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ESMA Consultation paper on Draft technical standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps

Comments from NASDAQ OMX

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Introduction

NASDAQ OMX welcomes the opportunity to comment on the Consultation paper on Draft technical standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps. We acknowledge that our response will be published.

NASDAQ OMX provides comments from the perspective of an operator of securities exchanges in multiple jurisdictions in the US and Europe, as well as from the perspective of provider of technology to exchanges worldwide.

General comments

As a starting point, we wish to highlight that there is a certain risk that the technical standards proposed in the consultation paper and the short selling regulation it is based on reduce the positive role short selling plays in financial markets. In addition, measures introduced only in the European Union level will have limited effects.

Answers to specific questions of relevance to NASDAQ OMX as an operator of exchanges:

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 fulfill?

NASDAQ OMX agrees with the need to have some guidance for the agreements, arrangements and measures adequately ensuring that shares or sovereign debt instruments will be available for settlement. We believe that an approach of providing indicative list of such measures would be helpful. We also consider the current list on page 9 indicative since point *f.* in the list *"Other claims or agreements leading to physicals exchanges of the shares or sovereign debt"* provides regulators and market participants with an adequate degree of flexibility. If the list was made exhaustive it would have to be updated on a regular basis to cover market developments, such as technological innovation.

We would support a list covering the agreements, arrangements and measures accepted to ensure that the relevant instruments are available for settlement, whose features are foreseen in Articles 12.1 (b) and 13.1 (b) of the proposal for the Regulation. However, we understand that Articles 12.1 (c) and 13.1 (c) may leave the door open to the use of arrangements that would likely fail to ensure that instruments are available for settlement. Such situation would certainly be against the objective and spirit of the proposed legislation and would pose additional risk to the financial system. Because of the above, we would advocate that Article 5. 1 (f) of the ESMA Draft Implementing Standards would be modified accordingly to ensure adequate levels of safety and risk control are guaranteed.

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 above, we believe that point *f.* in the list *"Other claims or agreements leading to physicals exchanges of the shares or sovereign debt"* provides regulators and market participants with the desired degree of flexibility and there is no need to add any other types of criteria to the list.

Instead, futures and options that are currently covered by the list do typically have a medium to long-term duration (i.e. months or years) which exceed the term of a naked short sale (limited to some days). Thus, we propose considering whether the options and futures should be part of the proposed list. However, we believe that options that can be exercised at anytime during their live (so called American style – options), should because of their nature be given due consideration as a part of the proposed list.

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?

NASDAQ OMX believes that the criteria will add costs compared to the current practices due to the complexities the criteria includes. These costs are very difficult to estimate and they will most likely also vary depending (current and future) trading practices. However, we assume the possible cost impact to be stronger on very active traders and those traders who do a deal of hedging with derivatives.

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 fulfill?

NASDAQ OMX as a trading venue believes that Regulated Markets should not be part of the list of third parties which may be parties to the arrangements or measures to confirm that settlement will take place. Regulated Markets act as the neutral and transparent platform where buyers and sellers meet to execute transactions in financial instruments. Moreover, Regulated Markets do not trade on their own account nor do they have any stocks at their disposal to confirm that settlement will take place on a short sale transaction.

Therefore, we believe the responsibility to confirm that settlement of a short sale transaction will take place should lie on the investment firm that accepts to initiate the transaction on its own account or on behalf of an investor, rather than on the venue that merely executes it in a transparent, neutral and non-discriminatory manner.

Q5: Are there further criteria which should be added?

No, but please see answer to Q6 below.

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.

NASDAQ OMX considers that the benefits of the proposal are very limited. According to the current market practice, most trading desks rely on their in-house resources in order to ensure the most optimal stock lending arrangement for investors. A failure to provide such service would increase drastically investment costs without producing any obvious benefit for the investors or the market as a whole. The costs due to such failure are very difficult to estimate. Therefore, we believe that ESMA should not interpret the third party requirement too strictly.

Where trading desks rely on in-house resources, however, certain guarantees need to be ensured (i.e. not to use client assets, not to use the same instrument several times, etc). Instruments made available for stock lending should be part of the firm's own instruments or be made available under the prior consent of the respective holders.

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 fulfill?

NASDAQ OMX agrees with the overall approach proposed by ESMA and particularly welcomes the arrangements and measures to be taken in relation to the shares included in Article 6.1.b *Standard Same Day Locate Arrangement and Measures* of the Draft implementing Technical Standards (page 51).

However, there is some concern with respect to Article 6.1.b.iv requiring that "when executed short sales are not covered by purchases in the same day, a prompt instruction is sent by the investor to the third party to procure the shares to cover the short sale to ensure settlement in due time". NASDAQ OMX has appropriate arrangements in place to ensure that such an instruction in the event of failure is not needed and thus the instruction should not be required.

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?

We consider the methods for effective allocation set out in the consultation paper adequate.

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?

Yes, we agree with the approach proposed by ESMA.

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

NASDAQ OMX considers the one standard format appropriate. However, we wish to note that the notification and disclosure processes described in Section III *Details for the information on net short positions to be notified to competent authorities and disclosed to the public* of the consultation paper (Q11-Q17) are rather detailed and thus adopting such processes might be costly.

Other comments on the consultation paper:

Section V: Information to be provided to ESMA by competent authorities

NASDAQ OMX proposes that information about the net short positions in shares, sovereign debt and uncovered sovereign CDS to be provided to ESMA by competent authorities, should be provided more often than on a quarterly basis. That would help ESMA to monitor the market adequately and to adjust more rapidly to market changes.

Section VI.IV: Exemption where the principal venue is located outside the Union, Carrying out the calculations

National competent authorities are responsible for ensuring that the calculations of the turnover of the relevant share are made. They may delegate the actual calculations to a third party, e.g. to a Regulated Market.

NASDAQ OMX welcomes the trust of European supervisors on Regulated Markets as a source of reliable turnover statistics. Regulated Markets would be glad to provide this service to competent authorities. However, due to the current market fragmentation where up to 40%[1] of the equity market is negotiated OTC, Regulated Markets cannot ensure that these calculations adequately reflect the real turnover in a specific share.

If taken into the account the abovementioned limitations, competent authorities would require Regulated Markets to perform these calculations, some type of agreement or compensation would have to be ensured for covering the costs incurred upon in performing these calculations. This issue is particularly sensitive in the current market conditions of fierce competition between all different types of EU trading venues (Regulated Markets, MTFs, etc.).

[1] Sources: FESE EEMR, Markit Boat, Thomson Reuters, and CESR.

Additional comments on specific issues not subject to ESMA consultation paper

Outside the scope of the consultation, we wish ESMA to pay attention to the following articles that should be clarified in the proposed Regulation:

Article 15 - Buy-in procedures

The provisions in Article 15 only cover trades in shares that are cleared through a CCP. This excludes all transactions that are not cleared by CCPs (including OTC transactions and all transactions on Regulated Markets that are not cleared by a CCP). This can represent up to 40% of market share, meaning that almost half of the market will be in practice exempted from the legislation. NASDAQ OMX wants to emphasize that transactions cleared by a CCP already follow a strict buy-in regime and in contrast all transactions outside a CCP have no consistent regimes to enforce high settlement efficiency. With the current provisions there will be incentives to perform transactions OTC or on platforms without CCP clearing. In addition, there will be incentives for platforms to move trade flows out of a CCP into non-guaranteed post-trade processes.

We suggest the Commission and ESMA to clarify in its technical standards that buy-in and fines regimes should apply to all transactions in shares and not only those cleared through a CCP. In case that is not possible, we consider that Article 15 should be deferred until clarification in the upcoming proposal for the CSD Regulation.

Article 14 - Restrictions on uncovered credit default swaps in sovereign debt

The proposed Regulation contains a number of restrictions on the holding of CDS positions. In particular, the Proposed Regulation would prohibit entering into CDS transactions relating to an obligation of an EU sovereign issuer where those transactions lead to an uncovered position in a CDS (Article 14).

In addition, pursuant to Article 21, Member State competent authorities are given the power to limit persons from entering into sovereign CDS transactions or limit the value of sovereign CDS positions that may be entered into by persons in order to address serious threats to financial stability or market confidence.

These proposals are welcomed but we believe that ESMA should consider the following: the need to ensure a continued clearing service to clients by CCPs in the event of a default, and the possibility to void contracts pursuant to the applicable clearing rules.

- **Need to ensure a continued clearing service to clients by CCPs in the event of a default**

  Rules including provisions that allow them to allocate the positions of an insolvent clearing member to other clearing members ("transferee clearing members") are quite commonly used by Regulated Markets active in the CDS clearing business. These provisions exist in order **to ensure a continued clearing service to clients in the event of a default**. If recourse is needed to this procedure with respect to a position in sovereign CDS, it would be without knowledge of transferee clearing members' underlying sovereign bond holdings. It is therefore possible that when requiring transferee clearing members to fulfil their contractual obligation to take on the position, or part of the position, the Regulated Market would inadvertently be obliging them to assume an uncovered position in sovereign CDS.

This is clearly not a circumstance that the Proposed Regulation was designed to prohibit. We note that the latest Council draft of the European Market Infrastructure Regulation ("**EMIR**") requires CCPs to "*take all the reasonable steps to ensure that it has the legal powers to liquidate the proprietary positions of the defaulting clearing member and to transfer or liquidate the clients' positions of the defaulting clearing member*" (Article 45(4)).

- **Void contracts**

Some clearing rules of the Regulated Markets contain provisions that allow voiding contracts (including contracts that are vitiated by mistake or illegality). CDS contracts that Regulated Markets enter into with clearing members may be void or unenforceable for various reasons, leaving the Regulated Markets with an unhedged exposure. Where the Regulated Market does not have a balanced book of CDS contracts, it will have an uncovered position in CDS. Furthermore, if any hedging transaction undertaken by the Regulated Market (including after a clearing member default) does not fully hedge its exposure, this may result in the Regulated Market having an uncovered position in CDS.

Therefore, we would suggest that **the reference to "entering into" an uncovered CDS in Article 14 of the proposed Regulation should be narrowly construed so as to apply only to transactions voluntarily entered into in the market**.

If such a narrow interpretation is not adopted, the prohibition on uncovered CDS in the proposed Regulation could have the unintended effect of catching and restricting the activities and default management practices of CCPs that enhance financial stability and are granted recognition and indeed protection by EU legislation, including the Settlement Finality Directive and EMIR.

If it is not possible to adopt a narrow interpretation of Article 14, **the proposed Regulation should explicitly exempt CCPs from Article 14** where positions in uncovered CDS are assumed for the purpose of or in connection with providing CCP services. The Proposed Regulation includes an exemption for market makers in recognition of the essential role they play in financial markets. However, given the important role for CCPs in supporting market confidence and financial stability acknowledged in EMIR, and the need to ensure CCPs have adequate tools available to them to manage their risk exposure prudently, it would be appropriate for there to be an express exemption for CCPs. An implicit or explicit exemption as outlined above is essential for CCPs to continue clearing CDS.