

## Comments

on ESMA's draft technical advice on possible  
Delegated Acts concerning the regulation on  
short selling and certain aspects of credit default  
swaps ((EC) No XX/2012)

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## **Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

### **Preliminary remarks**

First of all, we would like to thank ESMA for the opportunity to respond to its draft technical advice. We welcome ESMA's inclusive approach. Nevertheless, we consider the limited time available to ESMA for drafting the standards and the three-week consultation period for comment totally insufficient for adequate consideration of the implications of ESMA's proposals for the market.

It is particularly welcome that ESMA is generally seeking a balanced approach and endeavouring to take account of the interests of different market participants even when these interests diverge.

We are, however, critical of ESMA's approach to dealing with correlations in the calculation of short positions. Furthermore, certain questions of definition remain unclear, especially regarding group transactions in connection with netting and/or aggregating short positions and regarding the importance of significant falls in value. Finally, ESMA's current approach of evaluating the "adverse events" which will trigger temporary bans on short selling in purely qualitative terms risks exacerbating, rather than reducing, market uncertainty.

Our views are set out below in greater detail and are presented in the order in which issues are discussed in the consultation paper.

### **On ownership**

According to the Regulation, a short sale is deemed to exist if, among other things, the seller does not own the share or debt instrument. In Box 1, ESMA suggests interpreting the term ownership to mean both legal and beneficial ownership. Although the beneficial ownership concept is not common in German law, we see no arguments against an interpretation covering ownership in both legal and beneficial terms. Indeed, the concept of beneficial ownership may also have relevance for a German investor if he has not obtained ownership of securities deposited abroad but his depository is the owner of these securities and holds them for the investor in trust (securities account credit for securities purchased and deposited abroad).

By contrast, we have doubts about ESMA's solution to conflict of laws problems. ESMA proposes that the applicable law for establishing ownership will be the law governing the sale. Under Private International Law, however, the connecting factor determining the ownership of an object is not normally the law governing the sales transaction but that relevant to the object itself (*lex rei sitae* / *lex cartae sitae*). Securities clearing systems in the European Union are governed by special rules under which the applicable law is the law of the place at which the depository account is maintained (place of the relevant intermediary approach – PRIMA). Rules of this kind are contained in Article 9(2) of the Settlement Finality Directive (Directive 1998/26/EC), in Article 24 of the Reorganization and Winding up of Credit Institutions Directive (Directive 2001/24/EC) and in Article 9(1) of the Financial Collateral Arrangements Directive (Directive 2002/47/EC). Given that, as ESMA itself points out, securities law has yet to be harmonised in Europe and that, there too, a conflict of laws solution will have to be found, it might make good sense to base ESMA's technical advice on arrangements already enshrined in existing EU legislation.

**Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

We agree with ESMA's envisaged exemptions in para. 3 for securities lending and repo transactions and for cases where the seller does not yet own the securities simply because settlement is not yet complete and the securities have not yet been delivered.

There should also be an exemption, in our view, for cases in which the seller does not yet own the securities but has already acquired a claim to their delivery at the time of the sale. This exemption should apply if the seller is in a position to effect prompt delivery at the time of settlement as long as the transaction underlying his claim is duly completed. A claim of this kind could, for example, arise from a call option with an agreement that the securities actually be delivered.

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| <b>On holding</b> |
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According to Box 1, para. 2a, a short sale will not exist if the seller does not own the securities but is able to recall them under a securities lending or repo transaction. This exemption is based on the hypothesis that securities provided to another party by way of a securities lending or repo transaction are not generally to be considered a long position as long as the exemption set out in Box 1, para. 2a does not apply.

By contrast, Box 2, para. 2 is based on the principle that a claim to the retransfer of ownership should be considered the equivalent of holding the share or sovereign debt in question. We agree that having a claim to the retransfer of a share or sovereign debt should be deemed a long position. Nevertheless, the different approaches in boxes 1 and 2 are likely to create uncertainty and should therefore be harmonised.

In addition, we would like to draw attention to the fact that the definition of the term "holding" is indirectly determined by the method of calculating positions. As we will explain in more detail below, we consider it highly problematic to use the criterion of correlation as a basis.

With respect to investment funds, we would like to point out that investment funds in Europe are constituted in accordance with statute or contract law (cf. Article 1(3) of Directive 2009/65/EC). In the latter case, the investment fund does not have a distinct legal personality. The legal and beneficial owner of a share or sovereign debt included in the fund's assets is the joint group of investors in the investment fund. The investment management company does not act as the proxy of the joint group of investors. It is entitled to transfer assets of the investment fund in its own name, but for the joint account of the investors in the fund.

With this in mind, it needs to be clarified that, if an investment fund is constituted in accordance with contract law, it is the investment management company rather than the joint group of investors which will be deemed to hold shares or sovereign debt included in the fund's assets.

**Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

**Concept of having a net short position and method of calculation**

We basically agree with the proposed method of calculating short and long positions. For composite products such as index funds, however, we believe a minimum weighting should be set for individual basket assets below which the instrument can be left out of the calculation. We would recommend a 20% threshold along the lines of German legislation regarding the assessment of voting rights allotted to certain baskets and indices (cf. Section 17a of the German Securities Trading Notification and Insider Register Regulation – WpAIV).

We do not believe that the consideration of correlations will always prove a useful approach. Too many factors influence the price of public-sector debt, for instance. General interest rates play a particularly important role. Take, for example, a one-year bond issued by North Rhine-Westphalia (NRW) and a 30-year German federal government bond. These positions do not have any significant correlation as the NRW bond is essentially dependent on developments in the money market and the federal bond on the long-term capital market interest rate. A CDS contract, by contrast, is virtually independent of interest rates and depends almost entirely on the assessment of the borrower's creditworthiness. During the sovereign debt crisis, prices rose in response to interest rate developments and premiums for CDS contracts on the Federal Republic of Germany increased appreciably. If the Federal Republic of Germany defaulted, the CDS would act as a hedge for both the federal and NRW bond. Equally, a short position in the federal bond would hedge a long position in the NRW bond (and vice versa). For liquid products, too, a possible approach would be to consider economic fundamentals, as described in Box 6, para. 3.

Furthermore, the list of instruments in Box 3 should be clear and exhaustive in order to eliminate any uncertainty. In particular, the list should refer to derivatives which either directly or indirectly have one or more shares as underlyings rather than mentioning different kinds of derivatives such as "options", "covered warrants", "futures", "index related instruments", "contracts for difference", "swaps" and "complex derivatives".

The meaning of "packaged retail or professional investment products" is quite broad and needs to be clarified in more detail. We would disagree with any inclusion of investment funds in the term. This is because, as things stand, the detailed composition of an investment fund is treated as a business secret and is subject to banking secrecy. If the investment management company decides to purchase units of another investment fund other than those of an ETF, it does not know whether or not the assets of the target investment fund include a derivative with a share as the underlying, for instance.

In addition, it is not clear how structured bonds are to be treated.

Where reference is made to ETFs, this should be limited to ETFs tracking an index. For ETFs which do not track an index, it should be sufficient for calculation purposes to consider the most recent publicly available information about their structure.

The above points also apply to sovereign debt.

**Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

ESMA's proposed method of calculating net short positions is based on forming a percentage of the total outstanding amount of debt of a public issuer within the meaning of Article 2(1)(k) of the Short Selling Regulation. This will give rise to problems in practice. We therefore advocate that ESMA should stipulate the amount of the share capital, including ordinary and preference shares, which will serve as the basis of calculations. This would not only create greater legal certainty for affected banks and non-banks but, more importantly, would result in uniform practices throughout Europe. The instructions for calculating net short positions in Box 4, para. 10 are not worded clearly. They could be understood to mean that banks, prior to allowing a client to engage in a potential short sale, are obliged to verify the seller's ability to calculate any impact of changes in the issued share capital on his net short position. This cannot, in our opinion, be what is intended.

Regarding the method of calculating short positions in debt instruments of a sovereign issuer, only the nominal method seems appropriate, because sensitivities are too volatile and unstable in a crisis.

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| <b>Netting and aggregation</b> |
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We think the proposed method of calculating positions in cases where different entities in a group have long or short positions is unnecessarily complex and thus likely to result in contradictory reports. We fail to understand why ESMA would wish to consider net positions at the level of the decision maker.

It would be more desirable, in our view, to clarify at the outset that long, short and net positions should be calculated not at desk level, but at the level of the legal entity. This issue was already raised by us in the previous consultation (cf. our reply to question Q6 in Consultation Paper ESMA/2012/30). As far as the definition of "group" within the meaning of the Regulation is concerned, we prefer Alternative 1 of para. 62 ("group: legal entity that incorporates in its balance sheet the gains and losses of one or more single legal entities that belong to it").

With respect to investment funds, the provision in Article 3(7)(c) of the Short Selling Regulation relates to how net positions of more than one entity are to be aggregated. It is our understanding that a relationship between entities is required to justify a "group view"/aggregation. ESMA should focus on what constitutes such a relationship. ESMA refers to the "same investment strategy". In our view, however, coincidence should not be a criterion for a "group view". If, by contrast, a decision maker acts through more than one entity with an umbrella strategy, the transactions of all these entities (each a "piece of the puzzle") could be seen as "one common investment" or "one investment strategy". This might justify a "group view".

Also with respect to investment funds, it should be sufficient to determine net positions on the basis of a single investment fund and disclosures should be made by the relevant investment management company rather than by an insourcing asset manager.

Each investment fund has its own individual investment goal and strategy. The fact that there are long positions in more than one investment fund with respect to the same issuer (cf. para. 54 of the discussion paper) does not mean they result from the same investment strategy. Since investment management

**Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

companies do not manipulate the market by interacting through different investment funds, we do not see the regulatory need for the suggested aggregation.

Furthermore, we believe that outsourcing the management of an investment fund or segment of an investment fund should not involve the automatic transfer of calculation and disclosure obligations to the insourcing asset manager. As explained, investment management companies manage investment funds on a fund-by-fund basis; they do not execute transactions for the joint account of investors in one fund with the aim of influencing transactions for the joint account of investors of another. If, moreover, the management of an investment fund is outsourced to more than one asset manager (e.g. on the basis of segments), aggregation at the level of the decision maker would be misleading as the same positions might be subject to disclosure by different decision makers.

Since it would be highly onerous to implement a system under which the insourcing asset manager would have to consider positions in the investment fund subject to insourcing, ESMA should reconsider its proposal in this respect.

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| <b>Uncovered CDS</b> |
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Concerning CDSs and the question of which hedges should be permitted (Box 6), we would like to point out that setting the level of correlation too high runs the risk of less being invested at the first place. Finding a suitable level of correlation is a difficult undertaking.

Owing to the overlap of interest rate and credit risks, moreover, calculating the correlation would offer only limited informational value. The time and effort involved would therefore be disproportionate, in our view. Should this approach nevertheless be retained, it should be possible to calculate correlations using not only the reference obligation, but also all deliverable obligations, i.e. bonds that are comparable in terms of their risk structure (collateralisation, applicable law, right of redemption, etc.).

As far as delta-adjusted methods of calculation are concerned, it cannot be assumed that different institutions will always use the same method (e.g. relating to price data or times) to calculate the delta. It would thus be better for ESMA to set the relevant delta.

With respect to the indicative list of risks eligible for hedging (Box 6), the hedging of derivative positions should be expressly considered.

Concerning sovereign CDS positions which are obtained involuntarily, it should be borne in mind that a clearing member's default will occur either because of a very severe idiosyncratic shock (followed in all probability by acute market stress) or because of market stress directly. Closing positions (especially small and illiquid ones) is very difficult during times of stress and could even exacerbate market uncertainty. The requirement to close down positions "as soon as possible" is therefore not very helpful. We would suggest setting no time limits in such cases.

## **Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

Finally, regarding the value of a CDS position used to hedge dynamic risks, we suggest that changes in the risk-free rate should be considered when using a beta/CAPM. This is the usual formula, but it is not mentioned in ESMA's example (see para. 97).

### **Levels of the notification thresholds for sovereign debt position**

We basically take the view that ESMA should keep thresholds as simple as possible. In the interests of practicality, a fixed amount per issuer would be desirable.

### **Significant fall in value and method for calculating the fall**

Article 23(5) of the Short Selling Regulation envisages that the Commission will determine the extent of a "significant" fall in value of illiquid shares and other types of financial instruments. ESMA's technical advice on this issue is set out in Box 10. For shares included in the main index of a trading venue, a significant fall in value is to be assumed if the price drops by 10%. However, the current wording could be misunderstood and should in our view be amended to make it clear that the "main index" in question is the main national index, and not any other main index of a trading platform. This would be a substantial contribution to legal certainty.

The definition of illiquid shares in para. 154 raises the question of how to calculate the "average daily number of transactions in the share" and the "average daily turnover for the share". What time period and which exchanges are to be included? We request clarification of this point.

With respect to the definition of liquid and illiquid shares, we would ask ESMA to state clearly at what point in time the fall in price of liquid or illiquid shares may necessitate further regulatory steps. Under Article 13 of the Short Selling Regulation, measures are at the discretion of the competent authority. In the interests of legal certainty, however, financial institutions have a strong preference for clear rules.

Article 23 of the Short Selling Regulation should actually apply to all trading venues regulated by the same competent authority. In the case of a restriction or ban at one trading venue only, short selling in these financial instruments could continue unhindered at other trading venues. The text of the Regulation explicitly refers to "that" and not to further trading venues, however. The national competent authority is merely required to notify ESMA if action is taken (Article 23(4) of the Regulation). Discretion as to whether to take steps to prevent a disorderly fall in the price of a financial instrument lies with the relevant national authority (cf. Article 23(1) of the Regulation). ESMA will then notify the competent authorities responsible for trading venues on which the same financial instrument is traded. In the case of differences of opinion amongst the various national regulators on the steps taken, ESMA can support mediation proceedings pursuant to Article 19 of the ESMA Regulation. This procedure would indicate that the other relevant national authorities also seem to be bound by the restriction imposed by the first competent authority, thus establishing a Europe-wide restriction or ban on short selling after all. This makes good sense, in our view. Nevertheless, the form of the envisaged procedure could, in our opinion, be clarified to avoid any uncertainty.

**Comments on ESMA's Draft technical standards on Regulation (EU) XXXX/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**

We have reservations about the idea of basing calculations for an increase in yield on the trading prices of bonds at a trading venue since only a tiny fraction of bonds are traded on such exchanges. In our opinion, it would make more sense to use Bloomberg references, for example.

ESMA's proposals define the possibilities of suspending or banning options, futures, swaps, forward rate agreements and other derivative instruments. Para. 175 envisages that, in the case of a single underlying, both the financial instrument and the related derivative should be considered. However, if a German derivative is related to a financial instrument originating from another member state, it would seem virtually impossible for the relevant national authorities to decide "at the same time" whether measures should be imposed on both the financial instrument and the derivative.

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| <b>Adverse events and threats</b> |
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We consider the proposed list of qualitative criteria to be insufficient. A particular problem is posed by the fact that both the objectives ("financial stability", "market confidence", "functioning and integrity of financial markets") and some of the presumed dependent variables (in particular "financial instability", "uncertainty" and "unsubstantiated rumours ... of a default") are difficult to quantify. The evaluation of these factors can also differ from one market participant to another. Some definitions are also tautological (for example, "financial instability" poses a threat to "financial stability"). With respect to "unsubstantiated rumours", moreover, the question arises as to how it can objectively be established that a rumour is substantiated or unsubstantiated. This may be relatively straightforward when it comes to a rating action. The Greek crisis, however, shows that whether a rumour proves to be unsubstantiated in retrospect may sometimes be a question of timing and/or a complex interaction of (political) forces. In our opinion, it should also be possible to make quantitative assessments of factors such as "substantial selling pressure" and "unusual volatility". The basic danger associated with indicators which are so soft and difficult to measure is that it will be very difficult for market participants to follow the logic of intervention by ESMA. This risks fuelling uncertainty, which is more likely to increase rather than counteract instability. A list of clearly defined qualitative factors combined with quantitative indicators is essential, in our view, to justify such intervention.