

Client Alert

Latham & Watkins
Finance Department

Pan-European Short Selling Regulation

I. Introduction and Overview

As previously described in our *Client Alert* on the pan-European short selling regulation,¹ the European Commission (the Commission) adopted a proposal on September 15, 2010 to harmonize the regulation of short sales and credit default swaps across the European Union.² On March 14, 2012, the European Parliament and the Council of the European Union (the Council) each voted to adopt the proposed regulation, after including a number of significant amendments (the Regulation).³

The Regulation has been in force since March 25, 2012 (a day after it was published in the Official Journal) and is due to become 'directly' effective in the EU Member States (each a Member State) on November 1, 2012.⁴ As such, the Regulation will become law in each Member State in its own right without the need for domestic implementing measures. On September 13, 2012 the European Securities and Markets Authority (ESMA) published its first edition of Q&A on the 'Implementation of the Regulation on short selling and certain aspects of credit default swaps,' in response to frequently asked questions posed by market participants, market regulators and the general public.⁵ On September 17, 2012, ESMA published its consultation paper on the Regulation's exemption for market making activities and primary market operations.

The Regulation brings to an end the current fragmented approach to shortsale restrictions across Member States and also establishes a 'preventive regulatory framework' to be used in 'exceptional circumstances' for 'temporary' periods.

In this *Client Alert* we summarize the key aspects of the Regulation as well as the accompanying Implementing Regulation and the three Delegated Regulations which were published in the Official Journal on September 18, 2012, and which entered into force on September 19, 2012. As with the Regulation, save for certain provisions, the Implementing Regulation and Delegated Regulations will become directly effective on November 1, 2012. The suite of Implementing Regulation and Delegated Regulations set out the technical regulatory standards on the various subjects identified in the body of the Regulation — read together they form the overarching pan-European short selling regulatory framework. We have analyzed the short selling regulatory framework as it relates to shares and derivatives only. We have not extended our analysis to include sovereign debt or credit default swaps. This *Alert* also includes a list of measures that you may wish to incorporate and implement to ensure your firm's compliance with the Regulation by November 1, 2012.

"Compliance departments within trading entities, including investment managers, may wish to consider the points on page 6 of this *Alert* to ensure that their policies and procedures will be compliant by November 1, 2012."

II. Scope and Application

A. Principal Trading Venue

The Regulation applies to those financial instruments that are admitted to trading on EU regulated markets and multilateral trading facilities (MTF) (each a Trading Venue) in the European Union and whose principal Trading Venue is in the EU. The Regulation continues to apply to the relevant financial instruments even when they are traded outside a Trading Venue. However, the requirements of the Regulation do not apply if the principal Trading Venue of the relevant instrument is located outside the EU. The concept of the principal Trading Venue is defined within the Regulation and is determined based on trading volume, calculated in accordance with the provisions of the Delegated Regulation.⁸ ESMA has already published a list of shares admitted to trading on an EEA regulated market, and this list will constantly be updated and managed by ESMA.⁹ The Regulation also requires ESMA to publish a list of shares whose principal trading venue is deemed to be outside the EU on or around September 27, 2012 (35 days before the Regulation takes direct effect).

B. Extra-Territoriality of the Regulation

The Regulation has extraterritorial effect — the requirements apply regardless of where the person effecting the short sale is domiciled or established or where the trade may be booked or executed, provided that the relevant financial instrument is admitted to trading on a Trading Venue in the EU.

C. Exemptions Under the Regulation

The Regulation does not apply to (i) UCITS,¹⁰ (ii) certain defined market making activities or (iii) legitimate share stabilization activity pursuant to the EU Market Abuse Directive.¹¹ The market participants engaging in these activities may however continue to be subject to information requests by the applicable Member State competent authorities or ESMA.

D. Market Making Activities Exemption

ESMA's consultation paper on 'Exemption for market making activities and primary market operations under Regulation (EU) 236/2012' contains guidelines for the practical application of these exemptions. The closing date for responses to the consultation is October 5, 2012, with final guidelines proposed to be adopted in November 2012.

In summary, 'market making activities' is defined as the activities of (i) a MiFID financial institution, (ii) which is a member of a Trading Venue or a third-country trading platform, (iii) which deals as principal in a financial instrument by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, that provides liquidity on a regular and ongoing basis to the market, (iv) as part of its usual business, in response to clients' requests to trade, or (v) by hedging positions arising from the fulfilment of the tasks outlined above. Under the Regulation, the 'market maker' status is not automatic even where a trader or an institution satisfies all the conditions outlined above — a written notification to the competent authority at least 30 calendar days before the intended first use of the exemption is required. The relevant competent authority has discretion to deny such status on the notifier if it considers that the notifier does not adequately satisfy the conditions of the exemption. The competent authority also has the discretion and the authority to later withdraw its permission in respect of the exemption.

The guidelines stipulate that short positions must only be held for 'brief periods,' that arbitrage activities and proprietary trading activities are not considered market making activities under the scope of the Regulation and that the exemption applies on a per instrument basis (not globally with respect to any short selling activities).

With respect to derivatives and exchange-traded funds, market making activities on a 'related' financial instrument are permitted, provided that the market maker notifies the competent authority of its intent to use the exemption on that particular category of related financial instruments, and that the trades in these instruments relate to hedging activity.

E. Third-Country Market Making Activities

The Regulation includes in its definition of 'market making activities' a "third-country entity" and "...a member of a trading venue or of a market in a third country, the legal or supervisory framework of which has been declared equivalent by the Commission..." Article 17 requires an entity intending to rely on the market making exemption to notify the relevant competent authority of its intention to do so. Article 17(2) of the Regulation specifies that the Commission may render a decision that a particular third country has an equivalent legal and supervisory framework for its markets. However the Commission has not yet published any equivalency declarations. This may make it impossible for third-country market makers to qualify for the market making exemption under the Regulation until such equivalency declarations are published.

III. Key Provisions of the Regulation

A. Transparency — private and public disclosure requirements

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

'Private' 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 a 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 at 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.¹²

'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.
- 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.¹³

The public disclosure obligation is in addition to any private disclosure requirements of a shortseller. The first private and public disclosures will be due at 3:30 p.m. local time in the jurisdiction of the relevant 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.¹⁴

Exempted from the transparency requirements of the Regulation are (i) market makers in their capacity as market makers, (ii) persons carrying out legitimate, authorized stabilization/activity¹⁶ and (iii) 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.¹⁷

B. Net Short Positions in Shares

The Regulation defines a 'net short position' as the difference between the long position in a relevant financial instrument that is held by a natural or legal person and the short position in that financial instrument. The Delegated Regulation provides that (i) the holding of a share through a basket of shares (via a long position or a short sale) should be taken into account, (ii) cash settlement or physical delivery of the underlying asset is irrelevant for the purposes of the calculations, (iii) short positions on financial instruments subject to subscription rights, convertible bonds, other comparable instruments and a claim to unissued shares, do not form part of the calculation and should therefore not be taken into account.

The Delegated Regulation sets out the parameters of the delta-adjusted model for shares in relation to net short positions. In summary, any derivative and cash position must be accounted for on a delta-adjusted basis, with the cash position having 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 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 managed 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.

For group structures the net short and long positions of all the legal entities within the group are required to be aggregated and netted against each other.

The Implementing Regulation adopts technical standards on notification and disclosure requirements with regard to net short positions. The technical standards seek to standardize the content and format for disclosure and publication of details that short position holders will be required to provide to the relevant Member State competent authorities, and in turn, such competent authorities to ESMA (on a quarterly basis or when requested). The Commission has adopted similar technical standards with regard to public disclosure of significant net short positions. Public disclosure on net short positions must be published in the specified standard format, via a central website that is operated or supervised by the relevant competent authority.

C. Restrictions on Naked Short Sales

At the height of the financial crisis in September 2008, several Member States adopted emergency measures to restrict or ban short selling in some or all securities. However, there was a wide variation in the definitions and interpretations of what constituted "short selling" and "naked short selling" across Member States. In addition to standardizing the definition of a 'short sale', the Regulation harmonizes the restrictions in respect of 'any sales of the share or debt instrument which the seller does not own', and sets out the parameters with respect to ownership. Under the Regulation uncovered short selling or 'naked' shorting of shares is prohibited.¹⁹

However, arrangements between buyers and sellers of shares where the seller has borrowed the security or entered into arrangements with 'similar legal effect' will not constitute naked short selling. 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.²⁰ Where such arrangements have been entered into with a third party located in a non-EU country, the 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. an IOSCO²¹ signatory).

D. Settlement Risk

Under the Regulation, every central counterparty (CCP) in a Member State is required to ensure 'settlement discipline,' *i.e.* the CCP must impose a buy-in procedure on all clearing members where such clearing member is unable to deliver the relevant shares for settlement within four business days after the day on which settlement is due. Any subsequent failure in respect of delivery of the relevant shares must be penalized appropriately by the CCP, by imposing not only cash compensation requirements but also a daily fine for ongoing failure to deliver such shares. Although the delegated regulation that addresses the manner in which the CCPs are required to set the buy-in procedure or the penalties has yet to be published, we do expect that these requirements, once finalized, will likely have an impact on CCP margin requirements for clearing members and may result in potential membership fee increases to mitigate any risks of enforcement of the buy-in or penalty requirements.

E. Regulatory Intervention in 'Exceptional Circumstances'

The Regulation clarifies and grants 'temporary' intervention powers to both the relevant competent authority and ESMA in circumstances where there are 'adverse events' or developments that constitute a serious threat to financial stability or market confidence. Measures available to a competent authority include (i) increased transparency requirements (including requiring securities lenders to notify the competent authority of any significant change in the fees associated with the lending of a particular security), (ii) the imposition of a circuit-breaker prohibiting or restricting the entry into a short sale on the Trading Venue for a maximum of three trading days where the fall in value of the relevant share is 10 percent or more in a single trading day for liquid shares²² and as the Commission specifies for less liquid instruments, (iii) an outright prohibition on short selling for a period of time or (iv) an imposition of conditions on a short sale or transactions that indirectly create short positions.

The Regulation stipulates that any intervention measures imposed either by the relevant competent authority or ESMA should only be 'temporary' — a maximum initial period of three months, subject to renewal as prevailing market conditions require. The Delegated Regulation lists the factors and criteria that must be taken into account in determining "adverse events." If a Member State intervenes in its domestic market, it is required to notify ESMA of the measures taken, and ESMA has 24 hours to confirm its opinion on such Member State's measures.

ESMA has been granted controversial sweeping powers to intervene in the domestic capital markets of Member States in circumstances where ESMA concludes that there is a threat to the stability of the EU financial system and that the Member State(s) has not adequately addressed the threat(s) within its borders. In 'exceptional circumstances' ESMA may, in consultation with the European Systemic Risk Board (ESRB), take any of the measures that Member States are permitted to, without

the need to consult the relevant Member State(s) or issue an opinion. Further, any measure adopted by ESMA will prevail over any previous measure taken by a competent authority.

IV. Compliance with the Regulation — Next Steps

Compliance departments within trading entities, including investment managers, may wish to consider the following points in ensuring that their policies and procedures will be compliant by November 1, 2012.

- 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 mid-night of each trading day. 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 competent authority by 3:30 p.m. local time on the following trading day.
- Incorporate the format of the private disclosure template 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 also at each portfolio level.
- Amend any agreements with clients, which have strict confidentiality provisions with respect to trading and/or investment strategies to take into account the Regulation's public disclosure requirements.
- Ensure the firm's record-keeping policies incorporate the 5-year requirement to retain short selling trade documentation.
- If the firm has a market making arm/division and wishes to avail itself of the market making activities exemption under the Regulation, submit a completed notification to the relevant competent authority no later than October 2, 2012 (30 calendar days before November 1, 2012).
- 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 Latham & Watkins LLP *Client Alert, Fifth Update: Pan-European Short Selling Proposals and Status Update on Global Short-Selling Restrictions* (March 15, 2011), available at <http://www.lw.com/thoughtLeadership/ec-pan-european-short-selling-proposals>.
- ² The Commission, *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps*, 2010/0251 (September 15, 2010), available at www.ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf.
- ³ Regulation (EU) No 236/2012 of the European Parliament and of the Council of March 14, 2012 on short selling and certain aspects of credit default swaps.

- ⁴ Although the provisions granting the Commission power to adopt delegated acts or implementing or regulatory technical standards (or similar) came into effect on March 25, 2012.
- ⁵ See <http://www.esma.europa.eu/system/files/2012-572.pdf>.
- ⁶ Implementing Regulation (EU) No 827/2012 of June 29, 2012 laying down implementing technical standards with regard to Regulation (EU) No 236/2012.
- ⁷ Commission Delegated Regulation (EU) No 826/2012 of June 29, 2012 supplementing Regulation (EU) No 236/2012.
- ⁸ Article 6 of the Delegated Regulation.
- ⁹ See <http://mifiddatabase.esma.europa.eu/>
- ¹⁰ Undertakings for collective investment in transferable securities — see Directive 2009/65/EC of the European Parliament and of the Council of July 13, 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.
- ¹¹ Directive 2003/6/EC of the European Parliament and of the Council of January 28, 2003 on insider dealing and market manipulation.
- ¹² See Regulation, Chapter II Article 5.
- ¹³ See Regulation, Chapter II Article 6.
- ¹⁴ See Regulation, Chapter II Articles 5 and 6.
- ¹⁵ See Regulation, Chapter IV Article 17.
- ¹⁶ See Regulation, Chapter IV Article 17.
- ¹⁷ See Regulation, Chapter IV Article 17.
- ¹⁹ Article 3 (Specification of the term 'ownership' and defining a short sale) and Article 4 (Holding), Delegated Regulation.
- ²⁰ Article 5 (Agreements to borrow and other enforceable claims having similar effect), and Article 8 (Third parties with whom arrangements are made), Implementing Regulation.
- ²¹ International Organization of Securities Commissions.
- ²² Calculated in accordance with the provisions of the Delegated Regulation.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Vladimir Maly
+44.20.7710.1884
vladimir.maly@lw.com
London

Stephen P. Wink
+1.212.906.1229
stephen.wink@lw.com
New York

Gitanjali P. Faleiro*
+1.212.906.1645
gitanjali.faleiro@lw.com
New York

*Not admitted to practice in New York. Qualified as a Solicitor in England and Wales.

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