Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis

by

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The article provides a detailed analysis of the EU Short Selling Regulation (236/2012), which imposes significant changes to the European credit default swap (CDS) market. The Regulation consists of two principal elements: mandatory disclosures and short selling restrictions. The disclosure regime is found to be broadly reasonable, but it includes several inconsistencies, which exacerbate regulatory fragmentation and reduce the ability of regulators to identify abuses in the CDS market. The restrictions on uncovered sovereign CDS positions reflect an insurance-based view of credit default swaps; this is modestly supported by the empirical literature, but it is not developed consistently in the Regulation. The definition of hedging creates uncertainty, and the exclusion of corporate CDSs provides opportunities for regulatory arbitrage. There is an opting-out regime, which may go unused, because the conditions for invoking it are tight and possibly illogical. The Regulation also creates new powers of intervention in exceptional situation, potentially provoking turf battles between national regulators and the European Securities and Markets Authority (ESMA).

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I. Introduction

Credit default swaps (CDSs), essentially a form of insurance against credit risk, have received a barrage of criticism during the recent financial crises. The banking crisis of 2007-09 was partly blamed for the opacity of risks created by securitization and CDSs, while the European sovereign debt crisis brought the accusation that aggressive CDS speculation had aggravated the situation of troubled states[1]. Whatever the truth of these criticisms, one of their practical consequences is the new EU Short Selling Regulation (henceforth "the Regulation")[2].

The Regulation consists of two principal measures. The first is to increase transparency by mandating the disclosure of major net short positions in shares, sovereign debt and sovereign CDSs[3]. The second measure is to restrict uncovered short positions in shares and sovereign debt, and, controversially, prohibit uncovered credit default swaps in sovereign debt[4]. The advocates of the Regulation hailed its passage as a victory of "political will" over "speculating on a country's default"[5]. Yet the appropriateness of the Regulation has been fiercely contested by its critics, who argue that it will impose unnecessary

1 *See* Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, January 2011, <http://fcic.law.stanford.edu/report>, 8–10, 50–51, 140–146, 188–195, 200–202, 243–244, 348–351, 376–379 (for a dissenting view, see 447); James Rickards, 'How markets attacked the Greek piñata' *Financial Times* (11 February 2010) <http://www.ft.com/cms/s/0/e7168fc6-1740-11df-94f6-00144feab49a.html>; Wolfgang Münchau, 'Time to outlaw naked credit default swaps' *Financial Times* (28 February 2010) <http://www.ft.com/cms/s/0/7b56f5b2-24a3-11df-8be0-00144feab49a.html>; Satyajit Das, 'Sovereign CDS – The Case for Control' *Euro Intelligence* (16 March 2010) <http://www.eurointelligence.com/eurointelligence-news/home/singleview/article/sovereign-cds-the-case-for-control.html?no_cache=1>.

2 Regulation (EU) 236/2012 of the European Parliament and of the Council 14 March 2012 on short selling and certain aspects of credit default swaps [2012] OJ L86/1 (Short Selling Regulation).

3 Articles 5–8 of the Regulation (henceforth "Articles" refer to the Short Selling Regulation unless otherwise stated).

4 Articles 12–14.

5 European Parliament, 'Parliament seals ban on sovereign debt speculation and short selling limitations', Press Release, 15 November 2012. The quoted words are those of rapporteur Pascal Canfin (Greens, FR).

expenses and that the restrictions on CDS trade will increase the costs of sovereign borrowing[6].

This article provides a critical discussion of the Regulation, its theoretical underpinnings and its practical implications. Focusing principally on the effects on credit default swaps, it argues that while the Regulation seems to be rooted more in politics than economics, it is neither as tenuous as some critics have claimed, nor as damaging as it could have been. Yet, there are a number of inconsistencies between the recommendations of economic theory and the Regulation. Further, it is demonstrated that the CDS short selling ban reflects an insurance-based understanding of credit default swaps, an understanding that is economically sensible. However, this approach is not developed consistently in the Regulation, and the result is a mixture of contradictory elements.

Section II provides a brief on CDSs and short selling regulation. Section III discusses the transparency regulations mandating disclosure of major net short positions. Section IV analyzes the provisions restricting uncovered short positions. Section V examines the exemption of market makers and the effectiveness of the Regulation. The conclusion summarizes key findings and provides a look into the future.

II. Short Selling and Credit Default Swaps

Short selling is the activity of selling a financial instrument without owning it at the time of sale by borrowing or agreeing to borrow the same instrument for delivery at settlement[7]. It is widely practised by investors to adopt a negative position on the price of a security, either for hedging or speculative purposes[8]. Studies in the US indicate that short sales account for 15–30 % of equity trading volume, although in short sales on some financial institutions exceeded

6 *See* Darrell Duffie, 'Is there a case for banning short speculation in sovereign bond markets?' (2010) 14 *Banque de France: Financial Stability Review*, 55–59; Christian Weistroffer, 'Why getting tough on credit default swaps does more harm than good' *EurActiv* (14 April 2010) <http://www.euractiv.com/financial-services/why-getting-tough-credit-default-swaps-does-more-harm-good-analysis-445627>; Andrew Baker, 'Reasons not to ban naked sovereign CDS' *Financial Times* (9 October 2011) <http://www.ft.com/cms/s/0/4e954256-ef3e-11e0-918b-00144feab49a.html>.

7 The Regulation provides an essential similar but longer definition in Article 2(1)(b). The Commission will, upon consulting the European Securities and Markets Authority (ESMA), adopt delegated acts to specify the concept of "owning" a financial instrument (Article 2(2)).

8 *See generally* Financial Services Authority (FSA), *Short Selling*, DP09/1, February 2009, ch 2 <http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf>.

40 % of the trading volume in 2008[9]. In Europe, the levels of short selling activity are lower, and not accurately known[10].

The concept of "short sale" in the strict sense does not cover credit default swaps, but these are economically closely related. In simple terms, a CDS is an over-the-counter (OTC) contract between two parties, whereby one party ("protection buyer") pays periodic fees in return for a promise by the other ("the protection seller") to compensate the loss of value of the reference entity in case of a credit default[11]. The OTC nature of CDS transactions implies that statistical data is limited, but it is estimated that the gross notional size of the global CDS market was USD 14.5 trillion in May 2010, with 2.1 million contracts outstanding; the sovereign CDS market was worth USD 2.2 trillion, with 0.2 million contracts outstanding (15.2% and 9.5% of the total, respectively)[12]. In terms of market participants, major investment banks serve as the principal dealers, and other important participants include banks, hedge funds and insurance companies[13].

Economically, CDSs are equivalent to *credit insurance*. In the language of financial derivatives, they resemble *put options* on credit default (all insurance contracts can be reconstructed as knock-in put options). Thus calling them "swaps" is misleading, because a swap is an exchange of two cash flows, and CDSs exchange one cash flow for the promise of a lump sum payment in the event of a credit default. The economic equivalence of CDSs and insurance have led some commentators to argue that they should be regulated as insurance contracts; it has even been claimed that some CDS transactions are *de jure* insurance contracts, following general insurance law principles[14].

9 *See* European Commission, 'Impact Assessment, Accompanying document to the Proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps', 15 September 2010, SEC(2010) 1055, 11, and the references cited therein.

10 ibid 11–13.

11 The Regulation defines a credit default swap as "a derivative contract in which one party pays a fee to another party in return for a payment or other benefit in the case of a credit event relating to a reference entity and of any other default, relating to that derivative contract, which has a similar economic effect" (Article 2(1)(c)).

12 European Commission, 'Impact Assessment' (n 9) 14 (based on Depositary Trust & Clearing Corporation (DTCC) data).

13 David Mengle, 'Credit Derivatives: An Overview' (2007), *Federal Reserve Bank of Atlanta Economic Review*, Fourth Quarter 1, 9.

14 Arthur Kimball-Stanley, 'Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?' (2008) 15 *Connecticut Insurance Law Journal* 241; Benjamin B Saunders, 'Should Credit Default Swap Issuers Be Subject to Prudential Regulation?' (2010) 10 *Journal of Corporate Law Studies* 427; Oskari Juurikkala, 'Credit Default Swaps and Insurance: Against the Potts Opinion' (2011) 26 *Journal of International Banking Law and Regulation* 128.

1. Regulating short selling: politics vs. economics

In financial regulation, there is a constant tension between the industry and political pressures. In the words of one regulator, "There is always a problem when regulation is politicized. [. . .] Regulators are really technocrats who take account of predictable outcomes. When they have to respond to political pressure, you get a different result."[15] The politicisation of regulation has intensified since the ongoing financial crisis that started in 2007, making it more likely that unnecessary and costly rules are imposed[16].

Whatever the merits of the Short Selling Regulation, its passage was heavily influenced by political pressures and facilitated by the European sovereign debt crisis[17]. Initially, the UK was clearly against it, considering any kind of short selling legitimate; Italy and Spain were also sceptical, fearing a ban would drive investors away and put pressure on their borrowing costs[18]. However, the deepening of the European debt crisis gave an impetus for regulation.

Political motivation does not automatically exclude economic rationale, but their relationship tends to be strained. While short-sellers may not always be benign, their role in bringing markets down has probably been exaggerated ever since the Dutch market collapse in 1610 and the crash of 1929[19]. The political sentiment toward short selling curbs has been well expressed by Nuncan Niederauer, the head of NYSE Euronext, who in 2009 stated that while "there was no economic benefit" from having an uptick rule (a form of short selling regulation), "it would go a long way to adding confidence."[20]

There is an extensive literature on the economics of short selling[21]. On the *positive side*, it is widely acknowledged that short selling contributes to the

15 Martin Wheatley, CEO of Hong Kong's Securities and Futures Commission (SFC), in Margie Lindsay, 'Hong Kong regulator predicts continued success in attracting hedge fund managers' *Hedge Funds Review* (2 December 2012) <http://www.hedgefundsreview.com/hedge-funds-review/news/1929653/hong-kong-regulator-predicts-continued-success-attracting-hedge-fund-managers>.

16 Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 *Common Market Law Review* 1317, 1372–1373.

17 On the European debt crisis, see Clas Wihlborg, Thomas D Willett and Nan Zhang, 'The Euro Debt Crisis: It Isn't Just Fiscal' (2010) 11 *World Economics* 51.

18 Alex Barker, 'EU ban on naked CDS to become permanent' *Financial Times* (19 October 2011) <http://www.ft.com/cms/s/0/cc9c5050-f96f-11e0-bf8f-00144feab49a.html>.

19 *See* Erik S Sirri, 'Regulatory Politics and Short Selling' (2010) 71 *University of Pittsburgh Law Review* 517, 520–521; Investopedia, 'Short Selling: Making the Ban' (11 June 2009) <http://www.investopedia.com/articles/stocks/09/short-selling-ban.asp>.

20 Quoted in Sirri, 'Regulatory Politics and Short Selling' (n 19) 533.

21 For a literature review, see FSA, *Short Selling* (n 8) Annex 1.

accurate valuation of financial instruments, because it allows contrarian views to be expressed and reduces overvaluation in relation to fundamental value[22]. Importantly, studies suggest that short sellers tend to be well informed about fundamentals and likely future events[23]. Short selling also enhances liquidity (the ease of completing a trade), because there are more market participants.

On the *negative side*, short selling is claimed to be associated with instability and market abuse. While it does not explain price declines as such, the evidence suggests that it aggravates crashes and makes negative returns more negative[24]. For some firms such as banks, price declines may even become a self-fulfilling prophecy[25]. There is also some evidence that short sellers may use insider information to cause disorderly price movements[26]. These concerns explain why regulators intervened heavily to restrict short selling during the 2008 crisis[27].

2. *CDSs: concerns and related legislation*

The use of credit default swaps for short selling purposes has similar effects, but CDSs also raise different concerns. First, while credit risk transfer enables better risk management, it may also decrease efficiency by *reducing lenders' incentives to monitor borrowers*[28]. The overall effect may be positive or negative, depending on the circumstances[29].

Second, CDSs may *alter market dynamics* in damaging ways. Their value is determined by credit events, which can be problematic, because restructuring

22 Arturo Bris, William N Goetzmann and Ning Zhu, 'Efficiency and the Bear: Short Sales and Markets Around the World' (2007) 62 *Journal of Finance* 1029.

23 Ekkehart Boehmer, Charles M Jones and Xiaoyan Zhang, 'Which shorts are informed?' (2008) 63 *Journal of Finance* 491.

24 Bris, Goetzmann and Zhu (n 22), 1060–1063.

25 FSA, *Short Selling* (n 8) 12.

26 Stephen E Christophe, Michael G Ferri and James J Angel, 'Short-selling prior to earnings announcements' (2004) 59 *Journal of Finance* 1845.

27 An overview is provided in Seraina N Gruenewald, Alexander F Wagner and Rolf Weber, 'Emergency Short Selling Restrictions in the Course of the Financial Crisis' (June 22, 2010) <http://ssrn.com/abstract=1441236>. A summary of existing European regulations can be found in ESMA, 'Final Report – Draft technical standards on the Regulation (EU) No. 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps', 28 March 2012, ESMA/2012/228, 18–23 <http://www.esma.europa.eu/system/files/2012-228_0.pdf>.

28 Alan D Morrison, 'Credit Derivatives, Disintermediation, and Investment Decisions' (2005) 78 *Journal of Business* 621.

29 Hendrik Hakenes and Isabel Schnabel, 'Credit Risk Transfer and Bank Competition' (2009) Max Planck Institute for Research on Collective Goods <http://www.coll.mpg.de/pdf_dat/2009_33online.pdf>.

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and bankruptcy are socially and economically costly processes. Thus, holders of speculative CDS positions are set to profit from a credit event, and may try to cause one[30]. Likewise, bondholders possessing CDS protection (so-called basis holders) have control rights but not traditional economic ownership, so they may benefit from pushing stressed debtors into bankruptcy (this is known as the "empty creditor problem")[31]. However, one should note that the mere existence of destructive incentives does not mean *ability* to cause a crash, and "empty creditors" do not always have destructive incentives[32].

Third, restrictions on, and disclosures of, short positions limit the chances of insider dealing, but CDSs have created new opportunities for *market abuse*, given their opaque OTC-nature[33]. There is strong evidence that insider trading does happen in the CDS market[34], and authorities on both sides of the Atlantic have claimed that there is also collusive behaviour in the market[35]. Importantly, the EU Market Abuse Directive currently in force does not cover OTC transactions[36], although some national market abuse regimes may cover CDSs[37]. The Commission has recently proposed a new market abuse Regu-

30 Rym Ayadi and Patrick Behr, 'On the necessity to regulate credit derivatives markets' (2009) 10 *Journal of Banking Regulation* 179; David McIlroy, 'The regulatory issues raised by credit default swaps' (2010) 11 *Journal of Banking Regulation* 303.

31 Henry TC Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions', (2008) 156 *University of Pennsylvania Law Review* 625; Patrick Bolton and Martin Oehmke, 'Credit Default Swaps and the Empty Creditor Problem' (2011) 24 *Review of Financial Studies* 2617.

32 European Central Bank, *Credit Default Swaps and Counterparty Risk*, August 2009, 72–73.

33 Joanna Benjamin, *Financial Law* (Oxford University Press 2007), 74 (para 4.52).

34 Viral V Acharya and Timothy C Johnson, 'Insider trading in credit derivatives' (2007) 84 *Journal of Financial Economics* 110; Gaiyan Zhang and Sanjian Zhang, 'Information efficiency of the U.S. credit default swap market: Evidence from earnings surprises' (2011) *Journal of Financial Stability* (forthcoming, available online 4 November).

35 *See* European Commission, 'Antitrust: Commission probes Credit Default Swaps market', 29 April 2011, IP/11/509; Michael Mackenzie and Gillian Tett, 'US probe just what the credit derivatives sector did not need' *Financial Times* (15 July 2009) <http://www.ft.com/cms/s/0/e21277e8-70b9-11de-9717-00144feabdc0.html>.

36 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [2003] OJ L96/16 (Market Abuse Directive); *see* European Commission, 'Impact Assessment, Accompanying the document Proposal for a Regulation on insider dealing and market manipulation (market abuse); Proposal for a Directive on criminal sanctions for insider dealing and market manipulation', 20 October 2011, SEC(2011) 1217 final, 19.

37 For example, the UK FSA considers that "most CDSs are likely to be caught by the UK market abuse regime": see FSA, *Market Watch,* Issue 30, November 2008, 13 <http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter30.pdf>.

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lation that covers the OTC market and specifically mentions the importance of CDSs[38].

Fourth, *counterparty risk* is a major worry that gives rise to systemic stability concerns[39]. The notorious collapse and bailout of AIG in 2008 is but a symptom of a larger problem[40]. In this respect, the principal response in both the EU and the US is to force the majority of CDS transactions into central clearing, which is believed to reduce counterparty risks[41]. However, critics argue that concentrating risks in central counterparties may exacerbate systemic risks[42].

The Short Selling Regulation only focuses on disclosure and selling restrictions, so at best it can address issues of *market opacity* and *moral hazard* due to speculative positions. There are, on the other hand, interconnections between this Regulation and the other legislative proposals: more extensive disclosures to regulators facilitate the detection of market abuse, and increased use of central counterparties makes the market more transparent.

III. Disclosure Regulation

Economists generally argue that short selling prohibitions do more harm than good[43]. In line with this, the Regulation generally favours greater disclosure,

38 European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)' COM (2011) 651 final.

39 John Kiff, Jennifer Elliott, Elias Kazarian, Jodi Scarlata and Carolyne Spackman, 'Credit Derivatives: Systemic Risks and Policy Options' (2009), IMF WP/09/254 <http://www.imf.org/external/pubs/ft/wp/2009/wp09254.pdf>; European Commission, 'Impact Assessment' (n 9) 25.

40 *See* William K Sjostrom Jr., 'The AIG Bailout' (2009) 66 *Washington & Lee Law Review* 943.

41 In the EU, the so-called European Market Infrastructure Regulation (EMIR): see European Parliament legislative resolution of 29 March 2012 on the proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (COM(2010)0484 – C7-0265/2010 – 2010/0250(COD)); in the US, the Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act), Title VII (Wall Street Transparency and Accountability Act).

42 Frederik Dømler, 'A critical evaluation of the European credit default swap reform: Its challenges and adverse effects as a result of insufficient assumptions' (2012) *Journal of Banking Regulation* (forthcoming, available online 14 March).

43 Menachem Brenner and Marti G Subrahmanyam, 'Short Selling', in Viral V Acharya and Matthew Richardson (eds), *Restoring Financial Stability* (Wiley 2009) 269–276; Seraina N Gruenewald, Alexander F Wagner and Rolf H Weber, 'Short Selling Regulation after the Financial Crisis – First Principles Revisited' (2010) 7 *International Journal of Disclosure & Governance* 108.

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avoiding bans on short selling activity (with exceptions discussed later). In fact, the Parliament added a sentence to Recital 5 of the Regulation to the effect that "While in certain situations it could have adverse effects, under normal market conditions, short selling plays an important role in ensuring the proper functioning of financial markets, in particular in the context of market liquidity and efficient price formation."

The principal objective of disclosure regulation is to enable regulators to better detect market abuse, position build-up and their implications for market disorders[44]. It is also hoped that, especially if significant short positions must be disclosed publicly, this will reduce insider dealing and deter the taking of aggressive short positions, which might destabilise the market[45]. In most EU countries there are no disclosure requirements for short positions, and the requirements that do exist tend to be diverse, creating additional compliance costs; in this respect, the Regulation seeks to provide greater harmonisation[46].

The following subsections discuss the ordinary disclosure regime for shares and bonds, the different rules for corporate and sovereign bonds, the disclosure of CDS positions, and the emergency disclosure regime in exceptional situations.

1. *Ordinary disclosure regime: separate rules for shares and bonds*

The new disclosure rules are an amalgam of mixed elements. In relation to *significant net short positions in shares*, the Regulation imposes a two-fold obligation, following the German model[47]. First, such positions have to be *notified to the regulators* when they reach the notification threshold of 0.2% of the issued share capital of the company concerned, as well as each 0.1% above that (Article 5). Second, net short positions in shares must be *publicly disclosed to the market* when they reach the publication threshold of 0.5% of the issued share capital of the company concerned, as well as each 0.1% above that (Article 6).

It was acknowledged by the legislators that the regulatory rationale with respect to short positions in *sovereign debt and credit default swaps* is largely similar. However, the rules are slightly different (see Articles 7 and 8). For one

44 European Commission, 'Impact Assessment' (n 9) 28; CESR, 'Model for a Pan-European Short Selling Disclosure Regime', CERS/10-088, March 2010 <http://www.esma.europa.eu/system/files/10_088.pdf>, 5.

45 European Commission, 'Impact Assessment' (n 9) 28–30; CERS (n 44), 6; FSA, *Short Selling* (n 8) 24–25.

46 European Commission, 'Impact Assessment' (n 9) 28.

47 *See* European Commission, 'Impact Assessment' (n 9) Annex 3.

thing, the *notification thresholds* have to be defined separately, because they cannot be defined in terms of issued share capital. The principle will be the same, however: there is an initial level and then additional incremental levels (Article 7(2)). The Commission will specify the amounts and incremental levels after consulting the European Securities and Markets Authority (ESMA) (article 7(3))[48].

Further, according to Article 8, the disclosure of short positions on sovereign CDSs is only relevant when such positions are exceptionally permitted by the regulators in accordance with Article 14(2), which is discussed later. Apart from these minor issues, there are two points that stir attention: there is no public disclosure requirement for sovereign debt, and the transparency regulations do not cover short positions in corporate debt at all. These are discussed next in detail.

2. *Sovereign debt shorting: no public disclosure*

The transparency obligations related to short positions in sovereign debt are limited to notification to the regulators; there is no requirement of public disclosure. Given that such a publication requirement was imposed in relation to shares, and that it would have seemed politically opportune to discourage the taking of aggressive short positions in sovereign debt, one wonders why public disclosure was excluded here.

The matter received only a limited attention in the preparatory materials. The Commission impact assessment only noted that, in the public consultation, "serious concerns were expressed about the potential negative impact on liquidity of public disclosure of sovereign bonds and sovereign CDS short positions."[49] One reason for those concerns was a widely publicized study in 2010 by the consulting firm Oliver Wyman, claiming that when the UK imposed a partial public disclosure regime on shares in 2008, short selling participation was reduced by 20–25%, the trading volume of shares covered by the regime decreased by 13%, and their bid-ask spreads widened by as much as 45%[50].

48 *See* ESMA, 'Final Report – ESMA's technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No. 236/2012)', 19 April 2012, ESMA/2012/263, 45–49 <http://www.esma.europa.eu/system/files/2012-esma-263_-_final_report_on_technical_advice_on_short_selling.pdf>.

49 European Commission, 'Impact Assessment' (n 9) 64.

50 Bradley P Ziff and Thayer Moeller, 'The effects of short selling public disclosure regimes on equity markets: A comparative analysis of US and European markets' (2010) Oliver Wyman, 4–5 <http://www.oliverwyman.com/pdf_files/OW_EN_FS_PUBL_2010_-Short_Selling.pdf>.

On the other hand, the Commission went on to question the claims that public disclosure of significant short positions would have harmful effects, citing analyses made by the Commission of European Securities Regulators (CESR) and the UK Financial Services Authority (FSA)[51]. It also noted that the Oliver Wyman study was probably "distorted by the comparison of data in a declining market in 2008 with data in a benign market from April 2009 onwards."[52] In fact, one might even interpret the reduction of short seller participation and the widening of bid-ask spreads as evidence of the effectiveness of the public disclosure regime in moderating downward pressure on shares[53].

Another concern is that public disclosure might cause harmful effects in the form of short squeezes, copy cat trades and herd behaviour[54]. A *short squeeze* is produced by rapidly rising prices, which may force short sellers to liquidate their position, thereby adding momentum to the price escalation. Public disclosure of short positions can be a problem for short sellers, as others may exploit the information and seek to manipulate short-term prices to create a short squeeze[55]. *Copy cat trades* can be harmful especially for funds engaged in price arbitrage strategies, which may lose their research-based competitive advantage as a result of public disclosure[56]. This is a loss to the traders, but a benefit to market efficiency[57]. Note also that short squeezes and copy cat trades are not directly harmful for debtors (including troubled member states); whether they are indirectly harmful requires more study. Therefore they are not strong reasons to oppose public disclosure of short positions in sovereign debt, especially if similar disclosure exists for shares.

51 European Commission, 'Impact Assessment' (n 9) 58.

52 Ibid 59.

53 *See* FSA, *Short Selling* (n 8) 16.

54 The Impact Assessment (n 9) 58, notes that market participants felt that "if their positions are disclosure to the market, other investors may copy their strategies ('herding behaviour') and this could result in them making losses ('short squeezes')." This is not an accurate expression, however, because short squeezes and short-selling herding are opposite processes, so one cannot cause the other.

55 A survey by Oliver Wyman consultants found that 69% of fund managers were concerned that short squeezes would intensify as a result of public disclosure of short positions: Bradley P Ziff and Carey Shu, 'The effects of short selling public disclosure of individual positions on equity markets' (2011) Oliver Wyman, 21–22 <http://www.oliverwyman.com/pdf_files/OW_EN_FS_Publ_2011_Short_Selling_Public_Disclosure_Equity_Markets.pdf>.

56 ibid 29–30.

57 A difficult question is how efficient is optimal, as pricing efficiency will be reduced if investors have no incentives to do the research: see generally Sanford J Grossman and Joseph E Stiglitz, 'On the Impossibility of Informationally Efficient Markets' (1980) 70 *American Economic Review* 393.

In contrast, *herd behaviour* by investors can be damaging for debtors. Herding happens when some investors are relatively poorly informed and make decisions based on imitation, or when they try to profit by jumping on the bandwagon. As herding reinforces the price tendency, public disclosure of short positions will exacerbate downward price spirals if investors imitate major short sellers on trust[58].

3. *CDS disclosure: corporate vs. sovereign debt*

Another exception is that the disclosure regime only covers sovereign debt[59]. Again, the Commission proposal did not supply much explanation for this limitation, apart from pointing to the public consultation, which "showed very limited support for the inclusion of corporate bonds and their derivatives in a disclosure regime"[60].

This is surprising, particularly in relation to corporate CDSs, which raise specific issues such as market abuse and the empty creditor problem. In fact, the European Parliament's Committee on Economic and Monetary Affairs felt differently that "it would be appropriate to extend to corporate debt and corporate CDS the notification regime [in order to] ensure to the issuers that there is no price manipulation on these instruments."[61] Yet the move was opposed by some Committee members, notably UK's Conservative MEP Syed Kamall, who argued that the Regulation also covers short positions in shares, so "it would be disproportionate to also extend disclosure obligations to debt instruments issued by corporate issuers"[62]. However, the disclosure of major short positions in shares is not by itself a reason to exclude disclosure of

58 *See* FSA, *Short Selling* (n 8) 25.

59 "Sovereign debt" is defined in Article 2(1)(d) broadly to include any debt instrument issued by the European Union; a Member State or a government department, agency or special purpose vehicle (SPV) of the Member State; a member of a federal Member State; an SPV for several Member States (e.g. the European Financial Stability Facility); an international financial institution established by Member States (e.g. the European Stability Mechanism); and the European Investment Bank.

60 European Commission, 'Impact Assessment' (n 9) 64.

61 European Parliament Committee on Economic and Monetary Affairs, 'Draft report on the proposal for a regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps' (COM(2010)0482 – C7-0264/2010 – 2010/0251(COD)), 24 November 2010, 78; *see also* 7–8 (amendment 5) and 38–39 (amendment 63).

62 See European Parliament Committee on Economic and Monetary Affairs, 'Amendments 139–336, proposal for a regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps' (COM(2010)0482 – C7-0264/2010 – 2010/0251(COD)), 20 January 2011, 16.

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short positions in bonds; these can be similar in economic function, and it would be logical to have similar regulatory principles in both cases.

Indeed, it has been argued that European financial regulation is suffering from significant *regulatory fragmentation*[63]. In this respect, the present Regulation does well to cover sovereign CDSs, and not only sovereign debt, in order to reduce regulatory arbitrage. On the other hand, the corporate CDS market remains an exception. In fact, some countries, including Spain and the UK, have adopted mandatory reporting of some OTC derivatives transactions (including corporate CDSs) in their national rules, along the lines of MiFID[64]. But these reporting requirements differ from the disclosure of significant net short positions in the Regulation, and they do not exist in most member states[65]. Therefore, the result is that different are applicable for *short positions in shares* (disclosure to regulators and market), *sovereign debt and CDSs* (disclosure to regulators only), and *corporate debt and CDSs* (some or no disclosure).

Apart from regulatory fragmentation, another implication is that those wishing to bet against troubled companies may increasingly do so using credit default swaps, thus avoiding disclosing their position to the market. This is unlikely to be a welcome result, as CDS dynamics are less predictable than the market for shares, and there are more concerns about abusive behaviour.

4. *Emergency powers: exceptional disclosure regime*

These apparent inconsistencies of the Regulation may be explained by two factors: political pressure and the emergency powers. The passage of the Regulation was heavily influenced by the European sovereign debt crisis, and given the contentious nature of the rules, it may have been easier to agree to regulate the sovereign debt market more heavily. Further, Chapter V of the Regulation grants regulators powers of intervention in "exceptional circumstances". These emergency powers include the right to demand disclosures and to impose trade restrictions.

63 *See* Moloney (n 16).

64 The UK rule is found in *FSA Handbook*, SUP17.1.4 R(2), which covers the reporting of transactions in "any OTC derivative the value of which is derived from, or which is otherwise dependent upon, an equity or debt-related financial instrument which is admitted to trading on a regulated market or on a prescribed market". This possibility is mentioned in Recitals 45 and 46 of the Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments [2004] OJ L145/1 (MiFID).

65 European Commission, 'Impact Assessment' (n 9) 19.

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a) Inclusion of corporate debt and CDSs

According to Article 18, national regulators may require investors that have net short positions to disclose details of their positions. Article 19 also enables regulators to demand from lenders information about significant changes in their fees. Several things are worth noting about this exceptional disclosure regime.

Firstly, the regime may require *notifying the regulators or disclosing the position to the market*. Thus it may happen that short positions in corporate or sovereign debt will be publicised in exceptional circumstances. Secondly, the regime may apply to *any financial instrument or class of financial instruments*, including corporate CDSs. Recital 37 of the Regulation expressly mentions this possibility:

> Because of the specific risks which can arise from the use of credit default swaps, such transactions require close monitoring by competent authorities. In particular, competent authorities should, in exceptional cases, have the power to require information from natural or legal persons entering into such transactions about the purpose for which the transaction is entered into.

This Recital is not limited to sovereign CDS. In fact, Article 18(2) specifies that emergency disclosure shall not apply to instruments covered by the ordinary disclosure obligations under Articles 5–8, which include shares (Articles 5–6), sovereign debt (Article 7) and sovereign CDSs (Article 8, only applicable when Article 14(2) restrictions are suspended). The implication is that, paradoxically, regulators may in exceptional circumstances require *public disclosure* of short positions in corporate debt and corporate CDSs; in contrast, sovereign CDS positions will only be disclosed to the regulators, so in that case their regulatory treatment becomes relatively less onerous.

b) Intervention conditions

There are limits to the emergency powers, but they are not precise. For example, the exceptional notification thresholds are to be determined by the national regulators, although presumably they will mirror the thresholds of the ordinary disclosure regime. Further, two broad conditions must be present[66]:

> (a) there are adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State concerned or in one or more other Member States; and
>
> (b) the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits.

66 *See* Articles 18(1), 19(1) and 20(1).

The generic nature of these conditions makes it difficult to predict their interpretation. Following Article 30, the Commission will adopt delegated acts to specify in which cases the adverse events or developments arise. Although the literal wording suggests that there must be a market-wide stability concern, the preliminary non-exhaustive list of qualitative events, prepared by ESMA, reflects a different interpretation: basically, any serious concerns related to either EU member states or systematically important financial institutions would constitute the relevant adverse event or development[67].

Too hasty a reliance on emergency powers may be reduced by the fact that the regulator must notify ESMA as well as the other national regulators of the measure it proposes, including "the evidence supporting the reasons for those measures" (Article 26(2)). Moreover, the general conditions for intervening are formulated in such a way that these measures probably cannot be used to address firm-specific concerns such as insider dealing or empty creditor problems. On the other hand, one should not ignore the possibility that the powers of intervention will be interpreted widely, following Recital 37, which refers to "the power to require information [. . .] about the purpose for which the [CDS] transaction is entered into."

c) *National and European interventions*

An important question is who decides when and how the emergency powers are employed. The *relevant competent authority* making the decision varies depending on the financial instrument in question. On one hand, for an EU member state sovereign debt and CDSs, the power is in the hands of the *competent authority of that member state* (Article 2(1)(j)(i)). On the other hand, for corporate debt and CDSs (and non-EU sovereign instruments), the relevant competent authority is the national regulator in whose jurisdiction is *the most relevant market in terms of liquidity* for the financial instrument in question (Article 2(1)(j)(v))[68]. In the case of CDSs, this will in most cases be the UK regulator, because London is a global leader in the CDS market[69]. Other national regulators may also use the intervention powers, but only with the consent of the relevant competent authority (Article 22).

67 *See* ESMA, 'Final Report' (n 48) 65–67.

68 The detailed rules for this determination are found in Chapter III of Commission Regulation (EC) 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] OJ L241/1.

69 *See* letter from Richard Metcalfe, ISDA, to the Law Commission, in response to *In-*

However, the emergency powers are not limited to national regulators. In Article 28, independent powers of intervention are reserved to ESMA in equivalent situations if the relevant national regulators have failed to act so as to adequately address the "threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union" (Article 28(2)). According to Article 30, the concept of such threats will be specified by the Commission after consulting ESMA. As explained earlier, ESMA has adopted an expansive and flexible view of the matter[70].

Moreover, Article 31 gives ESMA a separate power to conduct "an inquiry into a particular issue or practice relating to short selling or relating to the use of credit default swaps to assess whether that issue or practice poses any potential threat to financial stability or market confidence in the Union." This right of enquiry may be conducted on ESMA's own initiative, or on the request of national regulators, the European Parliament, the Council or the Commission. It covers corporate as well as sovereign CDS markets, and it is not conditional on any actual threat to financial stability.

This means that the exceptional disclosure regime is highly unpredictable. It may be that the powers of intervention will be used sparingly, but there is plenty of scope for broader interpretation of those powers if regulators are determined to obtain more information about CDS trade. Considering the precarious state of European financial markets, and the nature of regulatory politics as ESMA seeks to establish itself in the regulatory landscape, one should not be surprised if the intervention powers were to be employed with substantial frequency.

IV. Short Selling Restrictions

Increasing transparency was not seen as sufficient. This is because there were other concerns related to short selling, particularly the risk of *negative price spirals*, and the risk of *settlement failure* associated with naked short selling[71]. The following subsections discuss the legislative history, the issue of insurable interest in uncovered CDSs, the exclusion of corporate CDSs, emergency powers and the opting-out rules.

surance Contract Law: A Joint Scoping Paper (18 April 2006) <http://www.isda.org/whatsnew/pdf/Law-Commission04-18-06.pdf>.

70 *See* ESMA, 'Final Report' (n 48) 66 (para 194): "Such powers need to be flexible enough to enable competent authorities to deal with a range of different exceptional situations."

71 *See* European Commission, 'Impact Assessment' (n 9) 24–28.

1. Commission vs. parliament

The original Commission proposal did not go very far. With respect to the risk of settlement failure, the Commission proposed imposing conditions on uncovered ("naked") short selling by requiring that short sellers either borrow the share or sovereign debt instrument, or they make an arrangement with a third party confirming that the instrument has been located and reserved for lending (the "*locate rule*")[72]. The proposal also included better *settlement discipline* on trading venues[73]. Similar rules already exist in the US[74].

These were broadly maintained in the final Regulation. The principal change was to soften the locate rule by a reference to "a *reasonable expectation* that settlement can be effected when it is due" (Articles 12(1)(c) and 13(1)(c)). The permitted arrangements have been specified by implementing technical standard prepared by ESMA[75]. Settlement discipline and buy-in procedures were defined for central counterparties (not "trading venues"), but limited to shares, excluding sovereign debt (Article 15).

Details matter, but settlement failure did not provoke major disagreement. While data on settlement failures is limited, according to national regulators, settlement failures represent about 2–4 % of all transactions[76]. Some regulators, including the UK FSA, felt that the overall risks from naked short selling are minimal. Other regulators, however, thought that the risk of price manipulation is greater with naked shorting, because it enables speculators to sell in principle an unlimited amount in a very short space of time[77].

To combat the risk of negative price spirals, the Commission only proposed giving national regulators powers of intervention in order to *temporarily restrict short selling*. For financial instruments traded on a trading venue, there would be a "circuit breaker" type rule, enabling regulators to restrict or prohibit short selling temporarily in the case of a significant fall in price[78]. For sovereign CDSs, national regulators would possess emergency powers to limit

72 COM (2010) 482 final, Article 12 ("Restrictions on uncovered short sales").

73 COM (2010) 482 final, Article 13 ("Buy-in procedures and fines for late settlement").

74 Regulation SHO; *see* Sirri, 'Regulatory Politics and Short Selling' (n 19) 524–525.

75 Following Articles 12(2) and 13(5); *see* ESMA, 'Final Report' (n 27) 58–62 (Annex IV, Chapter IV of Draft Implementing Technical Standards); Commission Implementing Regulation (EU) No …/.. of XXX (provisional version) <http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-technical-standards_en.pdf>.

76 *See* European Commission, 'Impact Assessment' (n 9) 26, for details.

77 *See* ibid 27.

78 COM (2010) 482 final, Article 19.

trading in exceptional situations[79]. These were both accepted, with changes, in the final Regulation (Articles 23 and 21 respectively).

The Parliament, however, was not satisfied with the possibility of temporary restrictions in the CDS market, and went all the way to ban uncovered positions in sovereign credit default swaps (Article 14(1)). To be precise, the prohibition is *semi-permanent*, because an opting-out provision was included (Article 14(2)). In effect, the difference is a question of presumption: the Commission proposal would have permitted CDS short selling as a rule, allowing its prohibition as an exception; the final Regulation made prohibition the rule and permission the exception.

2. *Insurable interest and uncovered CDS*

Although the semi-permanent prohibition of CDS shorting must have been influenced by the precarious borrowing position of some member states, the move is not as radical as it seems. Given the high level of fragmentation of financial regulation, frequent calls have been made for increased regulatory consistency along functional lines[80]. Now, it is widely acknowledged that credit default swaps are functionally like credit insurance, and some commentators have asked whether CDSs can meaningfully be distinguished from insurance contracts[81].

The Short Selling Regulation does not define credit default swaps as insurance, but it effectively imposes limits that resemble those in insurance law. In insurance law, the doctrine of *insurable interest*, which says that one cannot buy insurance without having a legitimate interest in the subject-matter, was historically motivated by concerns that insurance may be used with a destructive intent if anyone can take out insurance on another's life or property[82]. CDSs, which are functionally equivalent to insurance, raise similar concerns of moral hazard and perverse incentives[83].

79 COM (2010) 482 final, Article 18.

80 *See* Dwight B Crane, Kenneth A Froot, Scott P Mason, André F Perold, Robert C Merton, Zvi Bodie, Eric R Sirri and Peter Tufano, *The Global Financial System: A Functional Perspective* (Harvard Business School Press 1995).

81 *See* n 14.

82 Malcolm Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (Oxford University Press 2005), 26–38.

83 European Commission, 'Impact Assessment' (n 9) 25.

a) The pros and cons of CDS shorting

The appropriateness of the insurable interest doctrine for CDSs is subject to dispute. Indeed, within insurance law scholarship, that doctrine is debated, because it creates uncertainty and may be unnecessary[84]. It is therefore appropriate to consider the pragmatic case in more detail.

In terms of economics, there are arguments both ways. On the one hand, well-functioning markets in financial risk are beneficial to both lenders and borrowers, because they facilitate better risk management, which in turn lowers risk premiums and borrowing costs[85]. CDSs also reveal new information about borrowers, and this might reduce the informational premium on bonds and informational rents of bank loans[86]. Wider participation in credit risk markets also increases their liquidity, which makes credit insurance cheaper by narrowing bid-ask spreads and making prices more stable. Finally, the existence of more market participants favours more efficient price formation.

On the other hand, free markets may fail to function constructively[87]. Lack of transparency may open possibilities for abusive trading, while inefficient pricing may be exacerbated by leveraged bets seeking to profit from negative price spirals. The informational efficiency of markets is always relative, and boundedly rational and liquidity-constrained investors may fall into pricing errors, particularly in turbulent times. Moreover, just like any insurance, credit insurance weakens incentives to reduce risks (for example by monitoring debtors)[88].

The empirical evidence is limited. While liquid markets in credit risk are, in principle, beneficial to lenders, there is yet no strong evidence of benefits to *borrowers*. A widely-cited study by Ashcraft and Santos on corporate debt failed to find evidence that the onset of CDS trading lowers the cost of debt financing for the average borrower[89]. Contrary to the general hypothesis, the study discovered *economically significant adverse effects on risky and informa-*

84 *See generally* English and Scottish Law Commissions, *Insurable Interest* (Issues Paper 4, 2008) 2.

85 *See* Darrell Duffie, 'Innovations in credit risk transfer: Implications for financial stability' (2008) BIS Working Papers No. 255 <http://www.bis.org/publ/work255.pdf>.

86 *See* Adam B Ashcraft and João AC Santos, 'Has the CDS market lowered the cost of corporate debt?' (2009) 56 *Journal of Monetary Economics* 514, 515.

87 This has been emphasised by a school of thought known as behavioural finance: see Robert J Shiller, 'From Efficient Markets Theory to Behavioral Finance' (2003) 17 *Journal of Economic Perspectives* 83.

88 *See* Morrison (n 28) and Hakenes and Schnabel (n 29). In credit insurance, the insurer may, however, demand some form of monitoring.

89 Ashcraft and Santos (n 86).

tionally opaque firms; in contrast, safe and transparent firms have benefited from a small reduction of bond and loan spreads.

The finding is counterintuitive, because common sense suggests that CDSs should *reduce* the costs of risky and opaque borrowers, because their lenders are more likely to take interest in credit insurance, and the informational value of CDSs (if any) should reduce opaqueness[90]. The reason for the anomaly may be that CDSs are heavily used by banks to lay off their credit exposures; this reduces their monitoring incentives, and anticipating this, syndicate participants and bond investors "may demand higher compensation to extend loans to these firms, in particular to those for which monitoring is most valuable, riskier, and informationally opaque"[91]. This is a form of the classic "lemons problem" in the presence of asymmetric information[92]. Therefore, it may be that the CDS market is, paradoxically, reducing the informational efficiency of debt markets in some cases and rendering debt financing more expensive.

Another study on Asian bond and CDS markets has slightly challenged the previous finding, but it also raises new issues[93]. An investigation January 2003 to June 2009 found that, in general, CDS trading was associated with lower borrowing costs and highly liquidity. The authors speculate that the difference in comparison to US results may be due to a "jump-start effect" in the underdeveloped Asian bond markets[94]. Whatever the reason, the bad news is that during the crisis period, firms included in CDS indices faced higher spreads than their peers, suggesting that CDS trading may intensify shocks in difficult times[95].

Studies on European sovereign CDS prices during the sovereign debt crisis also give some cause for concern. One study found that, contrary to theory of complete markets, sovereign debt and CDS spreads did not track each other very well, but especially during the crisis, CDS spreads led bond yields, creating upward pressure on the latter[96]. Another study compared CDS spreads with economic fundamental and found that CDSs were significantly over-

90 ibid 515.

91 ibid 523.

92 *See* George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488.

93 *See* Ilhyock Shim and Haibin Zhu, 'The impact of CDS trading on the bond market: evidence from Asia' (2010) BIS Working Papers No. 332 <http://www.bis.org/publ/work332.pdf>.

94 ibid 2.

95 ibid 3.

96 Giovanni Calice, Jing Chen and Julian Williams, 'Liquidity spillovers in sovereign bond and CDS markets: An analysis of the Eurozone sovereign debt crisis' (2011) *Journal of Economic Behavior & Organization* (forthcoming, available online 26 October).

priced in comparison[97]. However, the data is subject to different interpretations, as it might be argued that in both cases CDS spreads better reflected *future* fundamentals.

The basic question is whether CDSs lead markets into error, or instead help to locate the accurate price more swiftly. The case may be one or the other, depending on the circumstances. There is some evidence suggesting that CDS prices are more informationally efficient than stock market prices[98]. This is consistent with the belief that credit default swaps are used by insiders who cannot use their knowledge in traditional markets; for example, banks have privileged access to client information and may hedge their exposure against forthcoming bad news. For borrowers this means higher borrowing costs, because the information leakage through CDSs is especially relevant for risky firms that are close to default[99].

On the other hand, the informational efficiency of CDS prices has also been questioned. For example, it has been found that the CDS market was efficient before the credit crisis of 2007–08, but during the crisis it under reacted to earnings announcements, and after the crisis it overreacted[100]. Specific studies on the European sovereign bond and CDS markets also indicate that, since September 2008, CDS spreads have on average exceeded bond spreads[101]. Possible pricing inefficiency may be due to various factors such as market concentration, which may cause high short-term volatility in CDS prices in comparison to bond prices, especially in turbulent times[102].

97 Joshua Aizenman, Michael M Hutchison and Yothin Jinjarak, 'What is the Risk of European Sovereign Debt Defaults? Fiscal Space, CDS Spreads and Market Pricing of Risk' (2011) NBER Working Paper No. 17407 <http://www.nber.org/papers/w17407>.

98 Gaiyan Zhang and Sanjien Zhang, 'Informational efficiency of the U.S. credit default swap market: Evidence from earnings surprises' (2011) *Journal of Financial Stability* (forthcoming, available online 4 November); Ioana Alexopoulou, Magnus Andersson and Oana Maria Georgescu, 'An empirical study on the decoupling movements between corporate bond and CDS spreads' (2009) ECB Working Paper No. 1085 <http://www.ecb.int/pub/pdf/scpwps/ecbwp1085.pdf>.

99 Zhang and Zhang (n 98) 4–5 (pre-publication version).

100 Nicole Thorne Jenkins, Michael D Kimbrough and Juan Wang, 'The extent of informational efficiency in the credit default swap market: Evidence from post-earnings announcement returns' (7 July 2011), <http://ssrn.com/abstract=1785734>.

101 Alessandro Fontana and Martin Scheicher, 'An Analysis of Euro Area Sovereign CDS and Their Relation with Government Bonds' (2010) ECB Working Paper No. 1271 <http://www.ecb.int/pub/pdf/scpwps/ecbwp1271.pdf>.

102 European Commission, 'Impact Assessment' (n 9) 25. The CDS market is extremely concentrated, as the 10 largest dealers account for 90 % of trading volume (in terms of gross notional amounts): see Rama Cont, 'Credit default swaps and financial stability' (2010) 14 *Banque de France: Financial Stability Review* 35, 36.

A further concern is that, given the informational limitation of markets and the tendency of many investors to imitate others, a contagion in the CDS market may become a self-fulfilling prophecy by causing a fright in the traditional bond market[103]. The opacity of the CDS market also facilitates trading strategies aimed at generating destabilising signals[104]. This concern is supported by a Fitch annual survey of credit derivative traders, reporting that the majority of traders believe that sovereign CDS prices have an important impact on cash market spreads[105]. The impact may or may not be informationally efficient, depending on what is driving the CDS spreads, but it will be detrimental to risky and opaque borrowers.

b) *Insurable interest: what makes a hedge*

A perennial problem with the insurable interest doctrine is what constitutes insurable interest[106]. This is a major question in the Regulation, too. One worry during the Parliamentary process was that "insurable interest" or "hedging" might be defined too narrowly. Originally, though, the Committee on Economic and Monetary Affairs took a hard line, considering that "all investors owning a CDS without possessing the underlying bond should be considered as having an uncovered CDS position"[107]. But this is a very narrow concept of hedging, and a wider definition was adopted in the end. According to Article 4(1), the prohibition of uncovered positions can be avoided if the sovereign CDS serves to hedge against:

(a) the *risk of default of the issuer* where the natural or legal person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates; or

(b) the *risk of a decline of the value* of the sovereign debt where the natural or legal person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations *the value of which is correlated to the value of the sovereign debt.* [emphases added]

This solution is more consistent with financial theory, because investors may have an indirect economic interest in assets not directly owned, and may wish

103 European Commission, 'Impact Assessment' (n 9) 25.

104 Luca Amadei, Simona Di Rocco, Monica Gentile, Renato Grasso and Giovanni Siciliano, 'Credit Default Swaps: Contract Characteristics and Interrelations with the Bond Market' (2011) CONSOB Discussion papers, 32–33 <http://ssrn.com/abstract=1905416>.

105 *See* Joseph Cotterill, 'A year in the life of sovereign CDS' *Financial Times* (17 September 2010) <http://ftalphaville.ft.com/blog/2010/09/17/346151/a-year-in-the-life-of-sovereign-cds>.

106 *See* English and Scottish Law Commissions, *Insurable Interest* (n 84) 26–32, 35–44.

107 'Draft report' (n 61) 79.

to obtain a "proxy hedge" when a direct hedge is unavailable or too expensive. Proxy hedging is based on value correlations, so the wording in Article 4(1)(b) evidently refers to it. However, this is not without concerns. Firstly, the Parliamentary Committee already expressed scepticism of proxy hedging, arguing it could be damaging for sovereign borrowers: "Using a CDS as a proxy for hedging other financial instruments by increasing demand for sovereign CDS is prone to sending misleading signals to the market. Such misleading signal could put Member State's financing costs at risk and thus increases the pressure on already strained public finances."[108]

Secondly, there is the practical concern of how the definition is specified. The reference to *correlation of value* is far too broad for regulatory purposes, so Article 4(2) empowers the Commission to adopt delegated acts in order to specify the hedging rules (and the method for calculating group positions)[109]. The ESMA technical advice adopts a liberal approach, noting that "a very wide range of exposures could potentially be eligible for hedging through a sovereign CDS position."[110] Preferring general principles to an exhaustive list of particular cases, ESMA lays down two broad requirements: correlation and proportionality between the risks being hedged and the referenced sovereign debt[111].

Neither of these is precisely defined. With respect to *correlation*, ESMA considers it "better not to produce a very precise quantitative definition as to the extent of the correlation required. There must be a meaningful positive (or negative) correlation but a general qualitative statement should be sufficient and would not risk setting an overly precise boundary."[112] However, correlation should normally be demonstrated by reference to historical data "for a sufficiently long period (normally at least 12 calendar months of trading days)"[113]. For exposures without a liquid market price or sufficiently long price history, a suitable proxy is to be used[114].

With regard to *proportionality*, the CDS position should not be totally disproportionate in comparison with the risks being hedged, but a perfect match cannot be expected[115]. Moreover, while position holders are generally responsible for ensuring that their CDS position remains covered, they should not be

108 'Draft report' (n 61) 79.
109 *See* ESMA, 'Final Report' (n 48) 34–44.
110 ibid 38 (para 78).
111 ibid 34–36.
112 ibid 39 (para 83). Negative correlation is relevant when a liability (as opposed to an asset) is being hedged.
113 ibid 40 (para 84).
114 ibid 40 (para 85).
115 ibid 40 (para 87).

punished for changes in market valuations without any active change of position[116].

ESMA's principled approach has the advantage of reducing compliance costs and avoiding too narrow rules, although it may also end up watering down the restrictions. There are a couple of more concrete guidelines, however. One is that involuntary uncovered sovereign CDS positions, which may be imposed upon members of a central counterparty, are not prohibited[117]. The other is that the risk being hedged (the counterparty) should be located in the member state whose sovereign debt is referenced in the CDS being used as a hedge, although there are some exceptions (for example, when the counterparty is a supra-national European body) and "it should be permissible to hedge the counterparty risk with an appropriately chosen basket of sovereign CDS."[118] This geographic limitation, which prohibits cross-country hedging, has in any case been criticised by market participants[119].

Further, ESMA's technical advice helpfully clarifies an issue concerning the use of sovereign CDSs to manage sovereign counterparty risk. This is important, because under current market practices, sovereigns do not post collateral in OTC derivative transactions, including popular deals such as interest rate swaps. Many traders therefore use sovereign CDSs to obtain a synthetic hedge[120]. On a narrow reading of Article 4(1), a synthetic hedge might be considered an *uncovered* position, because the counterparty does not have a long position in the sovereign debt, and the relevant risk is not one of a decline in the value of the sovereign debt as such. Economically, this would be an absurd interpretation, however, and ESMA helpfully notes that a hedge position includes "interest rate or currency swap transactions where the sovereign CDS is used as a counterparty risk management tool for hedging exposure on financial contracts"[121].

3. Scope: sovereign vs. corporate CDS

As earlier in relation to transparency rules, the CDS shorting ban is limited to sovereign debt. This was not obvious. Several members of the Committee on

116 ibid 41 (para 89).
117 ibid 41–42.
118 ibid 39 (para 81).
119 *See* 'AFME, ICMA, ISLA and ISDA joint input for ESMA Consultation Paper on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EU) No XX/2012)', 10 March 2012, 26–28 <http://www.esma.europa.eu/system/files/joint_response_afme_icma_isda_isla_20120312.pdf>.
120 *See* Bank of England, *Quarterly Bulletin, 2010 Q2*, 81; Cotterill (n 105).
121 ESMA, 'Final Report' (n 48) 37 (para 9.c).

Economic and Monetary Affairs took a harder line, some of them going so far as to wanting to prohibit CDS trade entirely[122]. In a Parliamentary debate on 4 July 2011, there was notable support for banning all uncovered CDSs[123].

In the end, the ban was limited to sovereign debt. This raises many issues. In terms of the empirical evidence discussed above, one might argue that sovereign borrowers are especially opaque, and they are particularly likely to suffer the adverse effects of unlimited CDS shorting. On the other hand, there are also corporations – banks, for example – that are in a similar position.

Secondly, it may be that the theoretical case for limiting CDS trade is weaker in the case of sovereign debt. Such concerns as insider trading and the empty credit problem do not seem particularly relevant for sovereign borrowers. Thus, again, the paradox that the Regulation imposes heavier rules for sovereign CDS markets when the stronger regulatory rationale might be in corporate CDSs.

Finally, the Regulation acknowledges that sovereign CDS buyers may have an insurable interest even if they do not strictly own bonds of the sovereign. In these cases, sovereign CDSs function as a proxy of some other risk that may be more difficult to hedge directly. However, *the Regulation fails to note that proxies are also relevant the other way around*: investors wishing to bet against member states may be able to do so using other proxies. Thus the *Lex* column in Financial Times notes: "Privately, they [hedge funds] add that if they want to bet that a country defaults, they will find proxies – such as leading bank stocks. Beware the unintended consequences."[124]

4. *Powers of intervention in exceptional situations*

One possible explanation for the limited prohibition is that the Regulation gives regulators powers to intervene in exceptional situations. These interventions may include restrictions such as prohibitions or conditions relating to

122 For example, German MEP Jürgen Klute argued: "Naked short sales, commodity short sales and credit default swaps do not provide any macroeconomic benefits and carry considerable systemic risks that can be assessed ex ante only with great difficulty. Risk hedging should be replaced by other, less detrimental instruments": Committee on Economic and Monetary Affairs, 'Amendments 139–338' (n 62) Amendment 149, 9-10.

123 A majority of the speakers expressed such views: Markus Ferber, Robert Goebbels, Sven Giegold, Dimitar Stoyanov, Wolf Klinz, Monika Flašíková Benová, Franz Obermayr, Jean-Paul Gauzès and Evelyn Regner; CRE 04/07/2011 – 21 <http://www.europarl.europa.eu/sides/getDoc.do?type=CRE.

124 Lex, 'Regulating traders' *Financial Times* (19 October 2011) <www.ft.com/cms/s/3/9975dbb6-fa59-11e0-b70d-00144feab49a.html>.

short selling and similar transactions (Article 20), or limitations to sovereign CDS transactions (Article 21). The general conditions for invoking these emergency powers are the same as in the transparency regime: (a) "there are adverse events or developments which constitute a serious threat to financial stability or to market confidence", and (b) "the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits"[125].

The approach taken by ESMA in interpreting these conditions suggests that they will be used particularly in relation to troubled member states and systematically important financial institutions (including banks, insurance companies, market infrastructure providers and asset management companies)[126]. Moreover, ESMA has emphasised that

> it is essential to make sure that competent authorities and ESMA can take steps before the risk situation spreads. The possibility of the development of self-fulfilling phenomena, like rumours of bank runs or sovereign or financial issuer defaults is a particular factor to watch when assessing adverse market conditions[127].

The emergency powers are formulated in a curious way. On the one hand, Article 20 enables national regulators to *prohibit or impose conditions* relating to (a) a short sale and (b)

> a transaction other than a short sale which creates, or relates to, a financial instrument and the effect or one of the effects of that transaction is to confer a financial advantage on the natural or legal person in the event of a decrease in the price or value of another financial instrument.

In other words, the latter category is defined as broadly as possible, and it certainly covers credit default swaps, *including corporate CDSs*. There is no reference to uncovered positions, and one should conclude that the wording is intended to include *covered CDS positions* too.

Under Article 21, on the other hand, national regulators "may *restrict* the ability of natural or legal persons to enter into sovereign credit default swap transactions or *may limit the value* of sovereign credit default swap positions that those persons are permitted to enter into". This provision likewise includes covered positions. It is not entirely clear what is contemplated by "limiting the value" of sovereign CDS positions. What is clear is that if one member state is suffering major difficulties, traders should not blindly rely on the normal permission of entering into covered positions.

125 *See* Articles 20(1) and 21(1).
126 ESMA, 'Final Report' (n 48) 65–67.
127 ibid 66 (para 194).

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a) Significant fall in price: circuit breakers and CDSs

CDS trading may also be restricted under Article 23, which empowers regulators to restrict short selling temporarily in the case of a *significant fall in price*. In its literal sense, this "circuit breaker" rule does not seem to apply for the CDS market, because market turbulence will be reflected in *rising* CDS prices. However, this would be economically contradictory and would permit regulatory arbitrage using financial derivatives.

ESMA is aware of this issue, and its technical advice proposes a broad and principled application of Article 23[128]. This is relatively straightforward when the derivative has a "sole underlying financial instrument [...] that is traded on a trading venue"[129], because the regulatory rationale is linked to the fall in price of the underlying[130]. ESMA does not discuss credit default swaps explicitly, but its Draft Regulatory Technical Standards appear to include CDSs[131]. Thus, for single-name CDSs based on publicly traded bonds, a significant fall in value will be determined by reference to the significant fall in value of the underlying[132].

This is a pragmatic solution, but in theoretical terms it is not perfect. Although single-name CDSs may have publicly traded bonds as their underlying instrument, CDS values are not determined by changes in *price* but by *credit events*. In other words, the price of default insurance is not based on the price of underlying bonds as such, so that a supposed need to intervene in the bond market does not necessarily imply a similar need for intervention in the CDS market (and vice versa).

The issue is even more complicated for other types of CDS, such as basket CDSs and single-name CDSs referenced to financial instruments not traded on a trading venue. In its consultation paper, ESMA though that "the simplest criterion would be to rely on margins that are required by central clearing counterparties", but this was dropped in the face of criticism[133]. For non-centrally-cleared derivatives, the consultation paper proposed determining the threshold according to the actual price of the derivatives in question, and the final report considered this possibility for centrally cleared derivatives also. However, ESMA was forced to admit that "defining a significant fall in

128 *See* ESMA, 'Final Report' (n 48) 60–62.
129 ibid 61 (para 175).
130 ibid 61 (para 176).
131 *See* ibid 89: Article 4 of the Draft Regulatory Technical Standards in Annex IV refers to the list of instruments in MiFID (n 64), Annex 1, Section C, which includes "(8) Derivative instruments for the transfer of credit risk".
132 ibid 89 (Article 4).
133 ibid 61 (para 177).

value for each and every type of such derivatives appears to be an impossible task"[134]. Devising a common threshold seems equally unsatisfactory, so it seems that none will be forthcoming[135]. This means, once again, different rules for different types of CDSs.

b) The relevant competent authority

The imposition of trading restrictions under Articles 20, 21 and 23 will not always be made by the same regulator. As within the exceptional disclosure regime, the intervention is conditional on the consent of the relevant competent authority (Article 22). For the purposes of Article 20 and corporate CDSs, that is the national regulator controlling *the most relevant market in terms of liquidity* for the financial instrument in question (Article 2(1)(j)(v)). In contrast, Article 21 and sovereign CDSs are covered by the regulator of the *member state to which the CDS relates* (Article 2(1)(j)(i)).

For reasons of coherence, the same distinction between companies and sovereigns should apply if CDS trading is restricted under Article 23. However, normally the circuit breakers are imposed by the national authorities that oversee the trading venue in which the significant fall in price occurs, and the text of the Article does not provide clear guidance for its application for CDSs.

It remains to be seen how the regulatory politics get played out, but some differences are to be expected. In most cases, the decision to impose limits or prohibitions to the corporate CDS market will be made by the UK FSA, and given the importance of London as a leading centre of the global CDS trade, the FSA will not take such decisions lightly. In contrast, interventions under Article 21 will be principally decided by the country that is subject to difficulties. Such situations imply significant political pressure, so the decision to intervene is more probable. On the other hand, the decision to intervene may be of limited practical relevance if regulators in other jurisdictions, notably the UK, do not follow, because that is where the CDS trading happens.

c) ESMA interventions

ESMA has an independent power of intervention if national regulators have failed to act so as to address "a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the

134 ibid 61 (para 179).
135 ibid 61 (para 180).

financial system in the Union" (Article 28(2)(a)). An ESMA intervention may be one of disclosures (discussed earlier), or prohibitions or conditions related to short selling and similar transactions (broadly defined: see Article 28(1)(b)).

This raises the hypothetical question of whether ESMA is likely to intervene if the FSA or another national regulator does little or nothing. The *failure to act* is formulated broadly: it is present when "no competent authority has taken measures to address the threat or one or more of the competent authorities have taken measures that do not adequately address the threat" (Article 28(2)(b)). Notably, the failure to act is defined in terms of *competent authorities*, so in principle, the wording does not refer to situations in which, for example, the FSA refuses to intervene in the London sovereign CDS market related to another member state, which has restricted trade in its CDSs (even if most of the said CDS trade took place in London, the FSA is not a competent authority). On the other hand, ESMA might argue that the intervention outside London is insufficient to adequately address the situation, and intervene.

ESMA can more easily claim jurisdiction when it comes to the corporate CDS market centred in London, because London is the most relevant market in terms of liquidity and the FSA is the competent authority. This, paradoxically, may signify that the FSA will adopt a more proactive stance so as to pre-empt an ESMA intervention.

According to Article 28(3), if ESMA contemplates intervening, it faces an additional requirement: it must take into account the extent to which the measure

(a) significantly addresses the threat [...];

(b) does not create a risk of regulatory arbitrage; [and]

(c) does not have a detrimental effect on the efficiency of financial markets, including by reducing liquidity in those markets or creating uncertainty for market participants, that is disproportionate to the benefits of the measure.

On paper at least, the reference to liquidity and uncertainty for market participants is significant, because restricting CDS trade in disorderly times is very likely to reduce liquidity and create uncertainty. However, the text only says that ESMA has to take these considerations "into account" – they are not a strict condition.

Even when ESMA does not intervene, it is according Article 26 entitled to notification before national regulators impose any measures under Articles 18–21. Moreover, Article 29 highlights that, in emergency situations relating to sovereign debt or sovereign CDSs, Articles 18 and 38 of Regulation (EU)

No. 1095/2010[136] are applicable. The first gives ESMA, among other things, the right to be "fully informed of any relevant developments", and to be "invited to participate as an observer in any relevant gathering by the relevant national competent supervisory authorities". The latter demands that ESMA "ensure that no decision adopted [...] impinges in any way on the fiscal responsibilities of Member States".

Overall, the future of ESMA interventions in this area is full of uncertainty. Creating further questions is the fact that a broad delegation of discretionary powers may contravene the so-called *Meroni* doctrine, according to which non-national agencies may only be delegated clearly defined powers[137]. The UK government has initiated legal action to challenge the discretionary powers delegated to ESMA[138]. However, the European Court is noted for its pro-integration stance, and even if it agrees with the legal challenge, it is only likely to demand more precise conditions for the use of the emergency powers[139].

5. *Opting-out*

Prior to the acceptance of the Regulation, there was much political wrangling about the semi-permanent prohibition of sovereign CDS shorting. The UK in particular was opposed, favouring a presumption of freedom. The compromise entailed an opting-out possibility, creating a presumption of prohibition (see Article 14(2)). The semi-permanent prohibition is not all that unsound even if one favours short selling freedom, but the end result involves some inconsistencies.

The principal argument in favour of a semi-permanent ban is that temporary restrictions to short selling are problematic. Several authors have noted that sudden changes to short selling rules have a particularly destabilizing effect. For example, when US authorities suddenly restricted the short selling of shares in September 2008, this "caused funds that ran convertible bond strategies to lose substantial amounts of money as they were no longer able to manage the risk of their holdings."[140] Studies on the US and UK markets have

136 Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84.

137 Case 9/56, *Meroni v High Authority*, [1957-58] ECR 133, 149–152.

138 Alex Barker, 'Osborne sues to deter EU overreaching' *Financial Times* (31 May 2012) <http://www.ft.com/intl/cms/s/0/bdd3f980-ab47-11e1-a2ed-00144feabdc0.html>.

139 *See* for example Case C-301/02 P, *Tralli v ECB*, judgment of 26 May 2005, [2005] ECR I-4071, paras 41–46.

140 Sirri, 'Regulatory Politics and Short Selling' (n 19) 537.

also found significant negative effects on spreads and liquidity as a result of short selling restrictions[141]. In this respect, the rule adopted in the Regulation seems more appropriate, as otherwise there would have been the risk that the prohibition is imposed when markets are already unstable, creating further disruptions. The Regulation also does well to exclude any retroactive effect related to uncovered CDS positions that were permitted when they were entered into (Article 46(2)).

However, there is some irony in the result. One of the arguments in favour of the prohibition was that short selling may cause a *downward spiral* in hard times, yet the opting-out rule enables regulators to permit CDS trade when sovereign debt markets are "not functioning properly" and it is believed that the ban is "increasing the cost of borrowing for sovereign issuers or affecting the sovereign issuers' ability to issue new debt". Yet in light of the empirical evidence, it seems highly unlikely that permitting sovereign CDS trade in difficult moments would be beneficial to the sovereign borrower.

Article 14(2) lists five indicators that support lifting the restrictions:

(a) a high or rising interest rate on the sovereign debt;

(b) a widening of interest rate spreads on the sovereign debt compared to the sovereign debt of other sovereign issuers;

(c) a widening of the sovereign credit default swap spreads compared to the own curve and compared to other sovereign issuers;

(d) the timeliness of the return of the price of the sovereign debt to its original equilibrium after a large trade;

(e) the amounts of sovereign debt that can be traded.

In some rare instances it may be argued that the CDS market is not functioning properly and restrictions should be lifted; but mostly these indicators refer to distressed markets in which the cost of sovereign debt is rising because there are worries relating to the solvency of the sovereign. In such times, the evidence suggests that CDS prices are less likely to be efficient than normally[142], and permitting CDS shorting may only feed a downward spiral.

The added paradox is that it is precisely in those times that regulators may invoke their emergency powers to *restrict* other forms of short selling, includ-

141 E Boehmer, CM Jones and X Zhang, 'Shackling short sellers: The 2008 shorting ban' (23 December 2011) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412844>; M Clifton and M Snape, 'The effect of short-selling restrictions on liquidity: evidence from the London Stock Exchange' (2008) Capital Markets Cooperative Research Centre <http://img.iex.nl/iexprofs/images/2008-12-01ResearchEvidenceofShortSellingRestrictions.pdf>.

142 *See* Jenkins, Kimbrough and Wang (n 100).

ing corporate CDSs. If, in the extreme, sovereign CDS speculation is permitted at the same time as corporate CDS speculation is restricted, the effect may be a major market dislocation as investors rush from one area (normally allowed, now banned) to another (normally banned, now allowed).

One supposes that such mishaps will be avoided. The decision to permit short selling sovereign CDSs is made by the authorities of the sovereign in question (Article 2(1)(j)(i)), and it is unlikely that they would make that decision during turbulent times. It seems, therefore, that the opt-out provision may become a dead letter unless new evidence is found that the CDS shorting ban is causing major problems in normal times.

V. Further Issues

Two further concerns are worth noting. One relates to the exemption of market makers, the other to the effectiveness and extraterritorial effect of the Regulation.

1. Exemption of market making

It was worried that imposing the same requirements and restrictions on market makers would be problematic, as they provide a crucial role in providing liquidity. Historical evidence from a NYSE short selling ban in the 1930s, which also covered market makers, suggests that this caused major liquidity deterioration[143]. The Regulation therefore acknowledges the crucial role played by market makers and their need to take short positions[144].

Article 17 provides a general exemption for market marking activities[145] and primary market operations (market making in sovereign debt issues)[146] from the requirements of Articles 5–7 (disclosure of net short positions) and Articles 12–14 (restrictions on uncovered short positions). The powers of intervention in Chapter V also refer to the possibility – but not the necessity – of exempting market makers and primary dealers.

However, the exemption does not affect Article 8, which requires notification of uncovered sovereign CDS positions to competent authorities when the restrictions have been suspended in accordance with Article 14(2). This is

143 Charles M Jones, 'Shorting Restrictions: Revisiting the 1930s' (2012) 47 *Financial Review* 1.

144 *See* Recital 26.

145 "Market making activities" are defined in Article 2(1)(k).

146 See definition of "authorised primary dealer" in Article 2(1)(n).

surprising, because it implies that market makers normally have no duties with respect to sovereign CDSs, but would be subject to disclosure within the (generally lighter) opt-out regime.

During the Parliamentary process, there were concerns that the exemptions could misused. Market makers include investment banks that are also major investors in the CDS market, and the rapporteur demanded that "market makers that do not have a Chinese wall between the activities and those of property trading not initiated by clients' orders should not be allowed to use these exemptions"[147]. Perhaps reliance on "Chinese walls" would be both unnecessary and naive, but Recital 26 did note that the "exemption should apply to the different types of market-making activity but not to proprietary trading".

The practical concern is how the regulators are to distinguish between market making and proprietary trading, given that market makers will be exempt from disclosing their market making positions. Certain control rights are therefore reserved. Article 17(11) empowers the competent authority to *request information* about short positions held or activities conducted under the exemption, and Article 17(7) refers to the possibility of *prohibiting the use of the exemption*.

2. *Enforcement and effectiveness*

These concerns about proprietary trading by market makers are closely related to a broader issue, which is the effective enforcement of the Regulation. There are at least two problems. One is the over-the-counter nature of CDS contracts, which makes it difficult if not impossible for regulators to know who is making what transactions. This may impede the enforcement of the ban on uncovered CDS positions, because even market participants will not normally know the nature (covered or uncovered) of their counterparties' positions, and there seems to be no mechanism to ensure that contraventions of the restrictions actually get discovered.

To be sure, Article 18 enables national regulators to require investors to disclose the details of their short positions, including CDS positions.Yet the question remains how the regulators are to know when and whom to request such information – we are talking about "unknown unknowns". On the other hand, the issue will be somewhat mitigated by the coming into force of the OTC derivatives regulation, which forces the majority of OTC transactions (including CDSs) into central clearing, thereby facilitating more transparency[148].

147 'Draft report' (n 61) 81.
148 *See* 'EMIR' (n 41).

Another concern is that financial markets are global, and CDS markets are particularly so. When the draft Regulation was first presented, some commentators argued that EU restrictions would be worthless without US participation[149]. In fact, a ban proposal was also mooted in the US in 2009, but it was subsequently watered down and finally abandoned[150]. Yet one might ask whether US participation would have mattered so much, given the availability of Asian markets.

Potential lack of effectiveness was acknowledged by the Commission in the preparatory stage, but its position was quite self-contradictory. On the one hand, the potential for easy avoidance was cited as one of the reasons for not initially imposing a permanent CDS short selling ban[151]. On the other hand, this was not seen as relevant for the disclosure regime, or for temporary CDS restrictions; the Commission only noted the importance of capturing trades that take place outside the EU:

> for this regime to be effective, it is important that notification and disclosure obligations apply no matter where a transaction takes place, including where it takes place outside the Union but in relation to a company or sovereign debt issuer that has shares or sovereign debt admitted to trading on a trading venue in the Union[152].

In principle, Article 10 specifies that the disclosure regime (Articles 5–8) applies regardless of whether the natural or legal person is domiciled or established within the Union or in a third country. There is, however, no similar provision in relation to the prohibitions. Neither does the Regulation specify penalties for infringement; these shall be established by member states, and they shall be "effective, proportionate and dissuasive" (Article 41). In practice, this may mean that penalties differ considerably between member states.

149 Ben Moshinsky and Aaron Kirchfeld, 'Naked Swaps Crackdown in Europe Rings Hollow Without Washington' *Bloomberg* (11 March 2010) <http://www.bloomberg.-com/apps/news?pid=newsarchive&sid=aj9Qo2YqmFKs>.

150 *See* ibid. The initial proposal was to ban naked CDSs, whereas a draft bill gave regulators authority to prohibit "abusive swaps", i.e. ones "that would be detrimental to the stability of a financial market or of participants in the financial markets." It was also dropped, however, on grounds that "a broad grant to ban abusive swaps would be unsettling."

151 European Commission, 'Impact Assessment' (n 9) 47: "a ban could easily be circumvented by investors trading in CDS in non-EU countries not subject to the ban and there would be very little that EU regulators could do about this."

152 ibid 65.

VI. Conclusion

The Short Selling Regulation is a combination of more or less sound elements, coupled with contradictions and political compromises. The ordinary disclosure regime is not radical, but presents anomalies such as the exclusion of public disclosure of short positions in sovereign debt and the differential treatment of corporate and sovereign debt and CDSs. The fact that sovereign debt markets are regulated more heavily is probably due to the sovereign debt crisis that gave the final impetus for the Regulation. However, the result exacerbates regulatory fragmentation and regulatory arbitrage, and it reduces the ability of regulators to identify potential abuses in the corporate CDS market.

The exceptional disclosure regime gives quite unlimited powers for regulators to demand disclosure of short positions, including to the public, in exceptional circumstances. Paradoxically, this regime may treat corporate CDSs more onerously than the holders of sovereign CDSs, because short positions in the former may have to be disclosed to the market, but not in the latter. The limits of the powers of intervention are not clear, as the formal conditions are open to interpretation. The rules on relevant competent authorities are also complicated and may provoke turf battles among national regulators, and between them and ESMA.

The most interesting and significant provision of the Regulation is the prohibition of uncovered short positions in sovereign CDSs. It effectively creates a doctrine of insurable interest in the sovereign CDS market. Although the ban has been criticised, it is not without empirical support; it also reduces regulatory fragmentation by more closely aligning the regulation of insurance and CDSs, which are functionally equivalent. However, the definition of what constitutes a covered position (hedging) is likely to cause uncertainty, and the exclusion of corporate CDSs is an anomaly that will increase regulatory arbitrage. The opting-out regime is an odd political compromise that goes against normal assumptions; it will probably be employed rarely, because permitting short positions in sovereign CDSs when the sovereign debt market is not functioning properly is likely to feed a downward spiral.

Looking into the future, the anomalies embedded in the Regulation provide an opportunity for scholars to empirically compare the effects of different rules. For example, it is important to study whether the restrictions are helpful for sovereign borrowers, and how they influence market prices in sovereign debt. Given that non-EU countries have not adopted these restrictions, it will be easier to estimate their impact empirically. Moreover, the contentious nature of the Regulation means that it should be critically reassessed in light of subsequent evidence.

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