locate requirement and allows for a number of circumstances where reasonable delays in delivery may occur. This approach seems appropriate particularly given the regulatory choice to obligate the broker-dealer to perform the locate as opposed to the short seller, as under the Regulation.

Net Short Position

Regulation

A "short position" is either a short sale of a share or the entry into a transaction in a financial instrument other than a share, where the effect or one of the effects of the transaction is to confer a financial advantage on the person in the event of a decrease in the price or value of the share.⁴⁸ A net short position, in turn, is defined as the difference between any "long position...in the issued share capital [and] any short position...in relation to that capital."⁴⁹

Under the Regulation, the calculation of a net short position must take into account any position held directly, or indirectly, by way of an index, basket of securities, warrants, options, interest in an exchange traded fund or other investment products. However, short positions on financial instruments that give rise to a claim to unissued shares, subscription rights, convertible bonds and other comparable instruments are not included in the calculation of a "net short position"⁵⁰ as ownership of these financial instruments is not considered a long position under the Regulation.⁵¹ The Delegated Regulation also specifies that the method of settlement (cash or physical) is irrelevant to the calculation of a net short position.

As mentioned in our last *Client Alert*,⁵² the Regulation employs a delta adjusted model for the calculation of net short positions in relation to shares, including derivatives, and states that such calculations must take into account "transactions in all financial instruments, whether entered into on or outside a trading venue, that confer a financial advantage in the event of a change in price or value of the share."⁵³ The Delegated Regulation also specifies the method for calculating short

positions in relation to investment fund management activities on both an individual and a managed portfolio basis. In summary, the managing entity is required to aggregate the net short positions in those funds and those portfolios under its management only (including delegated management) that pursue the same investment strategy. In the case of umbrella structures, the calculation of the net short position must take place at the level of the respective subfunds. In the case of master-feeder structures, it takes place at the level of the respective master fund.⁵⁴

Reg SHO

As described above, the definition of short sale includes any sale of a security that the seller does not own. Rule 200(c), in turn, specifies that a person shall be deemed to own securities only to the extent the person has a net long position in such securities. In order to determine a market participant's net short position, Reg SHO generally requires such market participant to aggregate all of its positions in a security on an entity-wide basis. However, under Rule 200(f), the SEC adopted aggregation unit netting, allowing multi-service brokers or dealers to aggregate their positions within defined trading units rather than on a firm-wide basis, provided that (1) the broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity,⁵⁵ (2) each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades, (3) all traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit, and (4) individual traders are assigned to only one aggregation unit at any time.

Key Distinctions

Both the Regulation and Reg SHO include the concept of netting short and long positions. Key distinctions include:

- The Regulation and Reg SHO differ in how they make use of the concept of net short position. Under Reg SHO, the determination of whether a market participant is net short in a given security generally serves to establish whether such market participant is subject to Reg SHO in the first place with respect to a particular transaction. Under the Regulation, on the other hand, the determination of net short positions also serves to establish the disclosure obligations of the participant described under "Transparency Obligations" (below).
- The calculations under the Regulation to establish the reportable net short position are more nuanced than is the case under Reg SHO. Under the Regulation, any derivative or cash position must be accounted for on a delta-adjusted basis, with all cash positions being assigned a delta-1. The delta for a derivative must be calculated based on the current implied volatility of the derivative and the closing price or last price of the underlying instrument. Shares held as part of a basket, index or exchange traded fund also form part of the calculations (taking into account the weight of that share in the underlier). The net short position in a derivative or cash position will therefore be the difference between the long and short delta-adjusted positions.
- The Regulation requires that netting occur essentially on a portfolio basis (across entities managed for the same purpose, etc.). Under Reg SHO, on the other hand, the general rule is that netting is entity-based, with Rule 200(f) allowing a broker-dealer to further limit the aggregation of net positions to specified divisions within the firm.

US Compliance with the Regulation

Enforcement and Liabilities

The Regulation provides that any infringement of the Regulation which has an impact on the financial instruments admitted to trading on an exchange in a Member State shall be enforced by that relevant Member State, in accordance with its domestic penalties and administrative measures. The only requirement imposed on Member States is that the penalties must be “effective, proportionate and dissuasive.”⁵⁶ The Regulation recognizes that certain enforcement measures may involve monitoring or enforcing actions against persons outside the EU – the Member State competent authorities, under ESMA’s coordination, are required to engage in cooperation agreements concerning the exchange of information and the enforcement of obligations with regulatory peers in third countries where the EU shares and associated derivatives are traded

Transparency Obligations

The Regulation establishes a two-tier disclosure regime, divided between:

- “Private” (confidential) disclosure of the following net short positions to the Member State’s competent authority where the relevant trading venue is located:
 - A net short position of 0.2 percent (the Initial Private Disclosure Threshold) of the issued share capital of a company admitted to trading on an EU trading venue must be reported to the Member State competent authority of such company, or the competent authority of the Member State in which the financial instrument was first admitted to trading.
 - In addition to the above base-reporting requirement, further reporting obligations to the competent authority are triggered (i) for each 0.1 percent increase in the net short position above the Initial Private Disclosure Threshold, for example 0.3 percent, 0.4 percent and so on (the Additional Private Disclosure Thresholds), and (ii) where the net short position falls below an Additional Private Disclosure Threshold or the Initial Private Disclosure Threshold, for example from 0.4 percent to 0.3 percent, from 0.3 percent to 0.2 percent and below.⁵⁷
- “Public” disclosure of the following net short positions where the relevant trading venue is located:
 - A net short position of 0.5 percent (the Initial Public Disclosure Threshold) of the issued share capital of a company admitted to trading on a trading venue must be disclosed to the public in accordance with the provisions of the Regulation.⁵⁸
 - In addition to the above base-reporting requirement, further reporting obligations to the public are triggered (i) for each 0.1 percent increase in the net short position above the Initial Public Disclosure Threshold, for example at 0.6 percent, 0.7 percent and so on (the Additional Public Disclosure Thresholds), and (ii) where the net short position falls below an Additional Public Disclosure Threshold or the Initial Public Disclosure Threshold, for example from 0.7 percent to 0.6 percent, from 0.6 percent to 0.5 percent and below.⁵⁹

The public disclosure obligation is in addition to any private disclosure requirements of a short seller, and entails publication of the net short position via a central website that is operated and supervised by the relevant competent authority. The first private and public disclosures will be due at 15:30 local time for the applicable principal trading venue on November 2, 2012. ESMA has been granted discretion

to adjust the thresholds regarding both the private and the public disclosure requirements, based on prevailing market conditions.⁶⁰

Exempted from the transparency requirements of the Regulation are (i) market makers in their capacity as market makers, (ii) authorized primary dealers in their capacity as primary dealers, (iii) persons carrying out legitimate, authorized stabilization activity, and (iv) shares of a company admitted to trading on a trading venue in the EU where the principal trading venue of the shares is located in a non-EU country.⁶¹

Compliance

In light of the potential enforcement actions and liabilities described above, compliance departments within US trading operations, including fund managers, investment banks and other financial institutions, should determine whether their trading activities could be subject to the Regulation. Compliance policies should be implemented to ensure that if such trading occurs, appropriate procedures will be triggered to ensure compliance. Initial measures to consider include:

- Ensure that the Middle-Office and Back-Office have calibrated all technical systems to calculate the firm's net short position in each issuer at the end of each trading day (at midnight). Calculations must be calibrated to take into account short positions held directly and indirectly (e.g. by way of any index, basket of securities or interest in an ETF or similar entity).
- Ensure specific Compliance personnel are tasked with making the required disclosures to the relevant Member State competent authority by 15:30 at the applicable primary trading venue on the following trading day (please refer to the section referencing "Transparency Obligations" (above)).
- Incorporate the format of the disclosure template for all private notifications to be made to the Member State competent authority into the firm's procedures.
- Incorporate the format of the public disclosure template into the firm's procedures.
- Incorporate the format of the cancellation form for erroneous notifications into the firm's procedures.
- Ensure that the internal methodology for the calculation of the firm's long position, short position and net short position for each financial instrument is consistent with the requirements of the Regulation.
- Where the firm has an investment management arm, or is a discretionary investment manager, ensure that the calculations for the firm's long position, short position and net short position for each financial instrument are conducted at the level of each legal entity (fund level) and at each portfolio level. The net short positions held by each fund and each portfolio that follows the same investment strategy in relation to a particular issuer must be aggregated.
- Consider whether any agreements with clients that have strict confidentiality provisions with respect to trading and/or investment strategies could be impacted by the Regulation's public disclosure requirements.
- Ensure the firm's record-keeping policies incorporate the five-year requirement to retain short selling trade documentation.
- If the firm has an EU based market-making arm/division and wishes to avail itself of the market-making exemption under the Regulation, submit a completed application to the relevant Member State competent authority on an instrument-by-instrument basis no later than 30 calendar days before the intended first use of this exemption.⁶²
- Conduct training sessions for trading desk, Middle Office and Back Office personnel on the new Regulation and practical, day-to-day requirements of the implementing and delegated regulations.

Endnotes

- ¹ See our most recent *Client Alert* entitled "[Pan-European Short Selling Regulation](#)," dated September 20, 2012.
- ² Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (the Regulation).
- ³ On the flip side, the US Securities and Exchange Commission (the SEC) has made clear that any broker-dealer using United States jurisdictional means to effect short sales in securities traded in the United States would be subject to Regulation SHO (as further described in this *Client Alert*), regardless of whether the broker-dealer is registered with the SEC or relying on an exemption from registration. The proposing release in connection with Regulation SHO explains that the short sale regulations apply to trades in reported securities when the trades are agreed to in the United States, even if the trades are booked overseas. Whether a short sale is executed or agreed to in the United States, in turn, depends on the particular facts and circumstances of the applicable transaction. See SEC Release No. 34-50103 (July 28, 2004), 69 Fed. Reg. 48008 (the Reg SHO Adopting Release), at 48014. See also SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Response to Question 1.3, available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.
- ⁴ For purposes of the Regulation, "financial instrument" covers any instrument listed in section C, Annex 1 of the MiFID Directive. See Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (the MiFID Directive).
- ⁵ For purposes of this *Client Alert*, we have restricted our analysis to shares and derivative instruments based on shares. The term "share" is not defined under either the Regulation or the MiFID Directive. We have therefore considered a "share" to bear its ordinary meaning, *i.e.*, as a unit in the share capital of any body corporate (wherever incorporated) and any unincorporated body constituted under the law of a country or territory (as per the UK Financial Services and Markets Act 2000 (Regulated Activities) Order 2001).
- ⁶ 17 C.F.R. 242.200-204. Reg SHO sets forth the requirements for conducting short sale transactions in equity securities. In addition to Reg SHO, there are other rules and regulations that may also apply to short sales, including the margin requirements of Regulation T of the Federal Reserve Board. Market participants conducting short sale transactions are responsible for complying with Reg SHO as well as any other rules and regulations that may apply to their short sale transactions.
- ⁷ Title 1, Article 4 (18), MiFID Directive. The definitions of the MiFID Directive are incorporated by reference into the Regulation.
- ⁸ The Regulation defines a "trading venue" as an EU regulated market or a multi-lateral trading facility (MTF). Article (2)(1)(l), Regulation.
- ⁹ Commission Delegated Regulation (EU) No 826/2012 of 29 June 2012 supplementing Regulation (EU) No 236/2012.
- ¹⁰ Article 16(2) of the Regulation requires ESMA to publish every two years a list of shares for which the principal trading venue is located in a non-EU country. The ESMA webpage on Short Selling states that this information will be published before the first trading day of April every two years.
- ¹¹ Article 16(2), Regulation.
- ¹² Available at <http://www.esma.europa.eu/page/List-exempted-shares>.
- ¹³ Answer 1(e), "Questions and Answers; Implementation of the Regulation on short selling and certain aspects of credit default swaps (1st Update)," ESMA/2012/666, published on October 10, 2012.
- ¹⁴ Based on the information included on the ESMA website, the countries include Belgium, Denmark, France, Germany, Greece, Ireland, Spain, The Netherlands and the United Kingdom.
- ¹⁵ Articles 5 and 6, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.
- ¹⁶ Annex 1, Part 1, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.
- ¹⁷ Our analysis reflects at least 935 ADRs.

¹⁸ Article 2(1)(b), Regulation.

¹⁹ Rule 200(a) of Reg SHO.

²⁰ See SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Response to Question 1.4, available at <http://www.sec.gov/divisions/marketreg/mfaqregsho1204.htm>.

²¹ See Section 3(a)(11) of the Exchange Act and Rule 3a11-1 promulgated thereunder.

²² See SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Response to Question 1.4, available at <http://www.sec.gov/divisions/marketreg/mfaqregsho1204.htm>.

²³ Chapter II, Article 3, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.

²⁴ Chapter II, Article 4, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.

²⁵ Rule 200(d). Block positioning occurs when a broker-dealer acts as principal in taking all or part of a block order placed by a customer in order to facilitate a transaction that might otherwise be difficult to effect in the ordinary course of trading. The block positioner may then seek to sell the securities so acquired. See Reg SHO Adopting Release, at 48011.

²⁶ Broadly speaking, there are three “types” of short sales in a regulatory context: (i) a hard short – where the seller borrows the share before the sale is entered into, (ii) a regular short – where the seller locates a borrow before the sale is entered into, and (iii) a naked short – where the seller has not borrowed the shares or located the shares for effective settlement.

²⁷ See Reg SHO Adopting Release, at 48009.

²⁸ Article 12, Regulation.

²⁹ Agreements with a distinct, legal third party to borrow shares and other arrangements having similar legal effect include: (i) a repurchase agreement covering at least the number of shares subject to the short sale, (ii) futures, options and swap contracts leading to a physical settlement of the relevant shares, (iii) a securities lending agreement for the relevant shares, and (iv) an agreement leading to delivery of the shares such that settlement can be effected when it is due. Where such arrangements have been entered into with a third party located in a non-EU country, the European Commission requires that the third party be subject to appropriate supervision and that there are appropriate arrangements for exchange of information between regulatory supervisors (e.g., where the third party is a signatory to the Multilateral Memorandum of Understanding Covering Consultation and Cooperation and the Exchange of Information under the International Organization of Securities Commissions (IOSCO)).

³⁰ ESMA has established a pre-determined list of the type of entities that can qualify as “third parties,” including investment firms, central counterparties (CCPs), securities settlement systems, central banks and a regulated/supervised person established in a third country who is authorized or registered and meets the equivalence requirements under the Regulation. Chapter IV, Article 8, Commission Implementing Regulation (EU) No 827/2012 of 29 June 2012 relating to Regulation (EU) 236/2012.

³¹ Chapter IV, Article 6, Commission Implementing Regulation (EU) No. 827/2012 of 29 June 2012 relating to Regulation (EU) No 236/2012.

³² Commission Implementing Regulation (EU) No. 827/2012 of 29 June 2012 relating to Regulation (EU) No 236/2012.

³³ See Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC available at http://www.esma.europa.eu/system/files/Reg_1287_2006.pdf.

³⁴ Chapter IV, Article 6, Commission Implementing Regulation (EU) No. 827/2012 of 29 June 2012 relating to Regulation (EU) No 236/2012.

³⁵ Answer 5(a) to “Questions and Answers, Implementation of the Regulation on short selling and certain aspects of credit default swaps,” (ESMA/2012/572).

³⁶ ESMA/2012/580, Consultation paper: Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of credit default swaps, published 17 September 2012.

³⁷ Under Rule 203(b) of Reg SHO, the broker-dealer effecting the short sale has the responsibility to perform the locate. The documentation required by Rule 203(b)(1)(iii) should include the source of securities cited by the customer. The broker-dealer should also be able to demonstrate that there are “reasonable grounds” to rely on the customer’s assurances. See Reg SHO Adopting Release, at 48014.

³⁸ See Reg SHO Adopting Release, at 48014.

³⁹ The term “bona-fide market making” refers to bona-fide activities described in Section 3(a)(38) of the Exchange Act. Whether activity is “bona-fide” will depend on the facts and circumstances of the particular activity. See SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Response to Question 4.8, available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

⁴⁰ This “broker to broker” exception applies only to transactions undertaken between broker-dealers registered in the US pursuant to the requirements of Section 15(a) of the Exchange Act. US broker-dealers must treat an assurance from a non-US registered broker-dealer that it obtained a source of securities that can be delivered in time for settlement in the same manner as an assurance originating from a non-broker-dealer customer. Moreover, the US broker-dealer must document this information, including the source of the securities obtained by the foreign broker-dealer and support for the reasonableness of the US broker-dealer’s reliance on the foreign broker-dealer’s assurances. See SEC Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Response to Question 4.6, available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

⁴¹ Rule 203(b)(2) of Reg SHO.

⁴² Section 3(a)(38) of the Exchange Act states: “The term ‘market maker’ means any specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer quotation system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.”

⁴³ This may occur, for example, (i) if there is a sudden surge in buying interest in a particular security, (ii) if few investors are selling a particular security at a given point in time, or (iii) in thinly traded, illiquid stocks such as securities quoted on the OTC Bulletin Board, as there may be few shares available to purchase or borrow at a given point in time. See SEC Division of Market Regulation: Key Points About Regulation SHO (April 11, 2005).

⁴⁴ See Reg SHO Adopting Release, at 48015.

⁴⁵ See FINRA Regulatory Notice 10-35 (August 2010).

⁴⁶ See SEC Release No. 34-58774 (October 14, 2008).

⁴⁷ See Reg SHO Adopting Release, at 48013. See also SEC Division of Market Regulation: Key Points About Regulation SHO (April 11, 2005).

⁴⁸ Article 3(1), Regulation.

⁴⁹ Article 3(4), Regulation.

⁵⁰ Article 7, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.

⁵¹ Answer 3(c) to “Questions and Answers, Implementation of the Regulation on short selling and certain aspects of credit default swaps (1st Update),” ESMA/2012/666.

⁵² See our most recent *Client Alert* entitled “[Pan-European Short Selling Regulation](#),” dated September 20, 2012.

⁵³ Article 3(7)(c), Regulation. Please also refer to Annex II of Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012 for further details.

⁵⁴ Chapter IV, Article 12 and Article 13, Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012.

⁵⁵ According to the SEC, the independence of the units would be evidenced by a variety of factors, such as separate management structures, location, business purpose, and profit and loss treatment. See Reg SHO Adopting Release, at 48011.

⁵⁶ Article 41, Regulation.

⁵⁷ Chapter II Article 5, Regulation.

⁵⁸ Chapter II Article 9, Regulation.

⁵⁹ Chapter II Article 6, Regulation.

⁶⁰ Chapter II Articles 5 and 6, Regulation.

⁶¹ Chapter IV Article 17, Regulation.

⁶² In order for any non-European Economic Area (non-EEA) entity to be able to use the market making activities exemption as defined in the Regulation, the market in its home jurisdiction is required to be subject to a legal and supervisory regime which is equivalent to the MiFID Market Abuse Directive and Transparency Directive and should be declared “equivalent” by the European Commission. However, the European Commission has not issued any equivalence decision at this time; therefore no non-EEA entity can claim the use of the market making exemption under the Regulation in relation to a third country market at this time. Question/Answer 8, “Questions and Answers; Implementation of the Regulation on short selling and certain aspects of credit default swaps (1st Update),” ESMA/2012/666, published on October 10, 2012.

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