

Measures on short selling

Background

The practice of short selling (selling shares or other instruments without owning them) by hedge funds and others shot into political and public awareness in the immediate aftermath of the banking crisis. Speculators were blamed for short selling banks heavily, betting on a fall in their share prices and in the process, it was argued, rendering such falls inevitable.

A number of countries responded with national prohibitions or restrictions, for a summary of these please click [here](#). The EU Commission took the view that this fragmented approach to short selling limited the effectiveness of supervision and resulted in regulatory arbitrage. For that reason, action at the European level was proposed. The initial intention was to include short selling regulation within the market abuse regime. The FSA had already taken this approach, imposing, with dubious legal basis, a ban on short selling through the existing market abuse regime by altering the interpretation of the prohibitions. However, upon consideration the Commission chose to regulate short selling separately on the basis that short selling does not always amount to market abuse and, following a period of consultation, the EU Commission in September 2010 published a draft [Regulation](#) placing limits on short selling. The rationale provided was that whereas in normal times short selling can enhance market liquidity and contribute to efficient pricing, in distressed markets short selling can amplify price falls, leading to disorderly markets and systemic risks.

Credit default swaps were also brought into this net because of their possible use in undermining sovereign debt issuers, as is thought to have happened with Greek sovereign debt.

On 9 February 2011, the European Securities and Markets Association (ESMA) published an updated list of measures on short selling adopted by EU authorities, demonstrating that most EU members had introduced permanent or temporary measures on disclosure or prohibition of certain types of short selling.

The European Central Bank issued its largely supportive Opinion on the draft Regulation on 3 March 2011. The European Parliament held its first reading on the Regulation on 14 March 2011.

UK-based financial institutions and politicians in particular have seen these moves as politically motivated and anti-UK. At an Open Europe forum on 31 March 2011, the FSA, the Alternative Investment Management Association (IMA) and various politicians condemned the increasing politicisation of ongoing negotiations.

The Proposals

The main features of the Regulation, as drafted by the EU Commission, are the following:

- Compulsory notification of short positions. For shares above a lower threshold (0.2% of capital), private notification to the regulator is required. At a higher threshold (0.5%), public announcement is required in the interests of market transparency. Only private notification to regulators will be required for credit default swap transactions involving sovereign debt issuers. The disclosure rules also apply to short positions created by OTC transactions and economic net short positions resulting from the use of derivatives. Short transactions are to be marked as such and exchanges will have to publish daily information on volumes of such marked transactions.
- Severe restrictions on naked short selling (selling shares without having identified equivalent shares to buy or borrow). Having general arrangements with brokers to provide shares when needed may suffice. The aim is to reduce the risk of settlement failures and market volatility.
- Granting ESMA powers to restrict or ban short selling in exceptional situations, to protect financial stability.
- There are a small number of proposed exemptions. The two main ones relate to shares that are mainly traded outside the EU and to market-making activities (but proprietary trading by market-makers is not exempt).

The Committee on Economic and Monetary affairs (ECON) voted on Regulation proposals in March 2011. A number of important amendments to the draft Regulation were proposed. In particular, short transactions would only need to be announced daily and not marked at each transaction. Naked short selling would be permitted provided the short position is covered within the same trading day. However, heavy daily fines are proposed for infringements of this rule to discourage profit-taking through naked short selling.

Next Steps

The influential Economic and Financial Affairs Committee (ECOFIN) will consider the proposed measures in May 2011. There will then be a prolonged period of negotiation between ECOFIN, the European Parliament the EU Commission and Member States, during which attempts will be made to reach agreement on an acceptable deal.

Due to the complexities of measurement of short positions, it is envisaged that independently to the Regulation negotiations, ESMA will produce draft technical standards. These are to be published by 31 December 2011.

It is currently envisaged that the short selling and credit default swaps Regulation will apply from 1 July 2012.

For more information about current developments see our outline of the EU Commission's Financial Services Proposals, click [here](#).

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