

November 28, 2011

## European Parliament Votes to Ban “Naked” Credit Default Swaps on Sovereign Debt and Restrict “Naked” Short Sales

On November 15, 2011, the European Parliament adopted a regulation banning any person or legal entity in the European Union (“EU entities”) from entering into “naked,” or uncovered, credit default swaps (“CDS”) on sovereign debt and restricting uncovered short sales on shares and sovereign debt (the “Regulation”) after November 1, 2012.<sup>1</sup> The Regulation also bans such transactions from being effected on any trading venue in the European Union (the “EU”). CDS on sovereign debt that do not hedge exposure to the sovereign debt itself or to assets or liabilities whose value is correlated to the value of the sovereign debt will no longer be permitted. Short sales of shares and short sales of sovereign debt will be permitted only where the seller has “located” the share or debt instrument prior to entering into the agreement and has a “reasonable expectation” of being able to borrow the shares. The Regulation provides exemptions for market making activities and primary market operations and allows Member States of the EU (“Member States”) to temporarily suspend the ban on uncovered CDS on sovereign debt if the Member State determines that its sovereign debt market is not functioning properly as a result of the ban. The Regulation also introduces reporting requirements for significant net short positions.

### Background

The European Commission (the “Commission”) proposed the ban on uncovered CDS and limitations on uncovered short sales in response to recent market volatility in Euro-denominated sovereign bonds. Member States reacted differently to the market volatility, some taking no action at all. The Commission proposed the Regulation to reduce regulatory arbitrage and compliance costs arising from a fragmented regulatory framework across the EU. While the Commission acknowledges that short sales and CDS have economic benefits, they also note that these transactions present risks to the market that must be controlled.<sup>2</sup>

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<sup>1</sup> Short Selling and Certain Aspects of Credit Default Swaps (COM(2010)0482 – C7-0264/2010 – 2010/0251(COD)), available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20111115+SIT+DOC+WORD+V0//EN&language=EN>.

<sup>2</sup> See Preamble to the Regulation.

Under the new regulation, entities in the EU will no longer be able to enter into credit default swaps on sovereign debt that does not serve to hedge exposure to a long position in the debt of the issuer or to assets or liabilities the value of which is correlated to the debt.

## Credit Default Swaps

The Regulation imposes a general and permanent ban on EU entities entering into uncovered CDS on sovereign debt.<sup>3</sup> The Regulation further prohibits such uncovered contracts from being traded on any trading facility in the EU. Under the Regulation, “sovereign debt” is defined to include debt instruments issued by the EU or its Member States (or if a Member State is a federal state, the debt instruments of any of the members making up the federation), any ministry or agency of any Member State, any special purpose vehicle of a Member State or several Member States that issues debt on behalf of such Member State(s), an international financial institution established by two or more Member States to mobilize funding and provide financial assistance to the benefit of its members that are experiencing or threatened by severe financing problems and the European Investment Bank.<sup>4</sup>

### Credit Default Swaps

#### Permanent Ban

- Uncovered CDS on sovereign debt.

#### Permitted

- CDS on debt issued by regional or local bodies in a Member State.<sup>5</sup>
- CDS that hedge a long position in the sovereign debt to which the CDS relates.
- CDS that hedge against the risk of a decline in the value of sovereign debt where the purchaser of the swap holds assets or is subject to liabilities (including financial contracts, a portfolio of assets or financial obligations) the value of which is correlated to the value of that sovereign debt.<sup>6</sup>
- Existing CDS in effect prior to the effective date of the Regulation may be held until the maturity of the contract.<sup>7</sup>
- Market making activities and primary market operations are exempt from the ban on uncovered credit default swaps.

The Regulation also authorizes Member States to prohibit the entry into any covered CDS on sovereign debt or limit the size of covered CDS positions on sovereign debt that may be established (where the purchaser owns the referenced debt) if necessary to address adverse events or developments constituting a serious threat to financial stability or to market confidence in a Member State.<sup>8</sup> Any such limitation must not have a detrimental effect on the efficiency of financial markets that is disproportionate to its benefit and is restricted to an initial period of three months. The Member State may extend such limitations for additional three month periods thereafter if the adverse events or developments are continuing.<sup>9</sup>

<sup>3</sup> See Article 14(1) of the Regulation.

<sup>4</sup> See Article 2(1)(i) of the Regulation. In our interpretation, “sovereign debt” therefore includes debt instruments issued by the current European Financial Stability Facility and the European Stability Mechanism, once operative.

<sup>5</sup> See Article 2(1)(i) of the Regulation and paragraph 9 of the Preamble to the Regulation.

<sup>6</sup> See Article 4 of the Regulation.

<sup>7</sup> See Article 46 of the Regulation.

<sup>8</sup> See Article 21 of the Regulation. The Regulation states that a Member State may “limit the value of sovereign credit default swap positions.” We read this to mean that a Member State may limit the size of CDS positions.

<sup>9</sup> See Articles 21 and 24 of the Regulation.

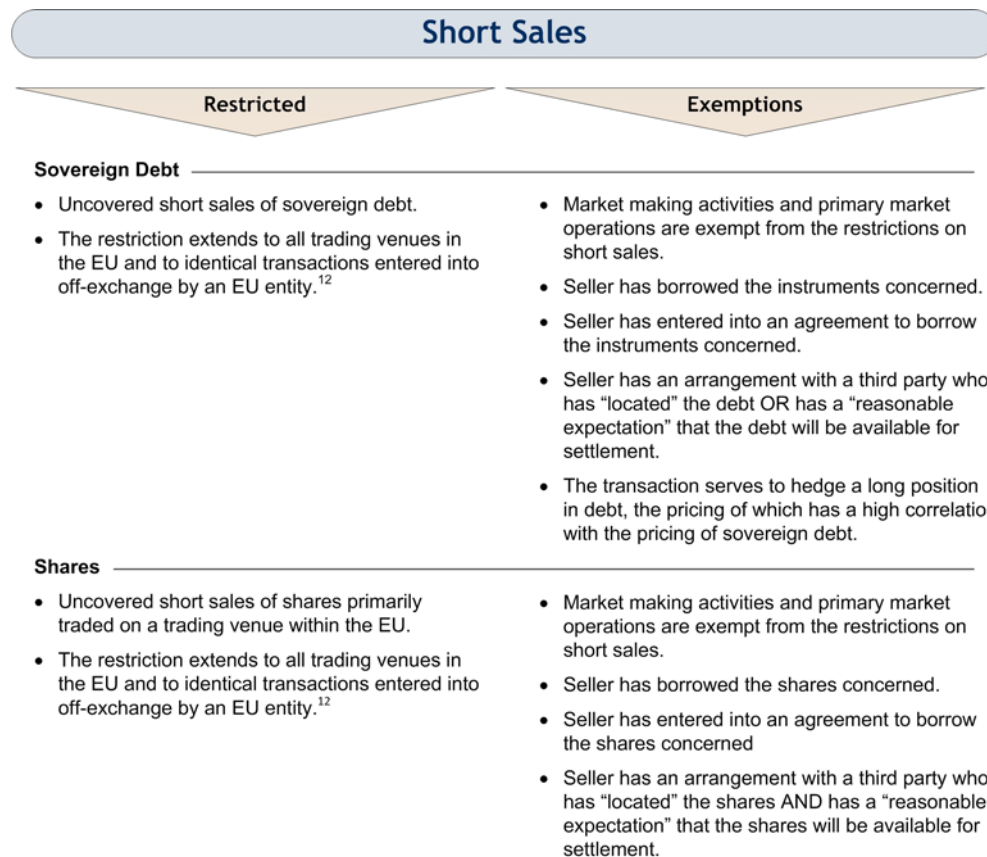
Individual Member States of the EU will be able to temporarily suspend the ban on uncovered credit default swaps referencing sovereign debt if they believe the ban is causing "tension" in their sovereign debt markets.

**Ability of Member States to "Opt Out"**

A Member State may temporarily suspend the ban on uncovered CDS if it believes the ban causes "tension" in its sovereign markets and/or increases its cost of funding and satisfies one or more of the conditions set forth in the Regulation. These conditions include rising interest rates on the sovereign debt, widening interest rate spreads and sovereign CDS spreads compared to other sovereign debts, timeliness of the return of the price of the sovereign debt to its original equilibrium following a large trade and amounts of sovereign debt that can be traded. The Regulation explicitly allows for other indicators of "tension" to be used by a Member State in deciding to suspend the ban on uncovered CDS. A decision to temporarily suspend the ban will be valid for up to 12 months with the possibility of renewal for further periods not to exceed six months in duration. A written justification for suspending the ban must be delivered to the European Securities and Markets Authority ("ESMA") which must decide within 24 hours if such suspension is justified.<sup>10</sup> ESMA does not have any authority to enforce its rejection of a Member State's decision to suspend the ban. Any uncovered CDS entered into during such a suspension of the ban may be held until the maturity of the contract regardless of any subsequent reinstatement of the ban.<sup>11</sup>

**Short Sales**

The new regulation restricts traders in the EU from placing short bets on shares primarily traded in the EU or on sovereign debt where they do not own the referenced instrument or are not otherwise exposed to risks highly correlated to the price of the sovereign debt.



<sup>10</sup> See Article 14 of the Regulation.

<sup>11</sup> See Article 46 of the Regulation.

<sup>12</sup> See Article 1(1)(b) of the Regulation.

### Sovereign Debt

Uncovered short sales of sovereign debt are restricted under the Regulation unless such 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 sovereign debt. The ban extends to all trading venues in the EU and to identical transactions entered into off-exchange by an EU entity.<sup>13</sup> A short sale of sovereign debt will not be considered “uncovered” where the seller (i) has borrowed the instruments concerned, (ii) has entered into an agreement to borrow such instruments or (iii) has an arrangement with a third party under which that third party has confirmed that the instruments have been located (the “locate rule”) **or** has a “reasonable expectation” that the instruments will be available for settlement.<sup>14</sup> ESMA will determine what constitutes a “reasonable expectation” that settlement will be effected.<sup>15</sup>

Member States may temporarily restrict short sales of sovereign debt otherwise permitted by the Regulation if the liquidity of its sovereign debt declines significantly relative to the average level of liquidity for such sovereign debt. Any such additional restriction on short sales of sovereign debt will be valid for a period of six months with the possibility of extending such restrictions for additional six month periods if the reasons for the additional restrictions continue. The Member State instituting such restrictions must notify ESMA 24 hours prior to such restriction taking effect.<sup>16</sup>

### Shares

Uncovered short sales of shares principally traded on a trading venue within the EU are similarly restricted under the Regulation.<sup>17</sup> Sellers entering into a short sale where the seller (i) has borrowed the shares concerned, (ii) has entered into an agreement to borrow such shares or (iii) complies with the locate rule **and** has a “reasonable expectation” that the shares will be available for settlement fall outside the restrictions.<sup>18</sup>

In the event that the price of a liquid share on a trading venue falls by 10% or more in a single day, the Member State in which such trading venue is registered may temporarily restrict short sales of such shares on that trading venue until the end of the next trading day. Threshold levels for the decline in value of illiquid shares will be set by the Commission. Restrictions implemented by a Member State may be extended for up to an additional two trading days should the price of the shares continue to fall significantly. Member States seeking to restrict such trading must notify ESMA at the latest two hours after end of the trading day on which the triggering price drop occurred.<sup>19</sup>

<sup>13</sup> See Article 1(1)(b) of the Regulation.

<sup>14</sup> See Article 13 of the Regulation.

<sup>15</sup> See Article 12(2) of the Regulation.

<sup>16</sup> See Article 13(3)-(4) of the Regulation.

<sup>17</sup> See Article 12 and Article 16(1) of the Regulation.

<sup>18</sup> See Article 12(1) of the Regulation.

<sup>19</sup> See Article 23 of the Regulation.

Market making activities and primary market operations are exempt from the ban on uncovered credit default swaps and the restrictions on short sales.

## Exemptions

Market making activities in EU shares and sovereign debt and primary market operations (where a person is acting as an authorized primary dealer in a financial instrument in relation to primary or secondary market operations) relating to sovereign debt are exempted from the ban on uncovered CDS and the restrictions on short sales. Both exemptions require 30 days' prior written notice to the applicable regulatory authority of the intent to make use of such exemption.<sup>20</sup>

## Reporting

The Regulation provides for several measures to enhance transparency in short selling for shares and sovereign debt. Only net short positions above certain threshold levels need be reported by EU entities. For shares, net short positions equal to 0.2% of issued share capital of the company concerned must be reported to the applicable regulatory authority, as well as each incremental net increase of 0.1% in such issued share capital.<sup>21</sup> Net short positions equal to 0.5% of issued share capital of a company, as well as incremental net increases of 0.1% of issued capital above that level, must be disclosed to the public.<sup>22</sup> Thresholds for significant net short positions in sovereign debt and credit default swaps will be established by the relevant Member State or the EU, as applicable.<sup>23</sup>

## Implementation and Effectiveness

The Regulation as adopted by the European Parliament next must be formally approved by the Council of the European Union (the "Council") in identical form. Approval is expected to be forthcoming within the next few weeks. Following approval by the Council, the text of the Regulation will be published in the Official Journal of the European Union. Publication is expected to take place by January 1, 2012 and the Regulation is scheduled to enter into force on November 1, 2012. In the intervening time, ESMA is directed to draft, and the Commission is directed to adopt, acts further defining terms set out in the Regulation, technical standards for calculating net short positions and specifying additional information and the methodology for reporting, as well as any other acts necessary to implement the Regulation.

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<sup>20</sup> See Article 17 of the Regulation.

<sup>21</sup> See Article 5 of the Regulation.

<sup>22</sup> See Article 6 of the Regulation.

<sup>23</sup> See Article 7 of the Regulation.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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