

## Proposed New European Short Selling Disclosure Thresholds

On 15 September 2010, the second anniversary of the collapse of Lehman Brothers, the European Commission announced proposals for two new financial markets regulations<sup>1</sup>. The first regulation deals with short selling and credit default swaps, the second deals with the derivatives market. This marks the first step in the Commission's proposals for a framework of further regulation of the European financial markets and follows a consultation process that ended in July 2010<sup>2</sup>. The stated aim of the proposed regulations is "effective supervision and smart regulation"<sup>3</sup>.

This advisory focuses on the proposed short selling regulation (the Regulation). The Regulation is aimed at encouraging the harmonisation of short selling disclosure obligations across Europe. To date, disclosure requirements on short selling have been introduced in different ways in each Member State, for example, the United Kingdom has introduced substantial disclosure requirements and Sweden<sup>4</sup> has not introduced any. The Regulation provides a new two-tier short selling disclosure regime (with 0.2 percent and 0.5 percent thresholds), which has been developed in consultation with the Committee of European Securities Regulators.

The Regulation is expected to come into force in July 2012, subject to approval by the European Parliament and the Council on Ministers. It will have direct applicability, meaning that no local implementation will be required, and it will be enforceable in all Member States simultaneously.

### Relevant Instruments

The Regulation would impose short sale disclosure obligations only with respect to:

- Shares of a company admitted to trading on a regulated market (e.g. the London Stock Exchange, Euronext, but not AIM) or multilateral trading facility;
- Sovereign bonds;

1 [http://ec.europa.eu/internal\\_market/securities/docs/short\\_selling/20100915\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf); [http://ec.europa.eu/internal\\_market/financial-markets/docs/derivatives/20100915\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf).

2 [http://ec.europa.eu/internal\\_market/consultations/2010/short\\_selling\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/short_selling_en.htm).

3 Michel Barnier, the Commission for the Internal Market and Services <http://ec.europa.eu/avservices/player/streaming.cfm?type=ebsvod&sid=165407>.

4 As at 1 September 2010, [http://www.cesr.eu/data/document/08\\_742.pdf](http://www.cesr.eu/data/document/08_742.pdf).

### Contacts



**Jeremy Willcocks**  
+44 (0)20 7786 6181



**Charlotte Lindsten**  
+44 (0)20 7786 6121



**Benjamin Kieft**  
+44 (0)20 7786 6132

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- Derivatives relating to sovereign bonds; and
- Credit default swaps relating to sovereign issuers.

National regulators will have powers to temporarily expand this list to include other instruments<sup>5</sup>, or prohibit or impose other restrictions on short selling<sup>6</sup> where there are “exceptional situations”. This would occur when:

- “There are adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State or one or more other Member States; and
- The measure is necessary to address the threat”.

It is proposed that the new European Securities Market Authority (ESMA), to be established on 1 January 2011, will play a coordinating role with the regulators facing “exceptional situations”.

## New Disclosure Obligations

For companies which have shares admitted to trading on a regulated market within the European Union (and for short positions created by over-the-counter trading and derivatives), there will be a two-tier system of notification:

- Lower threshold (0.2 percent<sup>7</sup>): Positions at or above this threshold will only be required to be made to the national regulator in private; and
- Higher threshold (0.5 percent<sup>8</sup>): Positions at or above this threshold will have to be notified to the market and the national regulator.

Each change of more than 0.1 percent above each threshold (i.e., 0.3 percent, 0.4 percent, 0.6 percent, or 0.7 percent, etc) will require additional notifications.

The new disclosure obligations will make short selling in the United Kingdom more onerous because (i) the types of instruments covered under the Regulation are broader than the current UK requirements which only apply to financial sector companies or companies undertaking rights issues; and (ii) the disclosure thresholds under the Regulation

are lower than the current UK requirement which starts at 0.25 percent.

The disclosure regime for shares will be complemented by a system of flagging: all share orders on trading venues would be marked as “short” by persons executing orders if they involve a short sale, so that national regulators can obtain additional information about short selling volumes. The trading venue would publish daily a summary of the volume of orders marked as short orders<sup>9</sup>.

For short positions held in sovereign bonds and credit default swaps relating to sovereign debt issuers, it is proposed that “significant”<sup>10</sup> short positions will require private disclosures to the regulators. The thresholds of what will be “significant” positions are still to be determined by the Commission and it is not clear when these are expected to be available.

## Exemptions

An exemption will apply to the shares of a company admitted to trading on a market in the European Union where the principal venue for the trading of shares of the company is a market outside the European Union.

The Regulation also exempts market makers, but only if they apply to the regulator for the exemption. This exemption will not apply to any proprietary trading carried out by the market maker for its own benefit.

## Uncovered Short Selling

The Regulation prohibits uncovered or “naked” short selling, by requiring persons entering into short sales of any size to show that they have either:

- Borrowed the instrument;
- Entered into an agreement to borrow the instrument; or
- Made other arrangements which ensure that the underlying securities could be borrowed, so that settlement can be achieved.

## Sanctions

National regulators will retain all powers required to investigate short selling and enforce the Regulation. This includes the right to take enforcement action and the power to request further information on the purpose of future transactions.

5 Article 16, Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps, 15 September 2010, [http://ec.europa.eu/internal\\_market/securities/docs/short\\_selling/20100915\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf).

6 Article 17, *ibid*.

7 Article 5, *ibid*.

8 Article 7, *ibid*.

9 Article 6, *ibid*.

10 Article 8, *ibid*.

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## Next Steps

The Regulation will now pass to the European Parliament and the Council of Ministers for final negotiation and adoption. If adopted, the Regulation will come into effect from 1 July 2012. As the Regulations will have direct effect and not require further legislation in order to be effective in Member States, the proposed disclosure obligations and prohibition on uncovered short selling will apply from that time, unless national regulators have already changed to the new regime.

## AIFM Directive

In addition to the Regulation described above, the proposed European Directive on Alternative Investment Fund Managers<sup>11</sup> (the AIFM Directive) also contains provisions regarding short selling. The wording of the AIFM Directive is controversial and there are currently two competing drafts of the legislation, which are expected to be consolidated at the European Parliament's plenary session on 19 October 2010.

It is proposed under the AIFM Directive that AIFMs who engage in short selling on behalf of one or more alternative investment funds must:

- Have agreed to borrow the relevant securities at the time they submit the short sale order (i.e. prohibits "naked" short selling);
- Implement a risk management procedure to adequately manage the risks associated with the delivery of short sold securities or other financial instruments<sup>12</sup>; and
- Regularly disclose information on "significant" short positions to the regulator<sup>13</sup>.

The national regulators are required to provide to ESMA the information they receive on short selling so that ESMA may, in exceptional circumstances, restrict short selling activities.

<sup>11</sup> Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC, 30 April 2009, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0207:FIN:EN:PDF>.

<sup>12</sup> Article 11, *ibid*.

<sup>13</sup> Article 21, *ibid*.

*We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:*

**Jeremy Willcocks**

+44 (0)20 7786 6181  
Jeremy.Willcocks@aporter.com

**Charlotte Lindsten**

+44 (0)20 7786 6121  
Charlotte.Lindsten@aporter.com

**Benjamin Kieft**

+44 (0)20 7786 6132  
Benjamin.Kieft@aporter.com

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