

Investment Funds Alert

EU Short-selling; the Final Countdown

October 23, 2012

The European Union (EU) Regulation on short-selling and certain aspects of credit default swaps (together with associated delegated regulations, the “Regulation”) becomes directly effective in EU member states on 1 November 2012. Clients with disclosable short positions will therefore be required to notify the relevant authority in each state by 3:30 p.m. (local time) on 2 November 2012.

The European Securities and Markets Authority (ESMA) published its first Q&A on the implementation of the Regulation on 13 September 2012 in response to questions posed by the market and continues to update such Q&A as the effective date approaches in order to promote common supervisory approaches and practices. The latest edition of the Q&A, published 10 October 2012, can be found [here](#).

In the wake of ESMA having published on its website links to the relevant national websites through which private notification and public disclosure should be made (which can be found [here](#) and [here](#)), this briefing sets out key disclosure and reporting requirements of the new short-selling regime, in particular, its application in respect of non-EU based funds.

Geographic Scope and Extra-Territoriality

The Regulation covers financial instruments admitted to trading on EU-regulated markets and multilateral trading facilities (each, a “trading venue”) in the EU whose principal trading venue is in the EU, even when such financial instruments are traded outside a trading venue. Where the principal trading venue of the relevant instrument is located outside the EU (“principal” in accordance with the Regulation being based on trading volume or otherwise where the financial instrument was first admitted to trading), the Regulation does not apply. ESMA has published an online list of shares deemed exempt from the Regulation on the basis that their principal trading venue is outside the EU, which can be found [here](#). ESMA will continue to update this and also intends to maintain an online list of shares falling within the scope of the Regulation.

ESMA has confirmed that the Regulation is to apply globally in respect of both the transparency requirements and the restrictions it imposes. Thus, wherever the relevant financial instrument principally trades on a trading venue in the EU, the Regulation will have an extraterritorial effect to apply, regardless of where the persons or organizations effecting a short sale are located or established or where the trade is executed or booked. Non-EU-based market participants are therefore required to comply with the Regulation in all dealings with relevant instruments.

The Regulation has a limited set of exemptions, including (i) where the principal trading venue is in a third country (i.e., outside the EU, as explained above); (ii) certain transactions performed due to market-making activities; and (iii) the carrying out of a stabilisation of a financial instrument pursuant to the EU Market Abuse Directive. Such exemptions are outside the scope of this Alert.



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Transparency

Transparency in respect of shares

The Regulation introduces a dual-disclosure regime in relation to short positions in shares, comprising an initial obligation to make “private” reports to the competent authority of the member state in which the relevant trading venue is located and an additional “public” disclosure obligation at a higher threshold. The current thresholds for each are set out below, and ESMA will have discretion to adjust such thresholds based on prevailing market conditions.

The private reporting obligations are triggered in the event of a short-seller coming to hold a net short position of 0.2 percent of the issued share capital of a company admitted to trading on a trading venue (the “Initial Private Threshold”), after which further private reporting obligations are triggered for each 0.1 percent increase in the net short position above the Initial Private Threshold, that is at 0.3 per cent, 0.4 percent and 0.5 percent, etc. (each an “Additional Private Threshold”). If the net short position should then fall below an Additional Private Threshold or the Initial Private Threshold (for example, from 0.3 percent to 0.2 percent), then this must also be reported.

The public disclosure obligations are in addition to the private reporting obligations and are required to be announced to the market. Public disclosure is triggered in the event of a short-seller holding a net short position of 0.5 percent (the “Initial Public Threshold”) of the issued share capital of a company admitted to trading on a trading venue. Further public disclosure then arises for each 0.1 percent increase in the net short position above the Initial Public Threshold, for example, at 0.6 percent, 0.7 percent and 0.8 percent, etc. (each an “Additional Public Threshold”). As is the case for private disclosure, the public must also be informed if the net short position falls below an Additional Public Threshold or the Initial Public Threshold.

Note that the reporting requirement extends to both direct short positions and indirect positions (such as those obtained via derivative instruments, ETFs and similar baskets of securities). There is no *de minimis* threshold even for broadly based indices.

Transparency in respect of EU sovereign debt (including positions in CDS referencing EU sovereign debt)

The Regulation introduces the requirement to report privately to competent authorities certain net short positions in respect of sovereign debt, including those positions derived from CDSs referencing an EU sovereign debt obligation. The relevant instruments are those sovereign debt instruments issued by any member state (including by any organization or vehicle on behalf of a member state), as well as instruments issued by the EU itself, the European Financial Stability Facility and the European Investment Bank.

The relevant reporting thresholds depend on the size of the outstanding debt and liquidity of the sovereign debt market. In summary, where the total amount of the outstanding issued sovereign debt of an issuer is up to €500 billion, the private disclosure obligation is triggered at a net short position of 0.1 percent and thereafter at 0.05 percent intervals. Where the total amount of outstanding issued sovereign debt of an issuer exceeds €500 billion or if there is a “liquid futures market” for a particular sovereign debt (by reference to turnover), then the relevant thresholds are 0.5 percent and 0.25 percent intervals thereafter.

Calculation of short positions

The Regulation sets out guidance in relation to the calculation method regarding short positions (in the “Delegated Regulation”, which can be found [here](#)). For both equities and sovereign debt, a net short position is calculated by netting long and short positions in a given issuer using the delta-adjusted model. In relation to

sovereign debt, a net short position must take into account any net long position the pricing of which is “highly correlated” to the pricing of the given sovereign debt.

Notably, the Regulation requires that short positions in relation to fund management activities should be calculated both (a) at the level of each individual fund (regardless of legal form) and (b) on a managed portfolio basis, where a manager should aggregate net short positions of funds and portfolios “for which the same investment strategy is pursued in respect of a particular issuer.” ESMA has clarified that, for the purposes of the Regulation, an “investment strategy” is whether the fund (portfolio) is long or short in a particular issuer.

In the case of short positions calculated on the basis of either aforementioned (a) or (b), it is the entity making the investment decisions that needs to report and/or aggregate positions. Where a single legal entity performs both management and nonmanagement activities, it should conduct two separate calculations and may have to make two separate reports. The definition of “management activities” covers only discretionary mandates, so it does not include execution-only mandates or proprietary/trading accounts.

Disclosure and Notification

Within the UK, both private reporting and public disclosure will be made to the FSA, using a form prescribed by the Regulation. The actual mechanism for making the report is yet to be announced by the FSA. ESMA has published links to the relevant national websites for private notification [here](#) and those for public disclosure, [here](#).

Notifications must include the identity of the positionholder at the legal person level; the size of the position; the issuer; and the date on which the position was created, changed or closed. With respect to both private reporting and public disclosure, the reported position should be rounded to the first two decimal places by truncating the other decimal places. For example, if the net short position is 0.3199 percent, a private notification should indicate the 0.31 percent position. Similarly, for a net short position of 0.1987 percent of the issued share capital, no notification is required. Template forms for both private disclosure to the regulator and public disclosure to the market are set out in the Regulation, and each competent authority is expected to adopt its own form of notification format in compliance with these.

Prohibition of “Naked” Shorts

Short positions in shares

The Regulation prohibits uncovered short-selling or “naked” shorting of shares, save for where arrangements between buyers and sellers of shares are in place such that the seller has borrowed the security or entered into binding arrangements with “similar legal effect,” which will not constitute naked short-selling (the so-called “locate” rule). For these purposes, appropriate arrangements under the Regulation include (a) repurchase agreements covering at least the number of shares sufficient to settle the short trade and (b) futures, options and swap contracts providing for physical settlement (or the “reasonable expectation” that settlement can proceed when due). In the event that such arrangements have been entered into with a non-EU third party, the Regulation requires that such third party be subject to appropriate supervision and the exchange of information between regulatory supervisors.

Short positions in sovereign debt (including positions in CDS referencing EU sovereign debt)

The Regulation outlaws naked or uncovered credit default swaps on EU sovereign debt in the underlying sovereign debt position, but contains a very limited exception to the “locate” rule for CDS relating to sovereign debt.

That is, a CDS position is not deemed to be uncovered, and, therefore, the locate rule does not apply, if the position serves as a genuine hedge. In this circumstance, the hedge will be permissible if it is designed to guard against (a) the risk of default of the issuer where the person has a long position in the sovereign debt of that issuer to which the sovereign CDS relates; or (b) the risk of a decline of the value of the sovereign debt where the person holds assets or is subject to liabilities, including, but not limited to, financial contracts, a portfolio of assets or financial obligations the value of which is highly correlated to the value of the sovereign debt. Article 14 of the Delegated Regulation (see link above) sets out in detail the criteria for determining whether or not a position is hedged (i.e., the consequence being that, if it is hedged, it is permissible under the Regulation, regardless of whether it is uncovered). ESMA has also clarified that, subject to compliance with the details of the Regulation, it may be legitimate to use a sovereign CDS position to hedge a risk related to another CDS position referring to the same sovereign debt.

What Next?

The first private reporting and public disclosures are required to be made at 3:30 p.m. local time in the jurisdiction of the relevant trading venue on 2 November 2012. In the event that this is not a trading day in the relevant member state, the first net short positions to consider are the ones held at the end of 2 November 2012 (5 November for Hungary), and, where relevant, these net short positions should be reported or disclosed not later than at 3:30 p.m. on 5 November 2012 (6 November for Hungary).

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