

AIMA Note
on the progress of the European Commission's draft
proposal for a
**Regulation on Short Selling and certain aspects of Credit
Default Swaps**



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1. Introduction

On 15 September 2010, the European Commission (the Commission) published its draft proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps (CDS) (the Draft Proposal).

This Note updates AIMA's Note of March 2011 and examines:

- what point have we reached in the legislative process and what happens next?;
- what were AIMA's concerns with the draft Proposal?; and
- to what extent have these concerns been addressed in:
 - the amended text adopted by the European Parliament (the ECON Text); and
 - the amended text agreed by the Council of the European Union (the Council Text)?

2. What is the current position and what are the next steps?

European Parliament

On 7 March 2011, the Economic and Monetary Affairs Committee (ECON) of the European Parliament passed a compromise text (the ECON Text) which made a number of amendments to the Commission's draft. These amendments, which are examined below, include the proposal to restrict the entry into an uncovered sovereign CDS position but would also provide for anonymisation when reporting significant net short positions in relation to shares.

European Council

On 17 May 2011, a general approach was reached by the Member State Finance Ministers (ECOFIN), approving the Council Text as the basis on which the Hungarian Presidency may enter into tripartite negotiations (or trialogues) with the European Parliament and Commission.

Agreement in the Council was delayed largely because of the differing views held by Member States on two main issues, (i) whether or not the text should include provisions to restrict the taking of naked short positions in sovereign cash debt instruments under Article 12; and (ii) the powers of ESMA to intervene in an emergency under Article 24. From the outset, most Member States were opposed to the introduction of restrictions in respect of sovereign CDS - of the Member States holding the minority view, Germany was most strongly in favour of imposing such a restriction. Coverage of the debate in Council was not assisted by ongoing confusion, both in the Press and more widely, between a possible ban on sovereign CDS (which was never likely to be agreed in the Council) and limitations on the short selling of sovereign cash debt instruments (which are included in the Council Text).

On the issue of Article 24, the UK delegation had been the most vocal in opposing provisions which would give ESMA new powers to intervene in an emergency, for example, by prohibiting short sales across the EU or by preventing market participants from entering into sovereign CDS. In the UK's view, it was not legally possible under existing EU legislation for ESMA to be given such authority. At the Ecofin meeting of 17 May 2011, it was nevertheless agreed that, under the Regulation, ESMA could be granted significant powers to restrict short selling activities in emergency situations as was proposed by the compromise text tabled by the Hungarian Presidency.

Trialogues

With agreement reached within the Council, the trialogues are now expected to commence on 23 May 2011 and will continue until agreement can be reached on a final text. AIMA anticipates that this text will be agreed by early Summer 2011.

This final text will then be formally adopted by the European institutions and will enter into force upon its publication in the Official Journal of the European Union.

Following further work to determine technical ('Level 2') standards on a number of issues, the intention is for the Regulation to be effective across the EEA as from 01 July 2012.

3. Comparison of ECON and Council Texts in respect of AIMA's main concerns

In December 2010, AIMA published its Position Paper on the Draft Proposal, in which we identified a number of key areas of concern. We set out below AIMA's key points and the positions taken by ECON and by Council to date in respect of each of these issues:

(a) Sovereign CDS

AIMA's key points:

- activity in the credit derivatives markets contributes to sovereign bond market liquidity and efficient price discovery;
- we agree with the Commission that there should be no restrictions on short positions in sovereign debt credit default swaps.

| ECON Text | Council Text |
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| <p>Under Article 12 (1a) of the ECON text, a person is permitted to enter into a sovereign CDS "only where that transaction does not lead to an uncovered position in a credit default swap as referred to in Article 4".</p> <p>As to what 'uncovered' means in this context, Article 4 provides that a position in a sovereign CDS is uncovered to the extent that it is not hedging against either:</p> <ul style="list-style-type: none"> (a) the risk of issuer default where the CDS buyer has a long position in that issuer's sovereign debt; or (b) the risk of a decline in the value of any asset or portfolio of assets "where the decline of the price of those assets or portfolio of assets has a high correlation with the decline of the price of the obligation of a Member State or the Union in the case of a decline in the creditworthiness of a member State or the Union". | <p>The Council Text, on the other hand, contains no restrictions on entering into uncovered sovereign CDS.</p> <p>However, by Article 8, the Council Text does require private disclosure to the regulator of uncovered positions in sovereign CDS when a given threshold is crossed. (The threshold itself is to be determined at Level 2).</p> <p>For these purposes, an uncovered CDS is defined as being one which is not serving the hedge:</p> <ul style="list-style-type: none"> (a) against the risk of issuer default where the CDS buyer has a long position in that issuer's sovereign debt; or (b) any long position in an issuer's debt instruments, the pricing of which has a high correlation with the pricing of the debt instruments of the sovereign issuer to which the sovereign CDS relates. |

(b) Naked short sales of shares and sovereign debt

AIMA's key points:

- current market practice in locating stocks for short selling has not led to any significant problems with settlement failure and should be allowed to continue;
- an exemption should be allowed for intra-day trading.

| ECON Text | Council Text |
|---|---|
| <p>The ECON Text allows a short sale of a share or a sovereign debt instrument to be entered into only where:</p> <ul style="list-style-type: none">• the financial instrument has been borrowed;• an agreement to borrow the financial instrument has been entered into; or• the financial instrument has been located and reserved for lending so that settlement can be effected when it is due. <p>However, the ECON Text improves upon the Commission's Proposal by permitting intra-day trading - i.e., positions which are closed out by the end of the trading day will not be considered 'uncovered' under the Regulation.</p> | <p>The Council Text permits the entering into of a short sale in shares or sovereign debt instruments where:</p> <ul style="list-style-type: none">• the financial instrument has been borrowed;• an agreement to borrow the financial instrument has been entered into; or• where the holder has located the financial instrument "or has otherwise reasonable expectation that settlement can be effected when it is due." <p>In addition, uncovered short sales in sovereign debt would only be permitted where the transaction "serves to hedge a long position in debt instruments of an issuer, the pricing of which has a high correlation with the pricing of the given sovereign debt".</p> <p>National competent authorities may, though, temporarily suspend this restriction for an initial period of up to 6 months where the liquidity of sovereign debt falls below a certain threshold. Such suspension is renewable for further periods of up to six months (provided the grounds for it continue to apply) but will expire automatically if not renewed.</p> <p>The level of the relevant threshold, and how this is to be calculated, are matters to be determined at Level 2.</p> |

(c) Public disclosure of significant short positions

AIMA's key points:

- public disclosure of positions in an anonymised form would meet the Regulation's aims of increasing transparency;
- naming of individual position holders can lead to market distortion and can cause harm to the position holder through short squeezes and reverse engineering;
- if public disclosure is to be on an individually named basis, the threshold should be set at 3%.

| ECON Text | Council Text |
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| <p>Under the ECON Text, public disclosure is now to be made by the relevant competent authority, rather than by the position holder itself.</p> <p>Furthermore, and of great significance, by Article 7(1), such disclosure is to be anonymous as to the identity of the position holder.</p> <p>Under the ECON Text, the relevant disclosure requirement would be triggered at 0.5% of the issued share capital of the relevant company, and again at each 0.1% interval above that.</p> | <p>Under the Council Text, public disclosure remains the obligation of the position holder and must include the name of that holder.</p> <p>The thresholds for public disclosure remain 0.5% and 0.1%, as under the ECON Text.</p> |

(d) Marking regime

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| <p>AIMA's key points:</p> <ul style="list-style-type: none"> the introduction of a marking regime would be costly to implement and would not deliver sufficiently meaningful information to competent authorities to justify this cost; AIMA would wish to see Article 6 deleted from the Proposal. |
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| ECON Text | Council Text |
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| <p>The requirement for an order marking regime has been replaced by an obligation for firms to include in their transaction reports a field indicating whether a given transaction in a share was a short sale. Such information would not be disclosed to the public.</p> | <p>The Council Text deletes this requirement in its entirety.</p> |

(e) Mandatory buy-in provisions

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| <p>AIMA's key points:</p> <ul style="list-style-type: none"> the level of settlement failure is low; there are many reasons why a trade may fail to settle - short selling is only one of these (and not a significant one); measures relating to settlement failures would be better considered as part of a separate legislative initiative not limited to short selling; as a result, Article 13 should be deleted from the Proposal. |
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| ECON Text | Council Text |
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| <p>The ECON Text deletes these provisions from the Draft</p> | <p>The Council Text provides that a central counterparty</p> |

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| <p>Proposal. Instead, the Commission is required (recital 16a) to make concrete proposals for a settlement regime in parallel with a proposal to create a harmonised legal framework for central securities depositories.</p> | <p>which provides clearing services for shares must ensure that buy-in procedures are automatically triggered when shares are not delivered within four business days after the due date or, where this is not possible, an amount be paid to the buyer based on the shares' value plus an amount for losses incurred by the buyer as a result of settlement failure.</p> <p>Daily penalty payments would be made by the defaulting party for each day that the failure to deliver continues, such penalties to be set sufficiently high as to deter parties from failing to settle on time.</p> |
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(f) Calculation of short positions

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| <p>AIMA's key points:</p> <ul style="list-style-type: none"> when making a net short position calculation in respect of positions held through exposure to indices, baskets of securities or ETFs, investors should be permitted to rely on publicly available information about the composition of the index or ETF; it is important to allow firms to net a long position held in a convertible bond (CB) off against a short position in the same issuer - to do otherwise could reduce liquidity in the CB market. |
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| ECON Text | Council Text |
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| <p>The ECON Text adopts amendments which would adequately address these concerns, and which would (a) no longer require firms to manually decompose baskets and indices in real time and (b) allow a long position in a CB to be offset against an equivalent short.</p> | <p>By the Council Text, the calculation of a short position in a share or sovereign debt would include any instrument which gives rise to a direct or indirect exposure to the share or sovereign debt and any economic interest held as part of a basket, index or ETF is to be included when calculating such positions.</p> |

(g) ESMA's powers of intervention in exceptional situations

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| <p>AIMA's key points:</p> <ul style="list-style-type: none"> we welcome the facilitating role proposed for ESMA; we are concerned at the extent of the powers suggested for ESMA to ban short selling in extreme conditions; previous bans on short selling activity have increased market volatility and the likelihood of systemic risk - bans should be avoided in the future. |
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| ECON Text | Council Text |
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| <p>ESMA would have the power to:</p> <ul style="list-style-type: none"> require private and/or public disclosure of net | <p>The Council Text follows that of the ECON Text opposite, except that:</p> |

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| <p>short positions in relation to a specific financial instrument or a class of financial instruments;</p> <ul style="list-style-type: none"> • prohibit or restrict the entering into of a short sale or a transaction which creates, or relates to, a financial instrument where the position holder would benefit from a decrease in the price or value of another financial instrument; • limit market participants from entering into sovereign CDS or limit the value of uncovered sovereign CDS positions that a market participant may enter; or • prevent the entering into, or limit the value of transactions relating to financial instruments which fall within the scope of the Regulation. <p>only in situations where both:</p> <ul style="list-style-type: none"> • by taking one or more of the measures below, ESMA would address a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EEA and there are cross border implications; and • a competent authority has not taken measures to address the threat, or the measures that have been taken do not sufficiently address the threat. <p>Any measure taken by ESMA under Article 24 would come into effect when published on the ESMA website. The measure must be reviewed at appropriate intervals and at least every three months - if not renewed after that three-month period, it will automatically expire.</p> | <ul style="list-style-type: none"> • ESMA would not have the power set out in the fourth bullet point in the ECON Text; and • in respect of limitations which relate to sovereign CDS, ESMA would require the consent of the relevant competent authority. |
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4. Conclusion

AIMA welcomed the publication of the Commission's Draft Proposal as we considered it generally provided a coherent and harmonised regime for the regulation of short selling on European markets, subject to the concerns which we raised in our Position Paper.

We consider that the majority of amendments put forward in the Council Text and by ECON are largely neutral or positive. Indeed, they contain much which would help alleviate the majority of our concerns.

In particular, we hope that the Council will be flexible and accept the Parliament's amendments in the area of anonymisation of the public disclosure of net short positions.

On the other hand, the restrictions on sovereign CDS proposed by the Parliament introduce an undesirable new element. We hope that, in this area, it will be the Parliament which will be receptive to Council's arguments, since the Council does not seem to be contemplating similar restrictions.

As the European institutions enter the trialogue negotiation phase of the legislative process, much work remains to be done to ensure that the final agreed text of the Regulation fully reflects not only legitimate regulatory concerns but also the commercial and market reality of short selling and derivatives trading.

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The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>

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