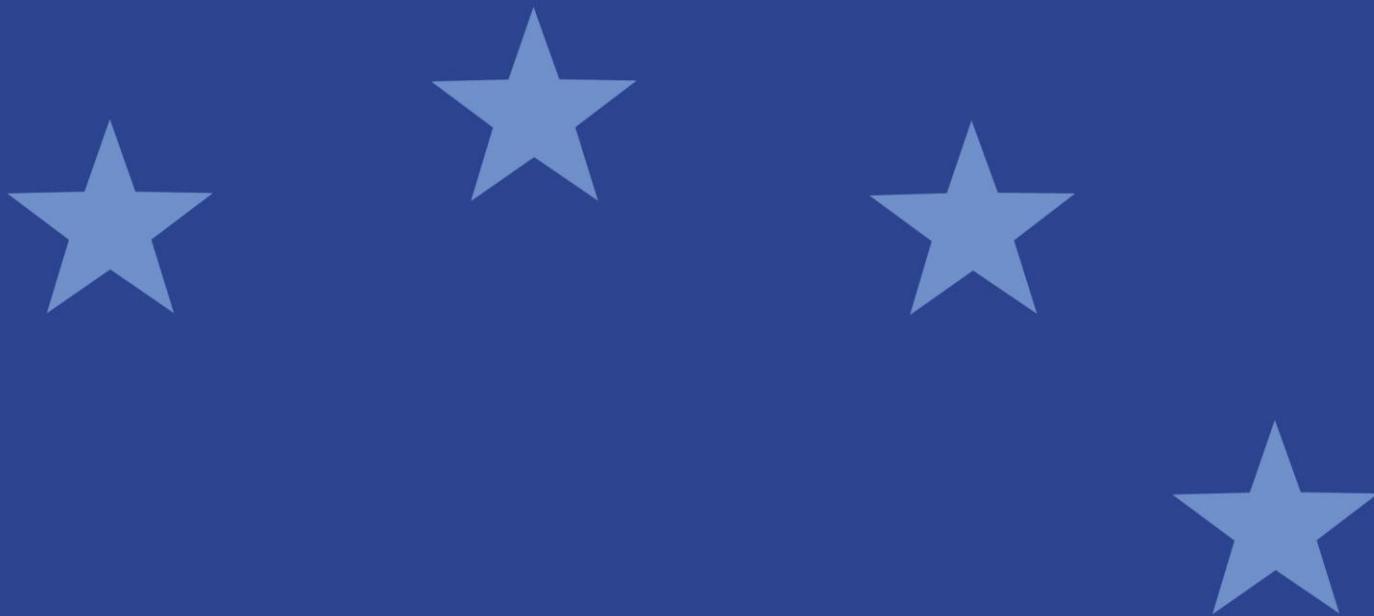




European Securities and  
Markets Authority

## Call for evidence

On the evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps



## **Responding to this paper**

The European Securities and Markets Authority (ESMA) invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- indicate the specific question to which the comment relates and respond to the question stated;
- contain a clear rationale, clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **15 March**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Your input / Consultations'.

## **Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

## **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Legal Notice'.

## **Who should read this paper**

This paper may be specifically of interest to investors that take short positions, hedge funds, fund managers, investment firms whose clients hold short positions or engage in CDS activity including non-financial actors, securities lending firms, prime brokers, custodians, settlement systems, national debt management agencies and issuers.



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## **Acronyms used**

CDS            Credit default swap

MiFID        Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on market in financial instruments

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## I. Executive Summary

### Background

1. The Regulation on short selling and certain aspects of credit default swaps (Regulation) lays down a common regulatory framework with regard to the requirements and powers relating to short selling and sovereign credit default swaps and ensures greater coordination and consistency between Member States. The Regulation aims to enhance transparency, reduce certain risks associated with short selling and uncovered CDS and ensure a common regulatory approach across Member States. It has been in application since 1 November 2012.
2. The European Commission is under an obligation to report to the European Parliament and the Council by 30 June 2013 on the appropriateness, impact and operation of the Regulation's requirements and restrictions. The Regulation requires the Commission to discuss these issues with the competent authorities and ESMA before doing so. As part of the Review process, the Commission has given a formal mandate to ESMA seeking its technical advice on the evaluation of the Regulation (see Annex 2).

### Reasons for publication

3. To inform its advice on the evaluation of the Regulation, ESMA is conducting a survey of market participants seeking their views and evidence on the Regulation's requirements and their operation.

### Contents

4. This Call for Evidence focuses on the six main areas of the Regulation: transparency and reporting requirements; restrictions on short selling of shares and sovereign debt; restrictions on entering into uncovered sovereign credit default swap positions; settlement discipline, including buy-in procedures; exemptions from provisions of the Regulation; and intervention powers and emergency measures. Each section summarises the relevant provisions and their objectives and then poses various questions on their operation and impact.

### Next steps

5. Responses to this call for evidence are requested to be submitted to ESMA by **15 March** and ESMA will provide its technical advice on the evaluation of the Regulation to the European Commission by the deadline of **31 May 2013**.

## II. Transparency and reporting requirements

6. The Regulation lays down various requirements concerning the reporting by market participants of significant net short positions in shares and sovereign debt. The purpose of the enhanced transparency is to benefit both regulators and market participants. For regulators, the objective is to enable them to monitor and, where necessary, investigate short selling that could create systemic risks, be abusive or create disorderly markets. Public disclosures are intended to provide useful information to other market participants about significant individual short positions in shares.
7. A holder of a net short position in a share at or above 0.2% of the issued share capital of the company is required to make an initial private notification to the relevant competent authority, with subsequent disclosures required for each incremental 0.1% threshold crossed (upwards and downwards) above 0.2%. A final notification is required once the position has fallen below 0.2%.
8. For net short positions in shares at or above 0.5% of the issued share capital of the company a public disclosure is also required, with further disclosures required when the position reaches or falls below increments of each 0.1% above that level. A final disclosure is required once the position has fallen below 0.5%.
9. For the purposes of the Regulation, short positions are obtained through a short sale of a share or through entering into a transaction the effect of which is to confer a financial advantage on the position holder in the event of a decrease in the price or value of the share. In calculating a net short position, derivative positions in a share are required to be delta adjusted. Positions held through baskets and indices are required to be taken into account.
10. The Regulation also lays down requirements concerning the notification of significant short positions in debt instruments of sovereign issuers (defined as EU Member States, members of federal Member States and various EU agencies and entities). Monetary thresholds have been set for each sovereign issuer which will trigger an initial notification to the relevant competent authority. These initial amounts are fixed every three months<sup>1</sup>. Further notifications are required when the position reaches incremental stages set at 50% of the initial amount. Short positions in sovereign debt instruments are calculated on a duration adjusted basis, with short positions held through derivatives only required to be delta adjusted. Positions obtained through sovereign CDS are required to be taken into account in calculating a net short position in a sovereign issuer.
11. The Regulation also makes provision for separate notification to a competent authority of uncovered positions in sovereign credit default swaps where that authority has lifted the

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<sup>1</sup> The table of the notification thresholds for sovereign issuers can be found on ESMA website: <http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers>

restriction on uncovered sovereign CDS. So far no authority has lifted these restrictions.

12. In all cases, notifications and disclosures are required to be made no later than 15.30<sup>2</sup> on the trading day following that on which the net short position triggering the reporting requirement was obtained.
13. Implementing and regulatory technical standards set out the content and format of the notifications and disclosures. The obligation to report is the responsibility of the natural or legal person who holds the position. However, as set out in Delegated Regulation No 918/2012, there are special requirements dealing with positions obtained through fund management activities and with cases where there is a group of legal entities.

### Questions

- Q1 Do you consider that the initial and incremental notification/publication thresholds for net short positions in shares and sovereign debt have been set at the correct levels? If not, what alternative thresholds would you suggest and why?**
- Q2 What use are you currently making of information made available by competent authorities or the central website operated or supervised by the relevant competent authority on public disclosures of net short positions in shares?**
- Q3 If you had taken short positions in shares and sovereign debt before the Regulation applied, what impact have the notification/disclosure requirements had on your trading behaviour since 1 November 2012?**
- Q4 Do you have any comments on the method of calculating net short positions in shares and sovereign debt (e.g. the requirement to duration adjust cash positions in sovereign debt)?**
- Q5 What is your view of the decision to adjust the monetary trigger thresholds for reportable short positions in sovereign debt every three months? Is there an alternative you would favour and if so please explain why?**
- Q6 Do you consider that reporting mechanisms are operating efficiently? If not, explain why and how they could be improved.**
- Q7 Do you have any other comments on the reporting and transparency requirements or on their operation since 1 November 2012?**

### III. Restrictions on short selling of shares and sovereign debt

14. The Regulation provides that parties can only enter into a short sale of a share or sovereign debt where certain specified conditions have been met. Uncovered short selling may

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<sup>2</sup> Time in the Member State of the relevant competent authority to whom the position is notified

increase the potential risk of settlement failure and volatility and the purpose of the restrictions on this activity is to reduce such risks. Before conducting a short sale the person needs either:

- a. to have borrowed the share or sovereign debt; or
  - b. to have entered into an agreement to borrow it or have another absolutely enforceable claim so that settlement can be effected when due; or
  - c. in the case of shares, to have an arrangement with a third party (i.e. a separate natural or legal person) which has confirmed the share has been located and has taken measures so that the person has a reasonable expectation that settlement can be effected when it is due. In the case of sovereign debt, the requirement is either to have an arrangement with a third party which has confirmed the sovereign debt has been located or that the third party otherwise has a reasonable expectation that settlement can be effected when it is due.
15. The implementing technical standards to the Regulation elaborate on the second and third conditions above. They provide examples of the types of agreement and enforceable claim necessary to ensure that settlement can be effected when it is due. As regards arrangements with third parties, for shares the standard requirements are that the third party has confirmed that it considers it can make the shares available for settlement in due time, taking into account amount and market conditions (the 'locate confirmation'), and has confirmed that it has at least put on hold the requested number of shares for the person. However, where the short sale involves a liquid share (essentially a MiFID liquid share) or an arrangement is needed only for intra-day transactions, the requirements are to obtain a locate confirmation plus confirmation that the share is easy to borrow or purchase in the relevant quantity taking into account market conditions. For sovereign debt, the implementing technical standards set out the various types of arrangements and confirmations necessary to provide reasonable expectation that settlement can be effected when due.
16. Where the relevant confirmations cannot be provided, it is necessary to meet a more stringent condition if the short sale is to be entered into. The implementing technical standards also specify the types of third party with whom an arrangement can be made.

## Questions

- Q8 Have you observed any improvements in settlement performance (either your own or that of counterparties) since the Regulation became applicable?**
- Q9 Have you noticed any impact on the cost or availability of securities lending since the Regulation has applied? Please specify any effect you have seen.**
- Q10 Have you observed any improvements in reducing the risks of volatility, downward spirals or settlement problems (e.g. inflation of shares) since the Regulation became applicable?**

- Q 11 Has the locate rule requirement affected the way you conduct short selling?**
- Q12 Has the definition of 'third party' in the implementing technical standards limited or constrained the operation of the locate confirmation or other arrangements? If so, please specify in what ways.**
- Q13 Are there any changes which could be made to the conditions for entering into a short sale which would improve the efficiency of the arrangements without undermining the purpose of the measures? Please explain any changes you would propose.**
- Q14 Do you have any other comments on the existing restrictions or their operation since 1 November 2012?**

#### **IV. Restrictions on entering into uncovered sovereign credit default swap positions**

17. The Regulation prohibits the entry by a natural or legal person into an uncovered sovereign CDS position. The rationale is that entering into a sovereign CDS without underlying exposure to the risk of a decline in the value of the sovereign debt could have an adverse impact on the stability of sovereign debt markets. An uncovered position is defined as one where the sovereign CDS does not serve to hedge against:
- a. the risk of a default by the sovereign in whose debt the person has a long position and to which the sovereign CDS relates; or
  - b. the risk of a decline of the value of the sovereign debt where the person holds assets or is subject to liabilities whose value is correlated to the value of the sovereign debt.
18. The detailed provisions on what is eligible to be considered as a covered sovereign CDS position are set out in Commission Delegated Regulation No 918/2012. This sets out alternative quantitative and qualitative tests for determining whether the assets/liabilities are correlated to the value of the sovereign debt including cases where correlation can be deemed to exist.
19. It also lays down the requirement for the size of the sovereign CDS position to be proportionate to the size of the exposures being hedged but specifies circumstances in which holding a greater value of sovereign CDS can be warranted or where it would otherwise not affect the covered status of the position. The Delegated Regulation also sets out a limited number of cases where it is permissible to use a sovereign CDS referenced to one Member State or another sovereign issuer in that Member State to hedge an asset/liability in a different Member State or where use of a pan-EU or euro area index of sovereign CDS would be permitted. Finally, the Delegated Regulation sets out how to calculate whether a sovereign CDS position is or is not uncovered, distinguishing between dynamic and static hedging strategies.
20. The Regulation provides that a competent authority may temporarily suspend the

restrictions on an uncovered sovereign CDS position in the sovereign issuer for which it is the competent authority where it has grounds for believing that its sovereign debt market is not functioning properly and the restrictions might be having a negative impact on the sovereign CDS market. So far no competent authority has made use of this provision.

## Questions

- Q15 Have you noticed any effect of the prohibition on entering into an uncovered sovereign CDS transaction on the price and on the volatility of the sovereign debt instruments?**
- Q16 Have any elements of the prohibition on entering into an uncovered sovereign CDS transaction had a noticeable effect on your ability to hedge your exposures? If yes, please quantify the impact and explain where the issue arises.**
- Q17 Have the restrictions on entering into an uncovered sovereign CDS led you to use any alternative methods for hedging your exposures? If so, please elaborate.**
- Q18 Do you have any other comments on the requirements concerning uncovered sovereign CDS positions or on how they have operated since 1 November 2012?**

## V. Settlement discipline including buy-in procedures

21. The Regulation specifies that central counterparties for clearing shares must ensure that, where a person who sells shares is not able to deliver them for settlement within 4 business days following the date when settlement is due, procedures are automatically triggered for the buy-in of the shares to ensure settlement. Where buy-in of the shares is not possible, the buyer of the shares must be paid an amount based on the value of the shares to be delivered plus an amount for losses incurred due to the settlement failure. The Regulation also provides that such central counterparties shall ensure that, where a person who sells shares fails to deliver them by the due settlement date, the person must make daily payments for each day that the settlement failure continues. The purpose of the requirements is to set basic standards relating to settlement discipline.

## Questions

- Q19 What is your assessment of the effect on settlement discipline in shares since the application of the Regulation?**
- Q20 What effect, if any, do you consider this provision of the Regulation has had on liquidity in shares since its application?**
- Q21 Do you have any other comments on the requirements of the Regulation concerning settlement discipline in shares or on how they have operated since 1 November 2012?**

## VI. Exemptions

22. The Regulation makes provision for various exemptions from its requirements. First, for reasons of efficiency, the requirements concerning notification and disclosure of significant net short positions in shares, restrictions on uncovered short sales in shares and settlement discipline and buy-in procedures do not apply to shares admitted to trading in the Union whose the principal trading venue is in a third country. ESMA is required to publish a list of such shares at least every two years on the basis of determinations made by the relevant competent authorities.
23. The second exemption provides that the requirements concerning notification or disclosure of significant net short positions in shares and sovereign debt, and the restrictions on uncovered short sales in shares or sovereign debt or on uncovered sovereign credit default swaps do not apply to transactions performed in the course of market making activities. The rationale for this exemption is that market making activities play a crucial role in providing liquidity to markets within the Union and market makers need to take short positions to perform that role. Imposing requirements on such activities could severely inhibit market makers' ability to provide liquidity and have a significant adverse impact on the efficiency of Union markets. Market making activities are defined in the Regulation and this has been supplemented by guidelines drawn up by ESMA (ESMA/2013/158). Market making activity is determined on a financial instrument by financial instrument basis. Those wishing to use the exemption must notify their home competent authority in advance and the authority then may prohibit use of the exemption within 30 calendar days of the notification or subsequently if the conditions for the exemption are no longer met. The exemption is available for market making activities in third countries providing the other conditions are met and that the Commission has decided that the legal and supervisory framework of the country complies with legally binding requirements equivalent to those laid down by MiFID concerning regulated markets and by the Market Abuse and Transparency Directives. So far the Commission has not adopted any such decisions.
24. There is also an exemption available to authorised primary dealers (APDs) in relation to primary or secondary market operations relating to the debt of the sovereign issuer(s) with which the APD has an agreement. The purpose of the exemption is not to impair important activities that assist the efficient functioning of markets. This exemption applies to the Regulation's requirements concerning notification of significant net short positions in sovereign debt, on restrictions on uncovered short sales in sovereign debt and on restrictions on uncovered sovereign credit default swaps. Those wishing to use this exemption must notify the competent authority of the relevant sovereign issuer in advance and the competent authority may prohibit use of the exemption within 30 calendar days of the notification or subsequently if the conditions for the exemption are no longer met.
25. The final exemption provided by the Regulation relates to those entering into a short sale of a security or who have a net short position in relation to carrying out a stabilisation under the Market Abuse Directive (MAD) and the relevant MAD implementing directive.

In such cases the Regulation's requirements concerning notification and disclosure of significant net short positions in shares, restrictions on uncovered short sales in shares and sovereign debt and restrictions on uncovered sovereign credit default swaps do not apply.

## Questions

- Q22 Does the current definition and scope of the exemption for market making activities allow sufficiently for liquidity provision?**
- Q23 Is the process for obtaining the exemption for market making activities appropriate for timely provision of liquidity in all circumstances?**
- Q24 Is the current unavailability of the exemption for market making activities in third country markets having any impact?**
- Q25 Do you have any other comments on the provisions of the Regulation concerning exemptions or on how they have operated since 1 November 2012?**

## VII. Intervention powers and emergency measures

26. In addition to the standards requirements laid down by the Regulation, individual competent authorities and ESMA have available various emergency powers of intervention if specific conditions are met. The purpose is to enable them to deal with a range of different exceptional circumstances. For competent authorities these powers include ones:
- (i) To impose notification or disclosure requirements concerning short positions in financial instruments other than shares, sovereign debt and sovereign CDS;
  - (ii) To require notification by lenders of financial instruments of any significant changes in the fees for lending that financial instrument;
  - (iii) To prohibit or impose conditions on entering into a short sale or equivalent transaction. Such action may be taken in respect of all financial instruments, a specific class of financial instrument or a specific financial instrument;
  - (iv) To restrict the ability of persons to enter into sovereign CDS transactions or to limit the value of sovereign CDS positions which may be entered into.
27. Use of the powers is subject to conditions. There must be adverse events or developments which constitute a serious threat to financial stability or market confidence. The measure taken must be necessary to address the threat and the detrimental effects must not be disproportionate to the benefits. ESMA and other competent authorities must be notified in advance and ESMA has a co-ordination role, including giving opinions on the measures proposed.

28. Since the application of the Regulation, two competent authorities have used the powers of intervention<sup>3</sup>. In one case, the measure concerns a temporary prohibition of short selling of shares and in the second case, a temporary prohibition of entry into short positions in specified shares. While the temporary prohibition of short selling was partially lifted, the temporary prohibition of entry into short positions expired at the end of January.
29. ESMA also has intervention powers of its own. It may require the notification or disclosure of net short positions in any specific financial instrument or class of financial instruments. It may also prohibit or impose conditions on entry into a short sale or equivalent transactions. In order for ESMA to exercise its powers, the measure must be necessary to address a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the EU financial system and there must be cross-border implications. It must also be the case that no competent authority has taken measures to address that threat or that, where one or more competent authorities have taken such action, the measures taken do not adequately address the threat. ESMA is required to take into account various factors and undertake various consultations and notifications before taking action.
30. The Regulation also provides powers to competent authorities to temporarily restrict short selling or otherwise limit transactions in a financial instrument on a trading venue where the price of a financial instrument on that trading venue has fallen significantly during a single trading day from the closing price on the previous trading day. The levels of intra-day price fall which trigger consideration of whether to exercise these powers are set for liquid shares in the Regulation itself and for other types of share and other types of financial instrument in Commission Delegated Regulation (EU) No 918/2012. No trigger thresholds have yet been set for UCITS or commodity derivatives. So far this power to temporarily restrict short selling or otherwise limit transactions in a financial instrument has been exercised in a couple of instances. .

## Questions

- Q26 What is your assessment of the effect of temporary restrictions imposed by competent authorities on short selling since the application of the Regulation? Please explain.**
- Q27 In case of emergency bans,**
- a) is the information to be published according to Art. 25 of the Regulation sufficient?**
  - b) If no, please explain what other/additional information should be provided when introducing an emergency measure.**

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<sup>3</sup> ESMA opinions of 1 November 2012:

<http://www.esma.europa.eu/system/files/2012-717.pdf>, and, <http://www.esma.europa.eu/system/files/2012-715.pdf>

- Q28** Do you consider the current thresholds set to identify a significant intra-day fall in the price of financial instruments are appropriate for all instruments? If not, what different thresholds should be set and why?
- Q29** Do you consider thresholds should be set for significant price falls in UCITS and commodity derivatives? If so, how should they be set and at what levels?
- Q30** Do you have any other comments on the provisions of the Regulation concerning intervention powers and emergency measures or on how they have operated since 1 November 2012?

## **Annex I**

### **Summary of questions**

#### **Transparency and reporting requirements**

- Q1** Do you consider that the initial and incremental notification/publication thresholds for net short positions in shares and sovereign debt have been set at the correct levels? If not, what alternative thresholds would you suggest and why?
- Q2** What use are you currently making of information made available by competent authorities or the central website operated or supervised by the relevant competent authority on public disclosures of net short positions in shares?
- Q3** If you had taken short positions in shares and sovereign debt before the Regulation applied, what impact have the notification/disclosure requirements had on your trading behaviour since 1 November 2012?
- Q4** Do you have any comments on the method of calculating net short positions in shares and sovereign debt (e.g. the requirement to duration adjust cash positions in sovereign debt)?
- Q5** What is your view of the decision to adjust the monetary trigger thresholds for reportable short positions in sovereign debt every three months? Is there an alternative you would favour and if so please explain why?
- Q6** Do you consider that reporting mechanisms are operating efficiently? If not, explain why and how they could be improved.
- Q7** Do you have any other comments on the reporting and transparency requirements or on their operation since 1 November 2012?

#### **Restrictions on short selling of shares and sovereign debt**

- Q8** Have you observed any improvements in settlement performance (either your own or that of counterparties) since the Regulation became applicable?
- Q9** Have you noticed any impact on the cost or availability of securities lending since the Regulation has applied? Please specify any effect you have seen.
- Q10** Have you observed any improvements in reducing the risks of volatility, downward spirals or settlement problems (e.g. inflation of shares) since the Regulation became applicable?
- Q 11** Has the locate rule requirement affected the way you conduct short selling?

- Q12** Has the definition of 'third party' in the implementing technical standards limited or constrained the operation of the locate confirmation or other arrangements? If so, please specify in what ways.
- Q13** Are there any changes which could be made to the conditions for entering into a short sale which would improve the efficiency of the arrangements without undermining the purpose of the measures? Please explain any changes you would propose.
- Q14** Do you have any other comments on the existing restrictions or their operation since 1 November 2012?

#### **Restrictions on entering into uncovered sovereign credit default swap positions**

- Q15** Have you noticed any effect of the prohibition on entering into an uncovered sovereign CDS transaction on the price and on the volatility of the sovereign debt instruments?
- Q16** Have any elements of the prohibition on entering into an uncovered sovereign CDS transaction had a noticeable effect on your ability to hedge your exposures? If yes, please quantify the impact and explain where the issue arises.
- Q17** Have the restrictions on entering into an uncovered sovereign CDS led you to use any alternative methods for hedging your exposures? If so, please elaborate.
- Q18** Do you have any other comments on the requirements concerning uncovered sovereign CDS positions or on how they have operated since 1 November 2012?

#### **Settlement discipline including buy-in procedures**

- Q19** What is your assessment of the effect on settlement discipline in shares since the application of the Regulation?
- Q20** What effect, if any, do you consider this provision of the Regulation has had on liquidity in shares since its application?
- Q21** Do you have any other comments on the requirements of the Regulation concerning settlement discipline in shares or on how they have operated since 1 November 2012?

#### **Exemptions**

- Q22 Does the current definition and scope of the exemption for market making activities allow sufficiently for liquidity provision?**
- Q23 Is the process for obtaining the exemption for market making activities appropriate for timely provision of liquidity in all circumstances?**
- Q24 Is the current unavailability of the exemption for market making activities in third country markets having any impact?**
- Q25 Do you have any other comments on the provisions of the Regulation concerning exemptions or on how they have operated since 1 November 2012?**

#### **Intervention powers and emergency measures**

- Q26 What is your assessment of the effect of temporary restrictions imposed by competent authorities on short selling since the application of the Regulation? Please explain**
- Q27 In case of emergency bans,**
- a) is the information to be published according to Art. 25 of the Regulation sufficient?**
  - b) If no, please explain what other/additional information should be provided when introducing an emergency measure.**
- Q28 Do you consider the current thresholds set to identify a significant intra-day fall in the price of financial instruments are appropriate for all instruments? If not, what different thresholds should be set and why?**
- Q29 Do you consider thresholds should be set for significant price falls in UCITS and commodity derivatives? If so, how should they be set and at what levels?**
- Q30 Do you have any other comments on the provisions of the Regulation concerning intervention powers and emergency measures or on how they have operated since 1 November 2012?**



## **Annex II - Commission mandate to provide technical advice**

### **FORMAL REQUEST TO ESMA FOR TECHNICAL ADVICE ON THE EVALUATION OF THE REGULATION ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS ((EC) NO 236/2012)**

With this formal mandate to ESMA, the Commission seeks ESMA's technical advice on the evaluation of the Regulation on Short Selling and certain aspects of Credit Default Swaps (the "Regulation")<sup>4</sup>.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final policy decision.

This request for technical advice will be made available on DG Internal Market's website once it has been sent to ESMA.

The formal mandate focuses on technical issues which follow from the Regulation. The Commission is under the obligation to Report to the European Parliament and the Council by 30 June 2013 on the following issues:

- (a) the appropriateness of the notification and disclosure thresholds for reporting of significant net short positions in shares to competent authorities (CA)'s, for publication of significant net short positions in shares, for reporting of significant net short positions in sovereign debt to CA's, and for reporting of significant net short positions in credit default swaps to CA's in times when restrictions on such positions have been lifted;
- (b) the impact of the individual disclosure requirements of significant net short positions in shares, in particular with regard to the efficiency and volatility of financial markets;
- (c) the appropriateness of direct, centralised reporting to ESMA;
- (d) the operation of the restrictions and requirements, notably the notification and reporting requirements, the ban on naked short selling of shares and government bonds, the ban on naked CDS, and the provisions regarding buy-in procedures;
- (e) the appropriateness of the restrictions on the uncovered sovereign credit default swaps and the appropriateness of any other restrictions or conditions on short selling or credit default swaps.

The Regulation requires the Commission to discuss these issues with the competent authorities

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<sup>4</sup> The text provisionally agreed by the Council and the European Parliament is available on the Council web site at this page: <http://register.consilium.europa.eu/pdf/en/11/st16/st16338.en11.pdf> Ref. Ares(2012)1243954 - 22/10/2012

and ESMA, before reporting to the European Parliament and the Council.

It should also be noted that the Regulation empowers CA's to temporarily limit short selling or otherwise restrict transactions in case of a significant fall in the price of a financial instrument. The Delegated Acts specified a threshold for most financial instruments but did not specify a threshold for those derivatives without a financial underlying – in particular commodity derivatives- and UCITS. The Commission wishes to assess the appropriateness of not setting a threshold for these derivatives and UCITS and requests that this issue be addressed in part (e).

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The European Parliament and the Council have been duly informed about this mandate.

## **1. Context**

### **1.1 Scope**

At the height of the financial crisis in September 2008, competent authorities in several Member States adopted emergency measures to restrict or ban short selling in some or all securities. More recently, several Member States have adopted emergency measures to restrict or ban short selling of shares, government bonds and through related derivatives.

The Regulation on short selling and certain aspects of credit default swaps (SSR)<sup>5</sup> lays down a common regulatory framework with regard to the requirements and powers relating to short selling and credit default swaps (CDS) and ensures greater coordination and consistency between Member States.

The Regulation aims to enhance transparency, reduce certain risks associated with short selling and uncovered CDS, and ensure a common regulatory approach across Member States.

The Regulation contains four principle measures to address these objectives:

- **Transparency:** significant short positions in shares must be notified to regulators above a threshold of 0.2% and to the public if above a higher threshold of 0.5%. Significant short positions in EU sovereign debt need only be notified to the regulator. There are exemptions for market making activities and primary market operations.
- **Settlement:** Restrictions on naked short selling are proposed through a requirement for a "locate plus" rule for short sales. This rule requires that the third party issue a "locate" which confirms that it is reasonable for the investor to expect to be able to cover their short sale. There are exemptions for market making activities and primary market operations.

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<sup>5</sup> Regulation (EU) No 236/2012

- **Intervention Powers:** The Regulation gives national regulators and the new European Securities and Markets Authority (ESMA) the power to adopt measures in exceptional situations to mitigate threats to financial stability.
- A ban on naked sovereign CDS is introduced. Only CDS positions for legitimate hedging are permitted but regulators may suspend the ban if their sovereign debt market's liquidity falls significantly. There are exemptions for market making activities and primary market operations.

The transparency provisions and exemptions apply to persons whether resident or established in the EU or outside.

### **1.2 Principles that ESMA should take into account.**

On the working approach, ESMA is invited to take account of the following principles:

- It should take account of the principles set out in the de Larosière Report and the Lamfalussy Report and mentioned in the Stockholm Resolution of 23 March 2001.
- The proper functioning of the internal market and to improve the conditions of its functioning, in particular with regard to the financial markets, and the high level of consumer and investor protection which are the objectives of this Regulation.
- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objectives of the Regulation. It should be simple and avoid creating divergent practices by national competent authorities in the application of the Regulation.
- ESMA should respond efficiently by providing comprehensive advice on all subject matters covered by the mandate.
- While preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.
- In accordance with the ESMA Regulation, ESMA should not feel confined in its reflection to elements that it considers should be addressed, if it finds it appropriate, it may indicate guidelines and recommendations.
- ESMA will determine its own working methods, including the roles of ESMA staff or internal committees. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different works being carried out by ESMA.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants (practitioners, consumers and end-users) in an open and transparent manner. ESMA should provide advice which takes account of different opinions expressed by the market participants during their consultation.

- The technical advice carried out should contain sufficient and detailed explanations for the assessment done, and be presented in an easily understandable language respecting current legal terminology used in the field of securities markets and company law at European level.
- ESMA should provide sufficient factual data backing the analyses and gathered during its assessment. To meet the objectives of this mandate, it is important that the presentation of the advice produced by ESMA makes maximum use of the data gathered.
- ESMA should provide comprehensive technical analysis on the subject matters described below covered by the relevant Commission's request included in this mandate.
- ESMA should provide the Commission with an "articulated" text which means a clear and structured text, accompanied by sufficient and detailed explanations for the advice given, and which is presented in an easily understandable language respecting current terminology used in the field of securities markets in the Union.
- ESMA should address to the Commission any question they might have concerning the clarification on the text of the Regulation

## **2 Procedure**

The Commission would like to request the technical advice of ESMA in view of the review to be conducted pursuant to the legislative act and in particular regarding the questions referred to in section 3 of this formal mandate.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

The Commission has duly informed the European Parliament and the Council about this mandate.

## **3. ESMA is invited to provide technical advice on the following issues:**

ESMA is asked to consider the observable effects of the Regulation, if any, in order to answer the following questions, taking into account both the provisions relating to short selling as those pertaining to CDS:

- i. Whether and to what extent the beneficial effects of short selling for volatility and price formation during normal times have been impacted by reporting and publication requirements or restrictions on uncovered short selling,
- ii. to what extent any temporary restrictions imposed by competent authorities on short selling have had any positive effects in terms of reducing price falls, or any negative effects on volatility and price formation,

- iii. to what extent the thresholds set for notification to CAs are appropriate for CAs' supervisory purposes and the thresholds for public disclosure are appropriate for the market's needs,
- iv. whether the thresholds set to identify a significant drop in the price of financial instruments are appropriate for all instruments, and whether (and if so how) thresholds should be set for significant price falls in UCITS and commodity derivatives,
- v. whether and to what extent the ban on naked sovereign CDS has had any effects in terms of market prices and of volatility of sovereign debt markets or investment by affecting the scope for hedging,

This assessment will require evaluation of statistics and, where possible, comparison of data before and after entry into application of the Regulation on 1st November 2012. More specifically, the statistical analysis would include:

- i. An analysis of published short positions since the regime has entered into force;
- ii. An analysis of volatility and price formation for shares and bonds, including spreads and news transmission, related to the size of published short positions;
- iii. An analysis of the impact on securities lending behaviour provided that data are available;
- iv. An analysis of the impact on settlement discipline;
- v. An analysis of the impact of short selling bans adopted under the new regulation, if any;
- vi. An analysis of the impact of the lifting of short selling restrictions adopted under the new regulation, if any.

ESMA would develop a baseline and appropriate benchmarks to try to measure the impacts mentioned above. It is acknowledged that there might be limitations to the exercise considering that it will be conducted soon after the Regulation enters into application and over a limited period of time and that relevant, accurate and reliable data may not be available in all instances (e.g. on securities lending).

In addition, ESMA would conduct a representative survey of market participants and competent authorities in order to answer the following questions:

- i. whether reported information is sufficient for CAs to perform their functions, including monitoring and supervision of systemic risk, market stability and market abuse,

- ii. whether published information is sufficient for market participants to better understand market dynamics,
- iii. whether and to what extent the Regulation has affected non-financial actors, notably their need to hedge,
- iv. whether there are possibilities for circumvention, notably through third countries,
- v. whether the exemption for market makers allows for liquidity provision without undue circumvention,
- vi. whether the thresholds set to identify a significant drop in the price of financial instruments are appropriate for all instruments, and whether (and if so how) thresholds should be set for significant price falls in UCITS and commodity derivatives,
- vii. whether reporting mechanisms are operating efficiently.

#### **4. Indicative timetable**

The Commission is under the obligation to Report to the European Parliament and the Council by 30 June 2013.

The deadline set to ESMA to deliver the technical advice is **31 May 2013**.