



Locate rules: requirements on short sales in shares and in sovereign debt instruments in articles 12 and 13 of the Regulation. March 2012.

The Regulation 236/2012, of 14 March 2012, on short selling and certain aspects of credit default swaps, published in the Official Journal of the European Union, has been during the last for months being developed by ESMA who has prepared a draft technical standards that should be submitted to the EC by 31 March and in which, among other issues, restrictions on uncovered short sales in shares and in sovereign debt instruments are developed. (Arts. 12 and 13 of the Regulation).

Short sale in relation to a share or debt instrument, is defined in article 2.1.r) of the Regulation, as any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement.

The agreements to borrow the share or sovereign debt instrument are described in articles 12 and 13 which, in b) and in c) establish the conditions that must be fulfilled to enter a short sale: b) the natural or legal person has entered into an agreement to borrow the share/debt instrument or has another absolutely enforceable claim under contract or property law to be transferred ownership so that settlement can be effected when it is due; and c) the natural or legal person has “arrangements” with a third party under which that third party has confirmed that the share has been located and has taken measures vis-à-vis third parties in order to have a reasonable expectation that settlement can be effected when it is due.(Art.12.1.c.), and the natural or legal person has “arrangements” with a third party under which that third party has confirmed that the debt instrument has been located or otherwise has a reasonable expectation that settlement the settlement can be effected when it is due (Art 13.1.c.).

ESMA, in the consultation paper on the draft technical standards on the Regulation of short selling, progresses on the contents of those articles that describe the named locate rules for short sales in shares and in sovereign debt instruments as follows (Locate rules) as follows:

1. Agreements to borrow securities or other arrangements enforceable claims having similar effects (adequately ensure the securities will be available for settlement). (Art 12.1.b and 13.1.b).

ESMA considers that an approach which provides an exhaustive list of types of agreements must be coupled with the criteria recitation that those agreements must fulfil in general. An exhaustive list of agreements will provide certainty and clarity whereas the criteria recitation will give it the consideration of an open list endowing it with the also necessary flexibility to cope with market evolutions.

Recital 18 provides examples of types of such agreements but there is no specification as to whether they apply to shares, sovereign debt or both: separate repurchase agreement on the basis of which the person selling a security short buys back an equivalent security in due term to allow settlement of the short sale transaction and includes collateral arrangements if the collateral taker can use the security for settling the short sale transactions, right issues of companies to existing shareholders, lending pools and repurchase agreement facilities provided, for instance, by trading venues, clearing systems or central banks.

ESMA considers that the following exhaustive list of types of agreement or enforceable claim having a similar effect should be set out in the implementing technical standards: futures, options, repurchase agreements, standing agreements or rolling facilities, subscription rights and other claims or agreements leading to physical exchanges of the shares or sovereign debt. There agreements or enforceable claims should meet the following criteria:

a) ensure that the amount of shares or sovereign debt subject to the short sale will be made available to the investor for the settlement of that short sale,

- b) be entered into prior or concomitantly to the investor entering into the short sale,
- c) be legally binding for at least the duration of the contract,
- d) cover at least the exact quantity to be sold short by the investor,
- e) specify an execution date consistent with ensuring that the settlement date of the sort sale in question is met,
- f) be recorded in a durable medium so the third party can provide evidence to e.g. the sort seller or the competent authority.

2. Third party confirmation (art. 12.1.c y 13.1.c).

ESMA considers that, for the proposed arrangements ensuring that the investor has reasonable expectation of timely settlement, third parties are investment firms, Trading venues, central counterparties, securities settlement systems, central Banks, national debt management entities and other new types of participants, services or business models subject to authorisation or registration in accordance with EU law and who is an active participant in the securities market and can provide data on its ability to deliver in time for settlement. Recital 19 (which refers only to shares) of the short selling Regulation describes the location (third party confirmation) as an arrangement with a third party under which the third party has confirmed that the share has been located and available for settlement when it is due and, with regard to short sales to be covered by purchase of the share during the same day, the measures should include confirmation by the third party that it considers the share to be easy to borrow or purchase in the markets conditions.

The locate third party confirmation arrangements, according to ESMA point of view, are different if they are referred to share or to sovereign debt instruments.

In relation to shares, two main factors should be taken into account: intraday trading and liquidity (liquid or illiquid) of the shares as defined under MiFID. Third party confirmation for illiquid shares should include that the share are at least identified and put on hold (icing) by the third party. Third party confirmation for liquid shares or for the specific case of intraday short selling, only should include that the shares are easy to borrow or purchase in the prevailing market conditions. In case the third party is not able to give that confirmation, that third party should obtain the effective allocation of the shares and take the necessary measures to put them on hold.

ESMA, in relation to sovereign debt instruments, appoints that the different types of third confirmations should refer, among others, to the following: a) availability for settlement in the amount requested, or b) a reasonable expectation that the investor would be able to cover his short sales by buying back the same amount of sovereign debt by the end of the day.

If you want to read ESMA's consultation paper on the on the draft technical standards on the Regulation on short selling and certain aspects of credit default swaps, do click on: http://www.esma.europa.eu/system/files/2012-30_0.pdf