

9 March 2012

Submitted via ESMA Website

Dear Sir

Consultation Paper: Draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No XX/2012)

Thank you for giving us the opportunity to submit evidence on the proposed technical advice on delegated acts and implementing technical standard.

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3.9 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies). The IMA's authoritative Asset Management Survey 2008 recorded that IMA member firms were managing 44% of the domestic equity market for clients.

Our member firms strongly support a consistent definition of, and approach to, short selling, both across the EU, and through the different pieces of legislation affecting it (e.g. MIFID and MAR).

In addition to answering the questions asked in the paper, I have identified the following issues in the proposed advice, with which we have concerns:

- We strongly object to the proposed limitation on hedging to within national boundaries as against the intent of the Regulation, in conflict with CRD IV, detrimental to investors' interests and likely to increase the cost of investment in EU economies.
- While we agree that convertible bonds should not be counted as part of the existing issued share capital for a firm, they should form part of your economic exposure to the firm and be included in the calculation of your net short position
- The setting of quantification thresholds for high correlation seems unnecessary, arbitrary and narrow. Showing a 90% correlation coefficient over 24 months may be one way in which this can be demonstrated, but other, equally valid, methods exist.

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- The proposals around aggregation are overly complicated. Firms in groups with both fund and portfolio managers may need to consider reporting at five different levels of aggregation. This is overly burdensome on firms and will be confusing to the competent authorities and public.

I would also like to make the point that there has simply not been enough time for this consultation process to be done properly. The truncated time scale meant that ESMA was unable to call for evidence, there is no meaningful cost benefit analysis (given Recital 3 of the draft Regulatory Technical Standard I trust that this will be published soon), and there were only three weeks for consideration of the proposals. Any delays in publishing final versions of Directives or Regulations, should lead to an equivalent delay in subsequent deadlines, so as to allow for considered development of Level Two legislation. Anything less leads to rushed production, a failure to consider all the implications, and the result will be sub-standard legislation. This is surely not the result the Commission wishes to see.

The Short Selling Regulation is still not published in the Official Journal – this is not expected until March - so we are all having to work from unofficial drafts.

I would be happy to discuss the implications of the issues I have raised, whenever is convenient.

Yours sincerely

Adrian Hood
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IMA

On Ownership

Q1: Do you agree with the proposal concerning Article 2(1)(r) of the Regulation?

We have no problems with these proposals.

Q2: Are there other cases which need to be excluded from the definition of a short sale?

No comments

Q3: Are there other definitions in Article 2(1), which need further clarification? Please explain which one(s) and why further clarification is required.

No comments

On Holding

Q4: Do you agree with the above proposal? If not, please give reasons.

No comments

Q5: Do you have any suggestions on possible further criteria to describe the holding of a share or sovereign debt?

No.

Having a net short position and method of calculation

Q6: Do you agree with the above proposal? If not, please give reasons.

We disagree with part 3 of Box 3, which would exclude a holding of convertible bonds from being incorporated in the calculation of a long position, on the basis that the shares which into which the bond would convert have not been issued yet.

Holding a convertible bond confers a financial advantage in the event of an increase in the price of the share, and the position, as it gives economic exposure, should, therefore, be taken into account. Indeed part 3 of Box 4 states that 'positions shall be calculated by taking into account transactions in all financial instruments... that confer a financial advantage in the event of a change in price or value of the share'.

This is separate from the stipulation that issued share capital of the company, means the total of ordinary and any preference shares issued but does not include convertible debt securities. One measure should include convertible shares as they provide economic exposure to the company; the other excludes them when determining the denominator for calculating the percentage of issued share capital held.

We also disagree with the effect of part 13 of Box 3: that a highly correlated position may subsequently cease to be highly correlated. We would suggest that the approach taken in part 6 of Box 6 would be more appropriate: that if the high degree of correlation is evidenced when the position is taken out then a mere breaking-down in correlation would not necessitate the closing out of the position.

Q7: Do you agree with setting a quantitative threshold for high correlation? If so, what would be the best correlation co-efficient to use for this purpose?

We would argue that setting a quantitative threshold is inappropriate. The Regulation requires, under Art 3.5 that the debt instruments of the other sovereign issuer merely be 'highly correlated to the pricing of the given sovereign debt'.

Nothing in the recitals to the Regulation, or in the mandate from the Commission to ESMA requires or requests any further criteria that the pricing of the debt instruments be highly correlated. It should be left up to the firm concerned to demonstrate that the level of correlation is high. Showing a 90% correlation coefficient over 24 months may be one way in which this can be demonstrated, but other, equally valid, methods exist.

If a quantitative value is to be use one should be set that is no lower than 50% (or it would be difficult to justify it being 'high') but no higher than 66%, or it becomes too limiting.

Q8: Do you think it is practicable to measure correlation for sovereign debt with a liquid market price and a long price history on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out? Do you consider that a 24 month reference period is the most appropriate one?

As in our answer to Q7 we consider that the proposed method of measuring correlation is one methodology, but not the only one. 24 months is not the universally appropriate period over which to measure correlation.

It should be up to firms to demonstrate that they have used an appropriate measure of correlation in their calculations.

Q9: Do you think it is practicable to measure correlation for assets with no

liquid market price or with no sufficiently long price history by using a proxy? What could be a good proxy? What criteria do you think are necessary?

We think that a good proxy is another debt instrument with a similar duration (not maturity) and credit quality (proxied by rating) which has historically demonstrated high correlation measured using daily data for the 12 and 24 months before the position is initiated, and for which there is no evidence of a structural break in correlation patterns. It is recommend to also carry out the test using 60, 90 and 120 day windows prior to the position being taken out.

Q10: Do you consider that this Delegated Act needs to provide further specifications on the calculation of whether the high correlation test is met? Do you have any suggestions on what they may contain (e.g. use of a maturity bucket)?

No comments

Q11: Do you think that there is a need for a buffer period addressing the issue of temporary fluctuations in the correlation of the sovereign debt (e.g. period of 3 months during which the correlation is less than the standard level (e.g. 90% or 80%) but at least met a prescribed lower threshold (e.g. 75% or 70%)?

As stated in our answer to Q8 we do not think firms should be bound to a 24 month correlation comparison so this question should not be relevant. Having said that, where firms are using a set period to assess correlation, there should be some allowance for short term fluctuations in the measures used.

Q12: Do you think it is appropriate the "delta adjusted method" for the calculation of short position for shares?

We recognise the reasoning behind requiring the use of delta adjusted figures, and most firms have been using such an approach for some time.

Q13: Is there any comment you would like to make in relation to the calculation of the position in shares set out in Box 4?

As mentioned above we consider that convertible bonds, as they provide economic exposure to the company, and confer a financial advantage in the event of a change in price of the shares in the company, should be included in the calculation of the long position held.

The position in convertible shares would, of course, also be subject to delta adjustment as part of the calculation of the position held.

Q14: Is there any additional method of calculation for shares that you would suggest ESMA to consider?

No comment

Q15: Which in your view is the most appropriate method for the calculation of short position for debt instruments of a sovereign issuer? Are there methods other than the nominal or sensitivity adjusted ones outlined above which you think ESMA should consider?

No comment

Q16: Is there any comment you would like to make in relation to the calculation of the position in sovereign debt of a sovereign issuer set out in Box 4?

We would query the reason for converting all nominal positions in bonds into Euros. While this may make sense in cases where the sovereign issuer uses Euros and the position holder is netting highly correlated non-Euro sovereign debt, it does not where none of the instruments in the calculation are Euro-denominated. In such a case the currency of the main sovereign issuer should be used to perform the calculation of any short position held.

Netting and aggregation

Q17: Do you agree with the approaches described above to cater for specific situations when different entities in a group have long or short positions or for fund management activities related to separate funds? If not, can you state your reasons and provide alternative method(s) of calculation?

The proposal for fund managers (by which we assume is meant operators of collective investment schemes) seems overly complex. However, it seems that part 4 of Box 5 will considerably simplify the situation by requiring only one report, for the highest of the net short positions.

It seems that, while part 3 sets out the aggregation requirements for fund managers, part 9 sets out the aggregation requirements for portfolio managers. These seem much simpler. I assume that it is only the aggregated position that should be reported, as this is not entirely clear in the proposed text.

Having said that, the situation becomes much more complex where a group contains multiple legal entities, fund management companies and portfolio management companies. Just as parts 4, 8 and 11 state that only the largest net short in the fund management company, group or legal entities respectively, there should be an overriding section that clarifies that a group need only report the highest short position arising from any of these different levels of reporting requirements.

One way to remove unnecessary levels of reporting would be to reflect the Level 1 text in the Regulation. This requires, or suggests, reporting at the following levels:

- different *entities* in a group
- fund management activities relating to separate funds:
 - o different investment strategies pursued through more than one fund managed by the same *fund manager*,
 - o *multiple funds* with the same investment strategy,
 - o *multiple discretionary portfolios* managed within the same entity with the same investment strategy.

Even if this extra clarification were made, then firms would still be required to report at each individual level when crossing a threshold at that level did not coincide with crossing a threshold at another level within the group. As such groups would need to ensure that systems were in place to catch all threshold crossings at all levels.

Also, understand that booking and position systems, as well as accounts, at Custodians do not generally relate to single legal entities. Positions in such systems or accounts are aggregated to certain levels, a breakdown to each legal entity is generally not possible.

Q18: Which do you consider the better definition of a group for the purpose of this Regulation?

We prefer Alternative 2, as it is consistent with the Transparency Directive and thus makes disclosures of long and short positions comparable.

Q19: Are there other situations that should be taken into account?

No comment

Uncovered CDS

Q20: Do you agree with the general conditions proposed for determining when a sovereign CDS position can be considered covered? Are there any modifications you would propose?

We agree with the general principles as set out in the Regulation that such positions must be correlated and proportionate.

We do not agree with ESMA's interpretation of the correlation principle to include the condition that the obligor of (or counterparty to) such asset/liability is located in the same Member State as the reference sovereign for the CDS. We do not see that this is required by the Regulation, or by the Commission's request to ESMA for advice.

There are many situations in which a long position in one country is correlated, even highly correlated with the sovereign debt in a different country. The most obvious and straight-forward example would be where a bank holds a significant amount of debt issued by the government of another country. The value of the bank may well be more correlated to the debt of the other country than to that of its own.

We would point out, that if the proposed text were implemented, then contrary to ESMA's own intention, stated in paragraph 79, 'hedging strategies which meet the criteria set out in the Regulation itself might therefore be unreasonably excluded'.

As to the statement in paragraph 82, we would dispute the fact that 'it was the intention of the co-legislators that the geographical scope of the provision should not be drawn too widely'. If this had been their intention then it would have appeared plainly in the Regulation.

Moreover, it would be inconsistent with Article 375 of the Capital Requirement Directive (CRD IV). The proposals would limit firms' ability to raise regulatory capital and do hedging as incentivised by CRD IV. CRD IV explicitly allows the use of index CDS as an eligible hedge for the purpose of mitigating CVA risk (Credit Valuation Adjustment risk: risk that the creditworthiness of the counterparty deteriorates). By limiting geographical scope of the CDS hedges, the use of indices such as the SovX to cross-country hedge CVA regarding exposures in several Member States seems to be excluded.

CRD IV prohibits the use of neither proxy hedging nor cross-country hedging. Article 375 states that 'for all counterparties for which a proxy is used, an institution shall use reasonable basis time series out of a representative group of *similar* names for which a spread is available.' If such cross-country macro-protection via the most liquid sovereign CDS is not available due to geographical limitation, hedging of an investment in any portfolio of European exposures would become more expensive. This would increase funding costs for sovereign debt and corporate debt.

We believe that the proposed geographic condition is unnecessary. The overarching requirement that there be 'correlation' and 'proportionality' already imposes a hedging obligation on market participants. Where a correlation exists and a hedge is proportionate market participants should be permitted to use CDS as a proxy hedging tool, irrespective of location. This is a particularly important principle in the context of the Single Market as well.

Q21: Do you have any comments or alternative suggestions on the proposed test for correlation? Do you have any estimates of the costs which applying the qualitative test envisaged by ESMA would entail for market participants or the costs which would be associated with the imposition of a quantitative test?

As in our answer to Q20 we would suggest that the requirement to limit hedging to within the borders of each member state should be removed.

We would also suggest that ESMA is being unduly restrictive in requiring that correlation must be “significant” and “consistent”: we would argue that these adjectives should be dropped from the test. We understand that concepts of “high” and “direct” correlation were specifically considered and then dropped in this context during the Level 1 negotiations, evidencing the intention of the legislators to maintain a broad exemption to allow legitimate hedging activity. ESMA’s inclusion of the adjectives is unjustified and unhelpful.

We approve of ESMA’s proposal that the tests in this area should be qualitative.

Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

Part 2 of Box 6 states that correlation should be measured over 12 months for assets with a liquid market price. We do not see why the period of 12 months has been selected. We can imagine scenarios where other ways of determining correlation may be valid.

We would suggest that it should be up to firms to demonstrate that they have used an appropriate measure of correlation in their calculations.

The advice does not set out any means of identifying which assets would have ‘a liquid market price’. Is it ESMA’s intention that this assessment to be left to individual firms?

Q23: Are any changes required to the proposals for determining whether a sovereign CDS position is proportionate?

No, we support the qualitative approach proposed by ESMA. Part 4 of Box 6 refers to ‘where a perfect hedge is not possible. We would suggest that this should be changed to ‘where a perfect hedge is not reasonably practical’.

Q24: Do you think that a position that had become partially uncovered due to fluctuations in the value of the assets or liabilities being hedged and/or the CDS used as the hedge should be allowed only for a certain period of time? If so, what would be an appropriate time limit?

No. We consider that if the hedge was proportionate initially, then drifts, there should not be a time limit imposed. Given the inability to predict future market movements, the hedge is as likely to become more proportionate as to drift further from it.

Should a limit be deemed necessary, we would propose that any excess position should only be held for a specific period of time, and that this should be framed by 'as soon as practical, bearing in mind the interests of the client'.

Q25: Do you agree that sovereign CDS positions which are obtained involuntarily as a result of the operations of a CCP clearing sovereign CDS should not fall to be considered as entering into a CDS transaction for the purposes of the Regulation?

No comment

Q26: Do you consider there are any other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position which should be included in the indicative list?

We would suggest the case of a bank in one country with large exposure to the debt of another country, as raised in our answer to question 20.

Q27: Do you agree that the net CDS position is the correct one to use in the calculations?

No. We would suggest that the beta-adjusted net CDS position should be used.

Q28: Do you consider that there should be different methods for calculating the value of the positions to be hedged by the sovereign CDS according to whether a static or dynamic hedging strategy is used?

Yes. We agree with the proposals.

Q29: Are there refinements which can be made to the proposed methodology? Are there any standard calculation formulae which can be used when applying risk adjustments which we should include in the draft advice?

No comments.

Q30: Do you agree with the proposed method of treating indirect exposures?

Yes.

Levels of the notification thresholds for sovereign debt position

Q31: Do you agree that the relevant notification threshold should be based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer?

Yes.

Q32: Do you agree with the proposal to convert these percentages into monetary amounts which would be updated quarterly to reflect changes in the issued sovereign debt? If not, what other arrangement would you suggest?

Yes.

Q33: Do you agree with ESMA's proposal to group sovereign issuers into categories for the purposes of setting the notification thresholds or would you prefer an alternative approach (e.g. a single threshold for all sovereign issuers or setting individual thresholds for each sovereign issuer)? Please state your reasons.

No comment.

Q34: If you support grouping sovereign issuers into categories, do you agree with ESMA's proposal to set the three categories of notification thresholds suggested above? If not, what other grouping would you suggest and why?

No comment.

Q35: Do you consider the proposed initial amounts and the incremental levels as reasonable and optimal? If not, what amounts and incremental levels do you consider as more appropriate and why?

No comment.

Q36: If given the thresholds ESMA has proposed above are implemented, how many notifications do you expect to make in a month to each relevant competent authority?

No comment.

Q37: What level of net short position do you regard as significant for the particular sovereign debt markets?

No comment.

Liquidity thresholds

Q38: Do you agree with the general proposal suggested by ESMA for setting the parameters and methods for calculating the threshold of liquidity of the issued sovereign debt for suspending restrictions on short sales? If not, please state your reason and explain what could be an appropriate alternative.

We agree with the general approach.

Q39: In particular, do you agree that a measure in percentiles of the monthly volume traded in the last twelve months is suitable to define a threshold that represents a significant decline relative to the average level of liquidity for the sovereign debt concerned?

Unless a better measure can be determined we would accept the proposed solution.

Q40: In light of your response to the question above, do you think that a threshold of a) the 5th percentile, b) 2nd percentile or c) 1st percentile would best represent a significant decline relative to the average level of liquidity for sovereign debt? Please explain why providing data if possible.

We would support option a) to use the 5th percentile.

We would note that reaching such a threshold would give the competent authority the right, not the obligation, to lift the restrictions on short sales of sovereign debt.

Significant fall in value ***Illiquid shares***

Q41: Do you agree that three categories are necessary? If not please state your reasons.

The three categories do make practical sense.

Q42: For the more illiquid shares, do you agree that EUR 0.50 is the correct cut off point to use? If not please state your reasons.

No comments

Q43: Do you agree that 10%, 20% and 30% are the correct percentages to use in relation to the fall in value? If not, what other levels would you propose; please state your reasons.

We are concerned that the 10% figure for illiquid shares may be too low for all EU markets, and further study should be put in to determine, and evidence, a figure for this class of shares that would not be triggered too often.

Sovereign bonds

Q44: Do you agree that an increase in the yield across the yield curve is the appropriate measure to use for sovereign bonds? If not, what other measure would you propose, please state your reasons.

While the 5% increase may be appropriate for large liquid markets, we are concerned that the threshold may be triggered too often in less liquid markets.

Q45: Do you agree that an increase of 5% or more in the yield across the yield curve is the correct percentage to use? If not, please say what alternative threshold you would favour and state your reasons.

No comments

Corporate bonds

Q46: Do you agree that an increase of 7% or more in the yield is the correct percentage to use for corporate bonds? If not please state your reasons.

No comments

Money market instruments

Q47: Do you agree that an increase of 10% or more in the yield curve is the correct percentage to use for money market instruments? If not please state your reasons.

No comments

UCITS

Q48: Do you agree with the proposed ESMA approach to units in collective investment undertakings? If not please state your reasons.

Yes.

Q49: If you consider that a trigger threshold in relation to fall in value in UCITS should be defined, what should be this percentage threshold and why?

We do not think a trigger threshold would be appropriate.

ETF

Q50: Do you agree that 10% or more is the correct percentage to use for ETFs? If not please state your reasons.

No comment.

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.

No comments

Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward rate agreement or other derivative instrument, including financial contracts for difference? If not, what alternative would you propose?

No comments

Q53: What could be an appropriate threshold to define a significant fall in

price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

While we support the general principle that, if a derivative is not centrally cleared and has no single underlying, a threshold is needed, we understand that, given the range of derivatives falling into this category, no one threshold could be appropriate for all.

On the method for calculating the fall

Q54: Do you agree with the abovementioned proposal for the methods of calculation for various types of financial instrument? Do you have alternative or complementary methods to suggest, in particular in relation to the yield curve calculation method?

No comments.

Adverse events and threats

Q55: Do you agree with the proposal for qualitative criteria should be set out?

Generally yes, although we would query how a competent authority is to determine whether or not a rumour is unsubstantiated unless it is the subject of the rumour, until after the event, by which time it is likely to be too late to take pre-emptive action.

Q56: Are there any additional criteria or factor that you would suggest adding to the list?

No comments.