

New European Short Selling Regulation to Take Effect November 1

From November 1, 2012, EU Regulation 236/2012 on short selling and certain aspects of credit default swaps (the “SSR”) will come into force. The SSR will harmonize rules on short selling across the European Economic Area (“EEA”),¹ and will affect all investment managers, including U.S. managers, engaged in short sales of shares primarily traded in Europe, or short sales of sovereign debt of European countries (including entering into credit default swaps in respect of such debt).

The final text of the SSR has been available since March. However, the text of an Implementing Standards Regulation - 827/2012 (“DISR”) and two Delegated Regulatory Standards Regulations – 918/2012 and 919/2012 (“DRSRs”), which supplement the SSR, have only recently been finalized. Moreover, the European Securities and Markets Authority (“ESMA”) has only published various lists (discussed below) and updated its Q&A on the SSR in the last month. As the final pieces of the short selling puzzle fall into place, we have set forth below some of the typical questions, particularly those asked by non-EEA asset managers, which we have encountered in the run-up to implementation of the SSR.

What are the basic requirements under the SSR?

The SSR will require managers to disclose short positions relating to EEA shares and sovereign debt (the “Transparency Requirements”) and places restrictions on managers who wish to take uncovered or “naked” short positions on such securities (the “Restrictions on Uncovered Positions”).

Will non-EEA managers, including those located in the United States, be subject to the SSR?

The SSR states expressly that the Transparency Requirements apply to “*natural and legal persons domiciled or established within or outside the [EEA]*”. The SSR is silent on the application of the Restrictions on Uncovered Positions to anyone located outside the EEA. ESMA takes the view in its Q&A on the SSR that the Restrictions on Uncovered Positions also apply globally – neither (a) the domicile or place of establishment of the person entering into a relevant transaction nor (b) the place of the transaction, including a non-EEA country, will be relevant in this regard. (As discussed below, territorial issues regarding the securities sold short may still have to be considered in order to determine whether the SSR applies to a transaction.)

Which securities will the SSR govern?

The SSR will govern:

- a) Shares that are admitted to trading/traded on a trading venue (i.e., a regulated market or Multilateral Trading Facility (“MTF”)) in the EEA, where the principal trading venue for the share is in the EEA (“Eligible Shares”). For example, shares of a company domiciled in the USA which are admitted to trading on a trading venue in Germany but whose principal trading venue is located in the USA would be exempt from the Transparency Requirements and Restrictions on Uncovered Positions (an “Exempt Share”). ESMA has published the list of Exempt Shares [here](#). Any shares admitted to trading on an EEA trading venue which are not Exempt Shares will be Eligible Shares.

¹ The EEA comprises: (a) the European Union (“EU”) Member States - Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom; plus (b) Iceland, Liechtenstein and Norway. Switzerland is not a member of the EEA.

- b) Debt instruments issued by any EU Member State (including ministry, agency or SPV) and various EU agencies, and credit default swaps (“CDS”) referencing such instruments (“Eligible Debt”). The currency in which Eligible Debt is issued is irrelevant. For example, US\$ bonds issued by the Spanish government would be covered. The location of the venue on which the Eligible Debt is traded is also irrelevant. For example, CDS trades executed or booked outside the EEA will be subject to the SSR.

What will the Transparency Requirements be for managers with respect to Eligible Shares?

Managers will be required to report a net short position of:

- a) 0.2% of the total issued Eligible Shares, such report to be made privately to the relevant regulator in the Member State where the Eligible Shares were first admitted to trading and updated to reflect each further 0.1% increase or fall up to 0.5%;
- b) 0.5% of the total issued Eligible Shares, such report to be made publicly to the trading venue for those Eligible Shares and updated to reflect each further 0.1% increase or fall.

How will net short positions in Eligible Shares be calculated?

Long and short positions in the issuer will have to be netted using a delta adjusted model. Long positions will need to include holdings in Eligible Shares and transactions in financial instruments, including options, index related instruments, units in an ETF and swaps (irrespective of whether cash or physical settlement of the underlying has been agreed), which confer a financial advantage in the event of an increase in the price or value of the Eligible Shares. Short positions will include positions in any of the financial instruments above where the position confers a financial advantage in the event of a decrease in the price or value of the Eligible Shares. Calculations are to be made as a percentage of the total “issued share capital” excluding claims to subscription rights, convertible bonds or similar instruments.

What will the Transparency Requirements be for managers with respect to Eligible Debt?

Instead of single notification thresholds, ESMA has published a monetary amount for each issuer of Eligible Debt (the “Threshold List”). The notification threshold will be calculated as a percentage of that monetary amount under two categories:

- a) for issuers where the total amount of outstanding debt for a particular Member State is not more than €500 billion, the reporting threshold is 0.1% and each 0.05% thereafter; and
- b) for issuers where the total amount of outstanding debt for a particular Member State is over €500 billion (or there is a “liquid futures market”), the reporting threshold is 0.5% and each 0.25% thereafter.

The Threshold List can be found [here](#). Generally, the relevant regulatory authority to whom reports will have to be made will be the securities regulator in the EU State in which the issuer is located.

How will net short positions in Eligible Debt be calculated?

As is the case with Eligible Shares, long and short positions in an issuer of Eligible Debt will have to be netted using a delta adjusted model, with derivative positions also being taken into account. In calculating long positions, a manager will have to include the sovereign debt of any other sovereign issuer where the pricing of that sovereign debt is highly correlated to the Eligible Debt. For Eligible Debt with liquid market

prices, correlation is measured on a historic basis. Where there is no liquid market, a proxy instrument with a similar correlation will need to be used.

Where a manager manages several portfolios containing Eligible Shares or Eligible Debt, where will the net short positions need to be calculated?

Managers will be required to calculate positions at a fund or a managed portfolio level whereby: (a) each fund or portfolio with a short “investment strategy”, i.e. one that results in a short position in an issuer of Eligible Shares or Eligible Debt, will have to be considered; and (b) these positions will then have to be aggregated at the level of the entity which makes the relevant investment decision (the “Management Entity”). The manager will not, therefore, have to include those funds or managed portfolios subject to a strategy which results in a long position. Any short investment strategy to be included does not have to relate to a particular issuer of Eligible Shares or Eligible Debt only but can relate to a market or sector. A manager will be required to include positions that have been delegated to it, as Management Entity, from a third party and exclude positions that have been delegated from it to a third party. As a Management Entity, a manager will only be responsible for aggregating any net short positions in respect of the portfolio(s) over which it has full discretion – execution-only mandates are excluded. Where these aggregated net short positions reach or exceed a relevant notification or disclosure threshold, the manager will have to submit a report to the regulatory authority with jurisdiction over the issuer of the Eligible Shares or Eligible Debt.

What happens where different Management Entities in a group have net-short positions?

Where a Management Entity is the direct or indirect parent of other Management Entities, that parent and all of its subsidiary Management Entities will be a group for the purposes of the SSR (a “Group”). In this case, the net short positions in Eligible Shares or Eligible Debt in a particular issuer held by Group members will need to be aggregated. Where the aggregated positions of the Group exceed a relevant reporting threshold, an entity acting on behalf of the Group will need to report the Group’s net short position. Where the net short position held by a Management Entity reaches a relevant threshold, but the aggregated positions of the Group to which it belongs do not, that Management Entity will have to make the report.

What are the mechanics of reporting?

Managers will have to calculate net short positions at midnight at the end of a trading day and make disclosure by 15:30 local time on the next trading day in the EEA Member State of the EEA Authority to whom the relevant net short position must be notified. The reports will need to be in English or the language of the relevant EEA Authority. Annex I to the first DRSRS identifies the types of information that would need to be reported. Annex II contains the template form which each EEA Authority is required to issue. On October 19, 2012, ESMA published a list of the links to the EEA Authority websites containing the information governing the relevant notification procedures in the particular EEA Member State so far published. The list can be found [here](#).

What if a report was made before November 1, 2012?

All net short positions in Eligible Shares or Eligible Debt existing at midnight local time of November 1, 2012 will have to be reported. It does not matter whether they have already been reported under an existing domestic regime. The SSR’s transitional or “grandfathering” provisions do not apply to the Transparency Requirements.

What will the Restrictions on Uncovered Positions be for managers?

A manager that wishes to take an uncovered position in an Eligible Share/Debt will be required to have:

- a) borrowed sufficient Eligible Shares/Debt to settle the short trade creating the position; or
- b) entered into a binding agreement to borrow the Eligible Shares/Debt (which would include a futures, options or repurchase agreement provided that the agreement is specific as to the number of Eligible Shares/Debt and the delivery/execution date); or
- c) entered into an arrangement with a third party confirming that the Eligible Shares/Debt have been “located”, i.e. are subject to locate arrangements.

What types of locate arrangements are acceptable?

For Eligible Shares, the DISR identifies two types of arrangements: (a) a “standard locate” consisting of a confirmation that the third party can lend or otherwise make available the Eligible Shares or Eligible Debt in the amount requested by the seller (a “Locate Confirmation”) and a confirmation that the third party has put on hold the requested Eligible Shares; and (b) a “standard same day locate” consisting of Locate Confirmation and a confirmation that the Eligible Shares are easy to borrow or purchase.

For Eligible Debt the DISR identifies four types of arrangements: (a) “standard locate” from a third party indicating that it can make the sovereign debt available; (b) “time limited confirmation,” similar to the standard same day locate for Eligible Shares; (c) “unconditional repo confirmation” indicating that it can make the sovereign debt available due to its participation in a central bank system; and (d) “easy to purchase confirmation” which, like the time limited confirmation, is similar to a standard same day locate for Eligible Shares.

Are there any exclusions from the Restrictions on Uncovered Positions?

Yes. A person (“M”) will be permitted to hold an uncovered short position in a sovereign CDS for the purpose of hedging against:

- a) the risk of default of the issuer where M has a long position in the sovereign debt of that issuer to which the CDS relates; or
- b) the risk of a decline of the value of the sovereign debt where M holds assets or is subject to liabilities whose value is correlated to the sovereign debt to which the CDS relates (the “Hedging Exemption”).

To fall within the Hedging Exemption, M will need to demonstrate that:

- a) (i) there is a quantitative correlation between the value of the asset or liability being hedged and the value of the sovereign debt referenced by the CDS of at least 70%, using the most recent 12 month trading data, or (ii) a qualitative or “meaningful” correlation based on appropriate historical data;
- b) the CDS position used for the purpose of hedging is proportionate to the size of the exposure that is hedged; and
- c) subject to limited exceptions, the CDS on debt issued by EU Member State A is not being used to hedge against exposure to debt issued by Member State B, i.e., no cross-border hedging.

What about CDS entered into before November 1, 2012?

The SSR's "transitional provisions" exempt transactions resulting in an uncovered position in a sovereign CDS concluded before March 25, 2012 (or during a suspension of restrictions on uncovered sovereign CDS) from the Restrictions on Uncovered Positions. These CDS may be held until the maturity date of the relevant CDS contract, even if that date falls after November 1, 2012.

Sovereign CDS entered into after March 25, 2012 but before November 1 would need to satisfy the Uncovered CDS Requirements for CDS if the CDS has not been unwound before November 1. Although not a binding interpretation, the Alternative Investment Managers Association ("AIMA") takes the view that it should be sufficient for a manager to demonstrate that it complied with the Restrictions on Uncovered Positions for CDS at the time it entered into the CDS.

What are the sanctions for breaching the SSR?

The SSR requires the EEA Member State regulators to determine the sanctions, in the form of penalties and administrative measures, for breach of the SSR with respect to Eligible Shares or Eligible Debt referable to that EEA Member State. The SSR states that the "penalties and administrative measures shall be effective, proportionate and dissuasive". The UK Financial Services Authority, for example, has indicated in its consultation on the implementation of the SSR in the UK that it will apply its existing regime of penalties to breaches with respect to Eligible Shares or Eligible Debt in respect of which it has jurisdiction. The list of links to the EEA Authority websites published by ESMA on October 19, 2012 should be helpful for tracking information on the approach to penalties in each EEA Member State. The list can be found [here](#).

What about the existing transparency requirements and restrictions on uncovered positions in the EEA Member States?

The SSR will replace the sets of the transparency requirements and restrictions on uncovered positions in each of the individual EEA Member States from November 1, 2012, unless an EEA Member State notifies ESMA that it wishes to delay implementation of the SSR until July 1, 2013. To date, only Austria has made such a notification.

Where can I find the links to the latest primary materials?

[SSR](#)

[DISR](#)

[First DRSR](#)

[Second DRSR](#)

[The ESMA Q&A](#) (updated 10/10/2012)

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If you have any additional questions about the contents of this briefing or any other European investment management related legal or regulatory issues, please contact Andrew Henderson at andrew.henderson@ropesgray.com or your normal Ropes & Gray contact.