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Ask the Professor: Did the European Court of Justice Properly Rule By Dismissing the U.K.'s Attempt to Annul ESMA's Regulation Banning Short Selling?

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ASK THE PROFESSORS: DID THE EUROPEAN COURT OF JUSTICE PROPERLY RULE BY DISMISSING THE U.K.'S ATTEMPT TO ANNUL ESMA'S REGULATION BANNING SHORT SELLING?

BY PROFESSOR RONALD FILLER

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AND PROFESSOR ELIZABETH RITTER

Elizabeth Ritter has practiced law at the Commodity Futures Trading Commission since 1989, and has received appointment as legal counsel to six CFTC Presidential appointees. She has held two Senior Executive Service positions at the CFTC, as Manager for the CFMA Reauthorization, and as Deputy General Counsel for Legislative and Intergovernmental Affairs, working extensively with all federal financial regulators and with Congressional offices. Professor Ritter was seconded as Senior Legal Counsel to the Chair of the Senate Agriculture Committee during the drafting of the Dodd-Frank Act. She is an adjunct professor of law at Georgetown University Law School, specializing in regulation of derivatives and complex derivative transactions, and has also taught at George Washington University National Law Center, American University College of Law, and Catholic University Law School. She has written and spoken extensively in the areas of derivatives and securities regulation.

On January 22, 2014, the European Court of Justice ("ECJ") dismissed a case brought by the United Kingdom (U.K.), in which the U.K. sought to annul Article 28 of Regulation (EU) No. 236/2012 of the European Parliament and of the Council of the European Union regarding short selling activities.¹ The U.K. government had brought this case on May 31, 2012.

by the Seller, who typically is betting that the price of that common stock will decline, and thus be cheaper to buy back, resulting in a profit. In a "naked" short sale, the Seller does not borrow or arrange to borrow the securities in time to make delivery of the underlying stock to the Buyer within

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INTRODUCTION ON SHORT SELLING

Short selling, in general, consists of selling shares of common stock that are not owned

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the standard three-day settlement period.² Short selling can often result in sudden price volatility of a particular stock, especially if there is a large amount of short selling on a particular stock within a relatively short period of time. Many believe that short selling, in addition to reckless credit default swap (CDS) trading, created major price volatility in the months of September and October, 2008, that contributed, in part, to the 2008 financial crisis.

The Securities and Exchange Commission (SEC) has taken many different positions on short selling, ranging from permitting or prohibiting the activity either on a temporary or final basis, to restricting it with respect to certain types of stocks traded. In one press release, the SEC stated:

“Short selling often can play an important role in the market for a variety of reasons, including contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and, importantly, limiting upward market manipulations. There are, however, circumstances in which short selling can be used as a tool to manipulate the market.”³

As a result of “fails-to-deliver,” which is a common occurrence in connection with short selling and the potential of abuse that may result from short selling, the SEC adopted Regulation SHO in 2004, which requires, among other things, firms that clear and settle trades, to purchase the shares to close out these fails-to-deliver within 13 days.⁴

The SEC imposed a ban on short selling on financial stocks on September 19, 2008.⁵ Shortly thereafter, the SEC adopted SEC Rule 10b-21, the “Naked Short Selling Antifraud Rule,” to make it unlawful for any person:

“to submit an order to sell a security if that person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding his/her intention, or ability, to deliver the security by settlement date and that person fails to deliver the security by settlement date.”⁶

The SEC later established an interim temporary rule, which it made final on July 29, 2009, that resulted in the adoption of SEC Rule 204.⁷ Rule 204 was designed to make it a violation of Regulation

SHO if a clearing firm does not purchase or borrow shares to close-out a fail-to-deliver that may result from a short sale within one day after the required settlement date, or T+4.⁸

Many other countries also established bans on short selling in September 2008, some of which continue to the present date. Given the importance of the financial services industry in London, the U.K. government has always taken a more aggressive view relating to restrictions placed on its financial services industry. This case is an example of other actions that have been taken by the U.K. government to challenge other ESMA Regulations involving, among other things, restrictions on executive compensation.

SETTING OF THE CASE

This action was brought by the U.K. against the European Parliament and the Council of the European Union. The principal argument raised by the U.K. was simply that the European Securities and Market Authority (“ESMA”) did not properly apply Regulation (EU) No 236/2012 (hereinafter referred to as “Regulation (EU) No 236”).

ESMA was initially established by Regulation (EU) No 1095/2010 of the European Parliament (“EP”) and of the Council of the European Union (“Council”) on November 24, 2010 (hereinafter referred to as the “ESMA Regulation”). ESMA is part of the European System of Financial Supervision (“ESFS”), whose purpose is to supervise the EU’s financial system. ESFS also comprises a Joint Committee of the various European Supervisory Authorities and those of the respective Member States.

Article 1(2) of the ESMA Regulation gives ESMA certain powers to legally bind the EU, and Articles 8 and 9 of the ESMA Regulation sets out its tasks regarding financial market participants. Specifically, ESMA Regulation 9(5) provides that ESMA may prohibit or restrict certain financial activities that may threaten the integrity or stability, in whole or in part, of the EU’s financial system. Pursuant to Article 44(1), a Member State, such as the U.K., may request ESMA to reconsider any decisions that it may make. The U.K. government brought this case based on this Article.

Regulation (EU) No 236, which was adopted in March 2012, lays the foundation for regulations established by ESMA. In particular, ESMA may establish regulations relating to financial instruments,⁹ certain derivatives and certain debt instruments. Article 2(1) of Regulation (EU) No 236 defines a “short sale” to mean:

“any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell, including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery ...”

Pursuant to Article 28 of Regulation (EU) No 236, ESMA may prohibit or impose conditions by natural or legal persons with respect to such short sales provided that such actions taken by ESMA (i) address a threat to the orderly functioning and integrity of the EU’s financial markets or to its financial system, in whole or in part, and (ii) no other competent authority (e.g., another EU country) has taken the necessary actions to address this threat. This is a conjunctive test. In making these determinations, ESMA must determine that its actions do not, among other things, create a risk of regulatory arbitrage or result in a detrimental effect on the efficiency of financial markets by, for example, reducing the liquidity in the market. If another EU country adopts, for example, a specific regulation that may differ from or conflict with ESMA’s fundamental regulatory policies, then ESMA may notify that other EU country, after consulting with the European Systemic Risk Board (“ESRB”) or with other authorities, that ESMA intends to take measures against the regulation adopted by that other EU country. The measure takes effect immediately after ESMA posts the notice on its website.¹⁰

This threat to the orderly functioning and integrity of the EU financial system implies a very high standard before ESMA may act, that is: (i) any threat of serious financial, monetary or budgetary instability concerning a Member State, (ii) the possibility of a default by a Member State; (iii) any serious damage to the physical structures of important financial issuers, clearing and settlement systems and supervisors; or (iv) any serious disruption in any payment system or settlement process.¹¹

The U.K. government thus challenged the right of ESMA, pursuant to Article 28, to ban short selling, even if just for a temporary period.

EUROPEAN COURT OF JUSTICE PROCEEDING

The action, as noted above, was brought by the U.K. to annul Article 28 of Regulation (EU) No

236, which gave ESMA the powers noted above to ban short selling within the EU. Interestingly, Spain, France, Italy and the European Commission joined the action in support of the EP, thus opposing the U.K. action.

ARGUMENTS MADE BY THE U.K. GOVERNMENT

The U.K. government basically made five arguments, namely:

1. The authority granted to ESMA, pursuant to Article 28(2), gives ESMA a very large measure of discretion, which is too subjective in nature in determining whether a threat to the EU financial system may occur. In addition, the U.K. argued that when ESMA must determine whether a competent authority (e.g., the U.K. in this case) has taken measures or not that address the threat, ESMA will actually be making actual economic policies, a power that ESMA does not have, and will thus require ESMA to arbitrate conflicting public interests of the country that adopted the conflicting regulation versus the entire EU.¹²
2. Article 28(2) gives ESMA too many choices to apply, each of which have very significant economic and financial policy decisions, including requiring a decision which determines the measure’s impact on liquidity and the level of uncertainty that will be created in the financial markets. The U.K. government argued that any such decision could result in unquantifiable judgments without any objective review.¹³
3. The tests to be applied by ESMA, pursuant to Article 28(3), are too subjective in nature, thus giving ESMA too much discretion in determining which measures to apply. This provision does not require ESMA to compare the detriments versus the benefits that the measure may bring to the markets.¹⁴
4. Even though any measures taken by ESMA may be temporary, such measures could still have long-term consequences on the markets and could adversely impact the overall confidence in the markets.¹⁵
5. ESMA is given too much discretion, which could affect macroeconomic policies.¹⁶

This article will summarize the ECJ’s decision on each of these arguments.

THE FIRST U.K. PLEA

From a legislative comparison perspective, the U.S. Congress enacts all laws that come into force after the U.S. President signs the respective law. In Europe, there is a Trilogue that comprise its legislative process. The three main European legislative bodies are the European Parliament (“EP”), the Council of the European Union (“Council”) and the European Commission (“EC”). Each of these three legislative bodies argued against the U.K. government’s positions in this case.

Arguments made by the European Parliament on the First Plea

The EP made the following arguments:

1. The EP contends that ESMA’s actions are not policy considerations but complex professional considerations. Article 28(2) permits actions needed to address certain well-defined threats, which require a high degree of technical and economic expertise and information.¹⁷
2. The powers bestowed on ESMA under Article 28 are subject to very specific criteria and information.¹⁸

Arguments made by the Council of the European Union on the First Plea

The Council made two arguments, namely:

1. ESMA does not have any discretion and is obligated to adopt such measures only if certain conditions apply (e.g., where there is a threat to the orderly functioning and integrity of the EU financial system).¹⁹
2. ESMA must exercise a certain power of assessment, and thus needs the ability to adopt executive decisions in a specific factual context.²⁰

Arguments made by the European Commission on the First Plea

The EC argued as follows:

1. An institution, such as ESMA, can be delegated clearly defined executive decision-making powers, especially, as here, there is no actual transfer of responsibilities.²¹
2. ESMA has the requisite authority, just as other EU bodies do, to apply its field of expertise to ensure the orderly functioning and integrity of the EU financial system.²²

The ECJ’s Decision on the First Plea

The ECJ opinion noted that all of the parties in this case had cited the importance of the case of *Meroni & Co., Industrie Metallurgiche, S.A.S. v High Authority* of the European Coal and Steel Community, a case decided by this same court back on June 13, 1958.²³ However, each party interpreted *Meroni* differently. The ECJ cited *Meroni* as holding that:

“ . . . the consequences resulting from a delegation of authority are very different depending on whether it involves clearly defined executive powers the exercise of which can, therefore be subject to strict review in the light of objective criteria determined by the delegating authority, or whether it involves a discretionary power implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of the actual economic policy.”²⁴

The *Meroni* court ruled against the decision made by the regulatory bodies in that case. The ECJ, however, distinguished *Meroni* as that case involved entities governed by private law whereas ESMA is a EU entity, created by the EP. It then stated that, unlike the powers delegated to the bodies at issue in *Meroni*, in this case, Article 28 of Regulation (EU) No 236 is “circumscribed by various conditions and criteria which limit ESMA’s discretion.”²⁵ The ECJ then stated:

1. ESMA clearly has the authority to adopt measures under Article 28(1) provided, however, that such measures address a threat to the orderly functioning and integrity of the EU financial system.²⁶
2. ESMA must take into account the extent to which the measure (e.g., the ban on short selling in this case) significantly addresses the so-called threat noted above. ESMA must therefore examine a significant number of the factors set forth in Articles 28(2) and (3) of Regulation (EU) No 236 before taking any such measure.²⁷
3. Pursuant to Articles 28(4) and (5), before adopting any such measure, ESMA must also consult with the ESRB and, if necessary, other relevant European bodies. Therefore, ESMA’s margin of discretion in adopting any such measure (e.g., the ban on short selling in this case) is circumscribed by both this consultation

requirement and the temporary nature of the measure being taken.²⁸

4. The ECJ then stated that ESMA's powers to temporarily ban short selling clearly complied with the requirements laid down in *Meroni*.²⁹

Accordingly, the ECJ held that the U.K.'s first plea shall not succeed.

THE SECOND U.K. PLEA

Arguments by the Parties

The parties addressed the principle set forth in the *Romano* case, another case regarding the powers of another European administrative body.³⁰ The U.K. argued that Article 28 exceeded its powers as it authorizes ESMA to adopt “quasi-legislative” measures, and that this power granted to ESMA is contrary to the principle established in *Romano*, which held, in essence, that an administrative body cannot adopt acts having the force of law.³¹ The U.K. then argued that a prohibition on short sales affects the entire class of persons engaging in transactions in that instrument.³² The EP argued that the measures taken by ESMA to prohibit short sales were related to specific financial instruments and that any such measures (e.g., the ban on short selling) constitute an executive decision and are not “quasi-legislative” provisions that constitute law under *Romano*.³³ The Council took a similar position and argued that “ESMA confines itself to pitting into practice EU legislation, so that decisions adopted under that provision (Article 28) are executive and not legislative in nature.”³⁴

The ECJ's Decision on the Second Plea

The ECJ held that, under Article 28, ESMA may adopt rules affecting natural persons who enter into specific financial instruments and that Article 28 is not at odds with *Romano*.³⁵ Therefore, the U.K. failed to establish that the delegation of powers granted to ESMA under Article 28 is at odds with the condition that “only clearly defined executive powers may be delegated.”³⁶ The ECJ thus rejected this second plea brought by the U.K.

THE THIRD U.K. PLEA

Arguments made by the Parties on the Third Plea

In this plea, the U.K. basically argued that the Council has no authority under the treaties to delegate powers, such as those embodied in Article 28, to a EU agency (e.g., ESMA). Therefore, the measure prohibiting an entire class of investors from engaging in short sales is “a measure of general application which cannot be entrusted to such an agency.”³⁷ The EP contended, on the other hand, that the EP may confer powers on EU agencies, such as ESMA, to adopt measures of an executive nature, especially in areas which require specific technical expertise.³⁸ The EC argued that the treaties “do not rule out the possibility that the EU legislature or the Commission may, in principle, delegate such powers to a non-institutional body.”³⁹

The ECJ's decision on the Third Plea

Article 28 delegates powers to a EU body or agency. The issue, therefore, in this Third Plea, is whether the treaties⁴⁰ were designed to create a single legal framework under which only the EC may act or whether certain powers can be delegated to EU bodies or agencies, such as ESMA.⁴¹ The ECJ then held that, while the treaties did not contain any specific provision delegating powers to a EU body or agency, there is a presumption that such a possibility exists.⁴² The ECJ then inferred that the judicial review mechanisms that apply to EU bodies and agencies, as included in the treaties, are comparable to the decision-making powers granted to ESMA under Article 28.⁴³ Therefore, Article 28 cannot be considered in isolation, and that ESMA was granted the necessary powers to intervene to deal with adverse developments that threaten the financial stability within the EU, including the power to impose temporary restrictions on short selling.⁴⁴ The ECJ rejected this third plea.⁴⁵

THE FOURTH U.K. PLEA

Arguments made by the Parties on the Fourth Plea

The U.K. then argued that Article 28 did not authorize ESMA to take measures against natural persons or companies, and that those measures adopted by ESMA to ban short selling are of a

general application.⁴⁶ The U.K. thus argued that the treaties did not empower the EP to delegate this power to adopt decisions that constitute a general application to a EU body or agency, such as ESMA.⁴⁷

The EP argued that there is a need for harmonization among the Member States, and that ESMA may intervene in situations where actions at a national level have not been sufficient or adequate, including taking actions, such as banning short-selling, to ensure this need for harmonization.⁴⁸ The EC claimed that ESMA's actions to regulate short selling activities also harmonized the divergent national provisions in this field.⁴⁹

The ECJ's decision on the Fourth Plea

The ECJ held, with respect to this fourth argument, that the EP may clearly delegate powers to an EU body or agency to implement harmonization among the Member States (e.g., EU countries) and those measures may be directed at certain persons, including natural persons or companies.⁵⁰ The ECJ also held that the EP permitted rules to take a legislative form to ensure that regulations, such as a ban on short selling, are applied in a uniform manner.⁵¹ The ECJ then held that Article 28, which was the basis behind ESMA's regulation to ban short selling, was clearly intended to harmonize the laws and regulations in the Member States relating to stock transactions and to improve the conditions for the establishment and functioning of the financial markets.⁵² The ECJ rejected this fourth plea.

CONCLUSION

What does this decision mean? While the heart of the decision deals with the validity of the delegation of authority by the Trilogue to European agencies, such as ESMA, the real test lies with the growth and powers granted to these agencies and whether these agencies actually improve the effectiveness and credibility of the European regulatory policies versus retaining that authority and power within the European Commission itself or by a Member State. The U.K. government clearly believed that it can and should be allowed to regulate financial firms located, and products sold, within the U.K. and should not be subject to the more harmonized EU rules established by ESMA. Some claimed that this case dealt a serious blow to the U.K.'s attempt to limit the power of the EU regulatory bodies.⁵³ It will be interesting to see whether these agencies, such as ESMA, will work closely with regulatory agencies located within a EU country, such as the

U.K. Financial Conduct Authority, or take on a more autonomous role.

On the specific issue of short selling, things have changed dramatically since the 2008 financial crisis. For many years, it has been a roller-coaster ride on this issue with prohibitions, followed by temporary permissibility, followed by additional regulatory approaches around the globe. In this case, the interest of a major financial center, London, lost its battle to regulate itself to the need for a more harmonized financial regulatory world within the entire EU. It will also be interesting to see whether this movement toward greater harmonization within the EU has an effect on U.S. regulations. Just witness the recent Joint Statement made by Acting CFTC Chair Mark Wetjen and European Commissioner Michel Barnier, in which they announced that the staffs at the CFTC and the EC have made significant progress toward harmonizing a regulatory framework for CFTC-regulated swap execution facilities ("SEFs") and EU-regulated multilateral trading facilities ("MTFs").⁵⁴

Another important policy issue is whether the increased amount of financial regulations within Europe produces the necessary results. This same debate is taking place here in the U.S. Moreover, in the U.S., we have a very large number of regulatory agencies, especially when you consider the roles played by the States in regulating banks, insurance companies and even securities firms. An interesting regulatory policy argument lies with whether more or less regulatory agencies prove to be beneficial or not.

One final point is the response by the U.K. government to the ECJ decision. On February 3, 2014, in a Written Answer issued by the U.K. government to a question raised by Lord Myners, in which the Commercial Secretary to the Treasury, Lord Deighton, stated:

"The Government is disappointed that the Court of Justice of the European Justice has not upheld the UK's challenge to annul Article 28 of the Short Selling Regulation. We have consistently said we want tough financial regulation that works, but any powers conferred on EU agencies must be consistent with the EU treaties and ensure legal certainty. However, this ruling bears no impact on the day-to-day application of the Regulation."⁵⁵

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END NOTES

1. The opinion can be found at: http://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&text=&pageIndex=0&mode=doc&docid=146621&occ=first&dir=&cid=829807.
2. See SEC Notice on Naked Short Sales, found at: <https://www.sec.gov/answers/nakedshortsale.htm>. See also SEC Regulation SHO, 69 Fed Reg. 151, at 48008 (August 6, 2004).
3. See also SEC Press Release No. 2009-172, dated July 27, 2009, which can be found at: <https://www.sec.gov/news/press/2009/2009-172.htm>.
4. See Note 2, *supra*.
5. See SEC Press Release 2008/211 (September 19, 2008), in which the SEC, acting in concert with the UK Financial Services Authority, took emergency action to ban short selling on 799 financial companies.
6. SEC Rule 10b-21, 17 CFR 240.10b-21. See also SEC Release 34-588774, in which the SEC adopted final rules on "Naked Short-Selling Antifraud Rule", which can be found at: www.sec.gov/rules/final/34-588774.pdf.
7. SEC Rule 204. See SEC Release 34-60388, entitled "Amendments to Regulation SHO", which can be found at www.sec.gov/rules/final/34-60388.pdf. See also Note 3, *supra*.
8. *Ibid*, at pages 2-3.
9. The term "financial instrument" means, among other things, securities, money-market instruments, UCITS, and options, futures and swaps on securities, interest rates, financial indices, commodities, credit and other derivatives. See Section C of Annex I to Directive 2004/39.
10. The notice may be at a different specific date established by ESMA. Once issued, the measure will expire after three months if not renewed by ESMA at or before that time.
11. See Article 28(2)(a) of Regulation (EU) No 236.
12. See Paragraph 28 and 29 of the opinion.
13. See Paragraph 30 and 31 of the opinion.
14. See Paragraph 32 of the opinion.
15. See Paragraph 33 of the opinion.
16. See Paragraph 34 of the opinion.
17. See Paragraph 35 of the opinion.
18. See Paragraph 36 of the opinion.
19. See Paragraph 37 of the opinion.
20. See Paragraph 38 of the opinion.
21. See Paragraph 39 of the opinion.
22. See Paragraph 40 of the opinion.
23. *Meroni v. High Authority*, [1957-58], ECR 133 at 157 (Case 10/56, June 13, 1958). The *Meroni* ruling held, in essence, that certain powers might be delegated to certain "bodies whose existence was not contemplated by the Treaties, if doing so appears compatible with the regulatory powers conferred on the institutions. However, the ruling also specified that such delegation is permissible only when it "involves clearly defined executive powers the exercise of which can, therefore, be subject to strict review in light of criteria determined by the delegating authority." See the paper on "European agencies: Delegation v. Authority", cited at <http://www.jeanmonnetprogram.com/archive/papers/02-020201-03.html>.
24. See Paragraph 41 of the opinion.
25. See Paragraph 45 of the opinion.
26. See Paragraph 46 of the opinion.
27. See Paragraph 47 of the opinion.
28. See Paragraph 50 of the opinion.
29. See Paragraph 53 of the opinion.
30. *Giuseppe Romano v. Institut national d'assurance maladie-invalidite*, Case No 98/80, European Court Reports 1981 at 01241 (May 14, 1981)
31. See Paragraph 63 of the opinion.
32. See paragraph 57 of the opinion.
33. See paragraphs 58 and 59 of the opinion.
34. See Paragraph 61 of the opinion.
35. See Paragraphs 64 and 65 of the opinion.
36. See Paragraphs 67 and 68 of the opinion.
37. See Paragraphs 69 and 70 of the opinion.
38. See Paragraph 72 of the opinion.
39. See Paragraph 76 of the opinion.
40. The applicable treaty in this case is the Treaty on the Functioning of the European Union. Article 114 of this treaty allows for new laws that harmonize rules within the EU.
41. See Paragraph 78 of the opinion.
42. See Paragraph 79 of the opinion.
43. See Paragraphs 81 and 82 of the opinion.
44. See Paragraphs 84-86 of the opinion.
45. This challenge brought by the U.K. government is quite similar to the challenges recently brought against the Commodity Futures Trading Commission ("CFTC"), which have alleged that the CFTC did not fulfill its obligations, as a federal regulatory agency, to consider, among other things, the economic cost benefit analysis required by the Administrative Procedures Act.
46. See Paragraph 88 of the opinion. The concept of "a general application" is merely a reference as to what type of authorities an administrative body, such as ESMA, may have. This is similar in concept to what occurs here in the U.S., that is, only the U.S. Congress may enact laws whereas regulatory agencies, such as the CFTC, may only adopt regulations.
47. See Paragraph 89 of the opinion.
48. See Paragraph 92 of the opinion.
49. See Paragraph 96 of the opinion.
50. See Paragraphs 106-108 of the opinion.
51. See Paragraph 110 of the opinion,.
52. See Paragraphs 112 and 116 of the opinion.

53. See Financial Times article cited at: <http://www.ft.com/intl/cms/c/0/68cbc64-11e3-aa65-00144feab7de.html#axzz2rRO05lrC>.
54. See CFTC Press Release 6857-14, entitled Statement by the CFTC and the European Commission on progress relating to the implementation of the 2013 Path Forward Statement, issued on February 12, 2014.
55. See Written Answer, dated February 3, 2014, cited at: <http://www.publications.parliament.uk/pa/ld201314/ldhansrd/text/140202w0001.htm>.