COUNCIL OF
THE EUROPEAN UNION

EN

Brussels, 17 May 2011
10232/11
PRESSE 133

Council agrees general approach on short selling and credit default swaps

The Council today[1] set out its position with a view to negotiations with the European Parliament on a draft regulation aimed at introducing EU rules for short selling and certain aspects of credit default swaps[2].

The proposal introduces common EU transparency requirements and harmonises the powers that regulators may use in exceptional situations where there is a serious threat to financial stability.

The negotiations with the Parliament will aim for adoption of the regulation at first reading.

At the height of the financial crisis in 2008, several member states adopted emergency measures to restrict or ban short selling in some or all securities in order to counter a downward spiral in the prices of shares that could create systemic risks.

As the EU lacks a common regulatory framework for dealing with short selling, member states adopted divergent measures. The current fragmented approach limits the effectiveness of the adopted measures and results in regulatory arbitrage[3]. It may also create confusion in the markets and impose additional costs on market participants.

The draft regulation is intended to address these issues, whilst acknowleging the role of short selling in ensuring the proper functioning of financial markets, in particular in providing liquidity and contributing to efficient pricing.

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1 The agreement was reached at a meeting of the Economic and Financial Affairs Council.
2 The short selling of securities is a practice whereby an investor sells a security he doesn't own with the intention of buying it back when the price has fallen.
A credit default swap is a financial instrument with the characteristics of an insurance, guaranteeing the creditworthiness of a loan.
3 i.e. where investors exploit differences between regulatory systems.

The proposal covers all types of financial instruments, providing for a response that is proportionate to the potential risks posed by short selling of different instruments. In particular, for shares of companies listed in the EU, it creates a two-tier model for transparency of significant net short positions: While at a lower threshold, notification of a position must be made privately to the regulator, at a higher threshold, positions must be disclosed to the market.

For sovereign debt, on the other hand, significant net short positions relating to issuers in the EU would always require private disclosure to regulators. The proposed regime also provides for notification of significant positions in credit default swaps that relate to EU sovereign debt issuers.

To tackle the increased risks posed by uncovered short sales[1], the proposal requires that anyone entering into a short sale must at the time of the sale have borrowed the instruments, entered into an agreement to borrow them or made other arrangements to ensure they can be borrowed in time to settle the deal.

However, these restrictions don't apply to the short selling of sovereign debt if the transaction serves to hedge a long position in debt instruments of an issuer. Moreover, if the liquidity of sovereign debt falls below a specified threshold, the restrictions on uncovered short selling may be temporarily suspended by the relevant competent authority.

In exceptional situations that threaten financial stability or market confidence in a member state or the EU, the draft regulation provides that competent authorities have temporary powers to require further transparency or to impose restrictions on short selling and credit default swap transactions or to limit individuals from entering into derivative transactions.

In such a situation, the European Securities Market Authority (ESMA) is given a co-ordination role to ensure consistency between competent authorities and to guarantee that such measures are only taken where it is necessary and proportionate to do so. ESMA is also given the power to take measures where the situation has cross-border implications.

The intervention powers of ESMA would be based on article 9(5) of the regulation establishing ESMA, which authorises the agency to "temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets." However, when it comes to short selling of sovereign debt instruments, ESMA would only be authorised to intervene after it has received the consent of the relevant competent authorities.

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1 "Uncovered" or "naked" short selling is a practice where the seller has not made arrangements to borrow the security.