LSEG Response to ESMA Consultation Paper on draft technical standards on the Regulation (EU) xxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps

13 February 2012

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Executive Summary

1. The London Stock Exchange Group (LSEG) supports the harmonisation of short selling rules across Europe, to ensure that pan-European trading activity can occur as safely and effectively as possible, and to ensure that European markets remain competitive and accessible to international investors.

2. Regulators should be adopting an evidence-based approach to regulation. ESMA has been hampered in its ability to make evidence-based proposals because of a lack of sufficient time. There is little evidence in the consultation paper concerning the effects of several of the proposals in the draft advice to the Commission (e.g. the issue of third party arrangements), and it is unclear what effects some proposed measures would have.

3. In the case of far reaching legislation, ESMA should request sufficient time from the Commission, to enable it to deliver the best possible advice to high quality and credible standards.

4. ESMA's proposals on the soft locate rules and borrowing requirements are unduly restrictive and in effect could amount to a hard locate, when the Level I does not mandate this. We believe that the Level II requirements must be proportionate and designed to have as limited an effect as possible on liquidity, whilst still achieving the objectives of the locate rule.

5. Introducing a definition of "third party" at Level II and limiting the third parties to persons that are "involved in the process" also goes beyond what was envisaged at Level I. It could render the Regulation open to legal challenge.

6. With regard to the method proposed for identifying an issuer in relation to which the relevant net short position is held, we believe that this is imprecise, as it would not allow for the identification of the actual financial instrument being shorted. It is our view that it would be difficult to manage.

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INTRODUCTION

The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to the consultation paper on ESMA's draft technical standards on the Regulation (EU) xxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps.

LSEG supports the harmonisation of short selling rules across Europe to ensure that pan-European trading activity can occur as safely and effectively as possible, and to ensure that European markets remain competitive and accessible to international investors.

LSEG accounts for a significant proportion of EU cash equities trading. Trading is conducted through LSEG's markets in the UK and Borsa Italiana in Italy, as well as its MTF, Turquoise. Across the two equity markets, over 2560 EU businesses are listed. We also have a majority interest in MTS, Europe's leading market for trading government debt.

This submission represents the views and experience of London Stock Exchange plc, Borsa Italiana, and other market operators and investment firms within the LSEG.

In our response, we only deal with those aspects where we have relevant experience on our markets and not some of the wider points.

We provide our response in two parts:

> **Part A** contains some high-level comments on general issues, which informs our approach to our response to the Discussion Paper.
>
> **Part B** contains our detailed responses to some of the individual questions posed in the discussion paper.
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> We have not responded to questions 16 to 20 as we believe that these questions are more appropriately addressed by regulatory authorities.

We confirm that we acknowledge that this response may be published by ESMA.

PART A – GENERAL OBSERVATIONS

1. It is clear from the consultation paper that ESMA has been hampered in its ability to make evidence-based proposals because of a lack of sufficient time. There is no impact assessment with the consultation, no cost benefit analysis was carried out and there was no call for evidence before the consultation period. There is no evidence of the effects of several of the proposals in the draft advice to the Commission on draft technical standards (e.g. the issue of third party arrangements), and it is unclear what effects some proposed measures would have.
2. However, we suggest that this could have been avoided, because the Council has not yet formally approved the Regulation. This gives the Commission the right to extend, by six months, the period specified in Level 1 for the adoption of delegated acts. Therefore, ESMA should point this out to the Commission and request sufficient time to enable it to deliver the best possible advice to high quality and credible standards. We agree with ESMA Securities and Markets Stakeholder Group in their letter of 17 January 2012 that the restrictive deadlines are obstructing its ability to offer ESMA the best possible advice on all relevant issues. This is especially true the case of legislation that has wide ramifications, such as the short selling regulation.
3. In our view, adoption of a more consultative approach will deliver a true constructive engagement between the Commission, ESMA and the various constituencies likely to be affected by the proposals, where all parties can seek to identify the issues and work towards devising appropriate and proportionate responses.
4. ESMA's proposals on the soft locate rules and borrowing requirements are unduly restrictive and could, in effect, amount to a hard locate when the Level I does not mandate this. We believe that the Level II requirements must be proportionate and designed to have as limited an effect as possible on liquidity, whilst still achieving the objectives of the locate rule. We suggest that introducing a definition of "third party" at Level II and limiting the third parties to persons that are "involved in the process" goes beyond what was envisaged at Level I. It could render the Regulation open to legal challenge, which would not be helpful.
5. Our experience as a market operator shows that short selling increases market liquidity by allowing contrarian strategies (i.e. the investor who goes against current market trends, e.g. by buying shares that most other investors are selling), which can dampen market volatility and/or restore the equilibrium between the prices of related assets. Without short selling, and the contrarian view it facilitates, price dislocations would grow, leading to a less efficient and more expensive market for participants.
6. As recognised by the Regulation itself (Recital 4), as a form of participation in the market, the practice of short selling plays an important role in ensuring proper functioning of financial markets. It provides liquidity which reduces spreads, thereby providing better prices for investors and thus reducing the overall cost of capital for issuers.

PART B – RESPONSE TO INDIVIDUAL QUESTIONS

Q1 Do you agree with the approach of providing an exhaustive list of types of agreement, arrangement and measure that adequately ensure shares or sovereign debt instruments will be available for settlement and setting out the criteria these should fulfil?

It is the LSEG's view that the locate rules and borrowing requirements must be proportionate and designed so as to have as limited an effect as possible on liquidity, whilst still achieving the objectives of the locate rule. This is what has been achieved in the Level I text.

We believe that ESMA's approach of providing an "exhaustive list" of types of the agreements, arrangements and measures could be seen as going beyond the provisions of the Level I text. We do not believe that it is for ESMA to introduce additional provisions in Level II that were not intended at Level I.

For instance, we do not believe that ESMA has taken into consideration the unintended consequences that could result from the creation of an "exhaustive list", such as the reduction in flexibility and the creation of regulatory gaps. Another unintended consequence is the creation of a closed group of persons or entities from whom sellers are allowed to obtain shares. This would increase the cost of arrangements and in turn will increase the cost of capital for issuers.

This could have potentially harmful consequences to the cost of capital for issuers of stock and will affect the ability of the EU to grow itself out of the current crisis. This will have a significant effect on the innovative, high growth SME sector at a time when bank lenders withdraw lines of credit and the EU is putting together an action plan to enable this sector to realise the benefits of the equity model.

Q2 Do you agree with the proposed list of agreements and enforceable claims and the criteria they should meet? Are there any other types of agreement or enforceable claims or criteria which should be added?

As stated in our response to question 1, we would caution against an "exhaustive list", as we suggest that this will reduce flexibility.

For instance, though the list at paragraph 11 attempts to cover the types of agreements that could be available to the borrower, this is only possible if (f) - *Other claims or agreements leading to physical exchanges of the shares or sovereign debt* – is further clarified so that it is clear that this allows enough flexibility to cope with market evolution; it is not exactly clear to what the phrase "*claims or agreements leading to physical exchanges*" relates. It seems to suggest reference to physical deliveries, which is not clear in this context.

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Q3 Do you consider that these criteria will entail additional costs as compared to current practices on the market? If so, could you specify the drivers for those additional costs and any indication of their amount?

Imposing additional regulatory requirements would normally bring additional costs, which could widen spreads and have a negative impact on liquidity.

The measures proposed should be supported by a cost/benefit analysis and should only be imposed where evidence has been presented with which to justify them, in order to achieve a proper balance between the costs and benefits.

Q4 Do you agree with the proposed list of third parties which may be parties to the arrangements or measures and the criteria proposed by ESMA that they should fulfil?

We suggest that the approach of the proposed list and the provision that agreements can only be transacted with persons "*subject to authorisation or registration*" is not helpful.

These requirements are restrictive and go beyond ESMA's remit in Art 12(2), which is "*to develop implementing technical standards to determine the types of agreements, arrangement, and measures that adequately ensure that the share would be available for settlement".* In effect they amount to another "hard locate" requirement.

In our view, introducing a definition of "third party" at Level II and limiting the third parties to subjects that are "*involved in the process*" goes beyond what was specified at Level I. There is also no evidence given by ESMA to support the assertion in paragraph 15 that the lack of a definition of "third party" would "...*make the whole process ineffective*". For example, we do not agree that there is any evidence to show that investment firms are any better than private clients in delivering securities on time.

The proposed list only mentions persons subject to or authorised under EU law. We suggest that ESMA should give consideration to Would this exclude those persons or entities not authorised under EU law, for example agreements and arrangements made with US entities or other third country firms or entities that have access to securities, but who are not subject to EU FSAP law.

While we understand the objective of limiting the third parties to subjects that are "involved in the process" and subject to authorisation, to aid supervision and enforcement, we believe that at any time the onus should be on the borrower to satisfy the relevant authorities that it has, according to Art 12(1)(c), "…*taken measures vis-à-vis third parties necessary for the natural or legal person to have reasonable expectation that settlement can be affected*". This would mean that the borrower would need to demonstrate that there is a relationship with the third party that gives the "**reasonable expectation**" of settlement. This could be by way of an exchange of email/recorded calls; or by having a general arrangement for a specified period; or by reason of a previous history of borrowing.

Q5 Are there further criteria which should be added?

See response to question 4.

Q6 Does the fact that a third party should be a distinct legal entity from the entity entering into the short sale entail costs? If so please provide estimates of those costs.

Although we believe that other market participants are better placed to comment on this question, it is likely that imposing additional corporate complexity and regulatory requirements will bring additional cost and could have an impact on liquidity and, consequently, on the cost of capital.

We would also point out that this is an additional provision that is not in the Regulation, or the draft technical standards and therefore goes beyond ESMA's original remit.

Q7 Do you agree with the approach proposed by ESMA on the standard/same day/liquid shares locate confirmation arrangements and measures and the criteria that they must fulfil?

Again we suggest that these requirements may be seen as restrictive and go beyond ESMA's remit in Level I. for instance, these requirements do not take into account the existing prime broker agreements of same day easy-to-borrow lists.

Settlement does not occur instantly, so those who open short positions and close them intra-day, or before the intended settlement date, should not be required to enter into formal 'reserving' arrangements to borrow shares. Any additional requirement will add to the cost of small firms and retail investors who would have to obtain borrowing agreements.

Q8 In circumstances other than intraday short selling or short selling on liquid shares, can you suggest any additions to the methods for effective allocation set out in this consultation paper which would provide the necessary comfort that shares can be delivered for settlement in due time?

Please see response to question 7

Q9 In relation to the approach suggested for liquid shares, do you consider it appropriate to use the MiFID definition of liquid shares? Do you think ESMA should consider different approaches to determine the reasonable expectation test for liquid and illiquid shares?

If not, can you provide indications as to the criteria to consider to define liquid shares or to take into account the liquidity of the shares in these circumstances?

Is securities lending activity an additional factor to consider when determining liquidity of a share?

In considering the liquidity of shares, measures need to be evidenced-based and calibrated according to the actual liquidity of a share, not by attempting to impose a single standard.

We also refer to the points made about the part that short selling plays in the provision of liquidity, which is critical to overall market efficiency.

Q10 Do you agree with the approach proposed by ESMA on the location confirmation and reasonable expectation arrangement in relation to sovereign debt and that the reasonable expectation test should only apply in the case of intraday short selling of sovereign debt?

No response

Q11 Do you agree that there should be one standard format for notifying relevant competent authority for each type of instrument?

Any measure that would reduce costs and administrative burdens is to be welcomed.

Q12 Do you agree that there should be one standard form for public disclosure of information on significant net short position in shares?

Please see our response to Question 11.

Q13 Do you agree with the proposed way to identify natural and legal persons, including the contact information details?

No response

Q14 Do you agree with the proposed way to notify and disclose the size of the relevant position?

No response

Q15 Do you have any comments on the proposed way to identify the issuer, in relation to which the relevant net short position is held, including how to use the ISIN code in this matter?

We believe that the proposed approach is imprecise, as it would not allow for the identification of the actual financial instrument being shorted, and would be also difficult to manage because it would require a cross-link between two financial instruments in the reporting firm's systems as well as knowledge as to which is the relevant ISIN to use. This is very likely to be information that is not currently stored or possibly even readily available.

We therefore believe that the correct approach is to

a) identify the financial instrument being shorted using the ISIN (possibly allowing for other identifiers if an ISIN does not exist, as in the rules for transaction reporting); and

b) identify the issuer by their name (i.e. not by using an ISIN).