

ROADMAP

Title of the initiative: **Legislative initiative on short selling/ CDS**

Type of initiative (CWP/Catalogue/Comitology): **CWP (Strategic)**

Lead DG/contact person/details: **DG MARKT/G3**

Expected date of adoption of the initiative (month/year): **October 2010**

Date of modification:

Version No:

Initial IA screening & planning of further work

A. Context and problem definition

(i) What is the political context of the initiative? (ii) How does this initiative relate to past and possible future initiatives, and to other EU policies?

What are the main problems identified?

During the financial crisis, EU Member States reacted differently to short selling that they believed was creating disorderly markets and systemic risks. Member States imposed a diverse range of emergency measures using varying powers, e.g. forbidding short selling or naked short selling of different types of financial instruments. A number of Member States imposed no measures at all. This fragmented approach created difficulties and costs for market participants. It may also have led to competitive distortions and potentially regulatory arbitrage. The divergent approaches were undesirable from a single market perspective.

In February 2010, the Committee of European Securities Regulators (CESR) published a report recommending pan European rules requiring the notification and disclosure of significant net short positions in EU shares. It urged the Commission to introduce legislation as soon as possible implementing these requirements.

Separately, in the context of the Greek government bonds there has been much debate about whether speculation in credit default swaps (CDS) led to an unjustified widening of spreads in the government bonds and had an adverse affect on the sovereign bond market. The Commission services have therefore set up a taskforce to examine whether there has been any link between speculation in CDS and the underlying bond markets. Although raising different issues to short selling, if measures restricting speculation in CDS are considered appropriate they could be included in the short selling initiative (as an analogy can be drawn between speculation in CDS and naked short selling of shares).

Who is affected?

Persons who engage in short selling, other investors, companies with shares traded and regulators.

Persons who enter into credit default swaps and issuers of bonds.

(i) Is EU action justified on grounds of subsidiarity? (ii) Why can the objectives of the proposed action not be achieved sufficiently by Member States (necessity test)? (iii) As a result of this, can objectives be better achieved by action by the Community (test of EU Value Added)?

Yes, in relation to short selling to the extent that the problems that have arisen are due to inconsistencies in legislation introduced by Member States. To provide for the uniform approach to disclosure recommended by CESR it is necessary to introduce new EU legislation. This legislation would provide for uniform rules and powers relating to short selling.

In relation to credit default swaps it remains to be seen whether any measures are appropriate. But if for examples restrictions on speculating by the use of CDS are appropriate then to be effective it is likely they would need to apply across Member States.

B. Objectives of EU initiative

What are the main policy objectives?

To reduce systemic risks and disorderly trading involving short selling.

To facilitate monitoring and, if necessary, enforcement against short selling that may involve market abuse.

To reduce information asymmetry between market participants arising from short selling.

To reduce the risk of settlement failure due to uncovered short selling.

To prevent speculation in CDS having an adverse effect on government bond markets.

Do the objectives imply developing EU policy in new areas or in areas of strategic importance?

There is already EU legislation which prohibits short selling that may be market abuse. There is also EU legislation that requires disclosure of transactions in shares to regulators and to the market (the markets in financial instruments directive). Therefore, initiatives relating to short selling of shares and, if appropriate, speculation in CDS would add to existing EU legislative requirements.

C. Options

(i) What are the policy options? (ii) What legislative or 'soft law' instruments could be considered?

(iii) Would any legislative initiatives go beyond routine up-date of existing legislation?

One way to deal with this issue is through the review of the Market Abuse directive. However we consider (as do most stakeholders) that this issue goes beyond possible links with market abuse and should be dealt with in a specific legal instrument (i.e. an EU regulation on short selling).

Most studies conclude that short selling generally is beneficial to the market e.g. it provides greater liquidity and deflates price bubbles. We believe the best approach is to introduce a number of targeted and proportionate requirements that address the specific risks associated with short selling without detracting unnecessarily from the overall benefits it can provide to the market.

Possible measures include:

- introducing a requirement for short sellers to disclose significant net short positions in EU shares to regulators and to the market on the basis of the CESR recommendations,
- giving powers to regulators to prohibit or restrict short selling in an emergency situation,
- giving powers to regulators to impose conditions to reduce the risk of non settlement of naked short sales.

For restrictions on the use of CDS, any initiatives will depend on the findings of the Commission taskforce and in particular whether there is any link between speculation in CDS and an unjustified widening of spreads in government bonds. If a link is shown, then options include restricting speculation in CDS or giving Member States emergency powers to restrict CDS if it is having an adverse impact on government bond markets.

Does the action proposed in the options cut across several policy areas or impact on action taken/planned by other Commission departments?

Some aspects of the proposals may cut across possible legislative proposals to give the new European Securities Market Authority powers to prevent certain transactions in an emergency (e.g. short selling) – so monitoring of ongoing proposals and discussion in the Council and Parliament will be necessary to see how the legislative text evolves.

Explain how the options respect the proportionality principle

The key proposals have been recommended by the Committee of European Securities Regulators and all proposals are designed to deal to the extent necessary with an existing problem of different measures being introduced across the EU.

D. Initial assessment of impacts

What are the significant impacts likely to result from each policy option (cf. list of impacts in the Impact Assessment Guidelines pages 32-37), even if these impacts would materialise only after subsequent Commission initiatives?

The goals of introducing new rules would be to diminish the identified risks of short selling, that is information asymmetries, settlement failure, market abuse, creating disorderly markets and systemic risks.

Any measures proposed for CDS relating to government bonds would aim to prevent speculation in CDS damaging the ability of governments to raise funds through bond markets.

Could the options have impacts on the EU-Budget (above 5 Mio €) and/or should the IA also serve as the ex-ante evaluation, required by the Financial Regulation?

The options would not have an impact on the EU budget.

Could the options have significant impacts on (i) simplification, (ii) administrative burden or on (iii) relations with third countries?

The options are not expected to have significant impacts in any of these areas.

The options will impose an administrative cost on persons engaged in short selling to the extent that they will be required to put in place new systems to disclose net short positions to the regulator and to the market and to comply with new conditions relating to settlement of short sales.

The options could have an impact on persons in third countries who take net short positions in EU shares (as the measures may apply to them). But as most trading of EU shares takes place in markets in the EU there is not likely to be significant arbitrage. The measures imposed may vary from the approach taken in other non-EU jurisdictions but this can be justified based on different market and regulatory structures.

E. Planning of further impact assessment work

When will the impact assessment work start?

April 2010

(i) What information and data are already available? (ii) Will this impact assessment build on already existing impact assessment work or evaluations carried out? (iii) What further information needs to be gathered? (iv) How will this be done (e.g. internally or by an external contractor) and by when?

(v) What type and level of analysis will be carried out (cf. principle of proportionate analysis)?

There is quite a bit of data and information available from regulators and academics relating to the effects of short selling of shares. For example, various academic studies are available on the benefits of short selling of shares and the effect of bans on short selling during the crisis on both liquidity and spreads for shares.

There is little data or information about the incidence or effects of short selling of instruments other than shares.

There is limited data or information about whether speculation in credit default swaps (CDS) led to the widening of spreads in Greek government bonds. The Commission services have therefore set up a taskforce to examine whether there has been any link between speculation in CDS and the underlying bond markets.

Which stakeholders & experts have been/will be consulted, how and at what stage?

A high level consultation on the possibility of introducing short selling measures was carried out as part of the review of the Market Abuse Directive in 2009.

A further meeting is scheduled with CESR members in April 2010 to discuss the possibility of including additional measures relating to short selling (i.e. beyond the disclosure requirements recommended by CESR).

There will be a further publication of draft text in May and June 2010.

There will also be ongoing discussions with regulators and other stakeholders.