



ADVICE TO ESMA

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

I. Executive summary

The members of the Securities and Markets Stakeholder Group (hereafter “the Group” welcome the opportunity to comment on the public consultation on the draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps (hereafter “the Regulation”). The Group believes that adapted Delegated Acts and their efficient enforcement are crucial to meet the goals of the Regulation, namely to address the risks associated with short selling while not undermining the benefits associated with this practice, in order to ensure a high level of investor protection and to protect the integrity of European financial markets. Instead of responding to each of the questions raised, the Group will identify, in this paper, the issues it considers as the most important in the present Consultation as well as in the previous one on the Draft technical standards on the Regulation, and provide comments on those.

The Group generally supports ESMA’s proposed Delegated acts and Draft technical standards. The clear definition of what is meant by “owning” or “holding” a financial instrument for the purpose of the Regulation is crucial, as well as the setting of clear methods in respect to the calculation of net short positions. However, the Group is concerned by some of ESMA’ proposals. Notably, the Group believes that a “third party” and the legal person entering into a short sale, should not necessarily be required to be part of different legal entities for the purpose of the “locate rule”, as long as the proper Chinese walls and procedures have been put in place. In addition, the majority of the Group members believes that the location (geographical origin) of a financial instrument is only one criteria to be used to determine its correlation with a sovereign debt risk for the purpose of determining whether a financial instrument is hold for the purpose of hedging against sovereign risk. In addition, the Group believes that the calculation of a “significant fall in value” should not be based on MiFID’s definition of liquid shares, for illiquid shares, and that it should be based, for bonds, on a combination of a minimum change in percentage yield in conjunction with a minimum absolute change in yield values. Finally, the Group believes that the suggestions in respect to price movements are appropriate as long as these do not automatically trigger a suspension of short selling.

II. Comments on the Consultation Paper

Third Party and need for a separate legal entity

1. The Regulation (articles 12(1), 13(1) et 19 of the Recital) mentions the terms « third party » and « separate legal entity ». However, no definition is given to these terms. ESMA asked in its first short-selling consultation if « third party » strictly meant a different legal entity or not.
2. The Group believes that even if these terms are already included in the Level 1 text, ESMA should interpret in a large and non-strict way the significance of these terms. The “separate entity” could be in the same company as long as it is independent and does not create potential conflicts of interest, even if the Group recognises that this might be difficult to assess. Transparency should also be applied. The Group believes that the costs to interpret strictly the above mentioned terms are too important for the benefits wished for by the Regulation.

Interpretation of “correlated” and “highly correlated”

3. There is no definition in the Regulation of what constitutes « highly correlated ». ESMA proposes the following definition”:

“percentage of 80% or 90% would seem to be appropriate for the purposes of calculating a net short position in sovereign debt. the calculation of correlation for assets with a liquid market price should be carried out on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out. However, ESMA recognizes that new sovereign debt instruments are regularly issued and will not have a 24 month trading history. Under the assumption that a high correlation exists, all net long positions in debt instruments of a sovereign issuer in the sense of Article 2(1)(i) of the Regulation should be included. There is no restriction that only debt instruments issued by the sovereign issuer, for which the net short position has to be calculated, can be used”. (p.14-15 de la consultation).

4. The majority of the members of the Group believes that it is important to highlight that correlation should not be limited to geography (i.e. to assets relating to entities located in the same jurisdiction as the sovereign debt) and that the fact that an asset is not located in the same Member State or region as the sovereign debt should not automatically imply, for the purpose of the Regulation, that the asset is not correlated to the sovereign debt at stake. Thus it should be included in the calculation of the net short position. However, a minority of members consider that geography (i.e. the fact that assets relate to entities located in the same jurisdiction as the sovereign debt) is a key criteria and that the holding of an asset shall only be considered as hedging against the risk of a sovereign debt if this asset is located within the same geography as the sovereign debt.

Significant fall in value for shares

5. The consultation proposes that « significant fall in value in the price of an illiquid share» be calculated on the definition of liquidity in MiFID 1 which states the following :

A share admitted to trading on a regulated market shall be considered to have a liquid market if the share is traded daily, with a free float not less than EUR 500 million, and one of the following conditions is satisfied:

(a) the average daily number of transactions in the share is not less than 500;

(b) the average daily turnover for the share is not less than EUR 2 million.

However, a Member State may, in respect of shares for which it is the most relevant market, specify by notice that both of those conditions are to apply. That notice shall be made public.

6. The Group believes that this definition is too narrow in the context of short-selling as it would have a negative effect on market efficiency. A possible solution is to remove the free float criteria by proposing a new definition of “liquid share” and therefore of what is to be considered as an “illiquid share” strictly applicable to short-selling.

Significant fall in value for sovereign bonds

7. ESMA proposes: “An increase of 5% or more in the yield across the yield curve (i.e. to move from a YTM of 5.00% to 5.25%) would be an appropriate trigger for the competent authority”.
8. However, ESMA should consider a combination of a minimum percentage yield in conjunction with a minimum absolute change in yield values. This approach would prevent the price change of a relatively small number of basis points from activating the trigger point for low-yield bonds.

Price movements

9. The Group believes that measures proposed in the consultation for suspension of trading on regulated platforms would not be disproportionate as long as the suggested price movements only trigger an in depth analysis of the situation by competent authorities, so as to assess the appropriateness of suspending short sales. The Group believes that the suggested price movements should not automatically trigger a suspension of short sales. In addition, the Group believes that any short selling ban should be applied coherently across member States.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 26 April 2012

Guillaume Prache
Chair
Securities and Markets Stakeholder Group