

Summary record of the 11th ESME meeting on 19th March 2009

The meeting was chaired by Ms Maria Velentza, Head of the Securities Markets Unit of the European Commission.

1. Adoption of the agenda

The agenda was adopted.

2. Short selling

The Chairperson thanked the ESME subgroup on short selling for the quality of the report. She also informed the members that the Commission services are in the process of assessing the need to come up with an EU policy response, including developing a legislative proposal. She explained that in case the Commission services propose legal measures, they will be subject to thorough cost-benefit analysis. The work of the CESR will also be taken into consideration.

The rapporteur of the subgroup presented the report. The conclusions of the report can be summarised as follows:

On short selling in general:

- Short selling plays an integral part of the proper functioning of the equities markets (there is an interesting list of its main advantages on page 5);
- Short selling can be used abusively, however if short selling can give rise to market abuse so does long purchase, and the MAD already deals with that;

On temporary measures:

- Temporary measures were introduced recently in 25 markets, with different forms of application, which were in Europe mainly:
 - o ban of on the creation or increase of a net short position (UK, Ireland, Netherlands);
 - o ban of naked short selling of physical shares (Germany, Italy);
 - o ban on naked short sales of both the physical shares and financial instruments giving an economic exposure to the underlying shares (France).
- The anticipated effectiveness of these temporary measures have not been supported by evidence; recent studies showed that market quality deteriorated (e.g. spreads, trading sizes, intraday volatility) and that prices were not prevented from falling.
- These measures produced serious uncertainties, compliance costs and burdens due to a lack of consistency.

On possible permanent rules:

- Any future rules should be based on a common understanding of basic definitions (short selling; naked short selling; market makers); it is imperative that short selling regulations - if any - are coordinated at a European as well as global level. No regulation by a single Member State should be implemented before a common position among the EU institutions has been reached.
- Bans on short selling or even on naked short selling should not be applied on a permanent basis. They should be applied only in extreme circumstances, as a first level of intervention, by restricting naked short selling.
- However, it would make sense to address the issue of late settlements, e.g. by reinforcing buy-in procedures. As settlements procedures are closely connected to the design and market model of infrastructure providers, any European initiatives should be based on high level principles only, leaving the details to be designed locally;
- Permanent disclosure on the amount of short selling (and not of stock lending) could be envisaged either on physical or on economical short selling; those rules should be introduced in all sectors and on a daily basis; they could apply to the end user which will report to the regulators that will then aggregate the information and publish it on an anonymous basis; such information can help the market to judge the extent to which short selling is driving the price of the stock and the amount of overhang; it is not relevant for the market to know who the short seller is; ESME cannot determine a threshold; an exemption should apply to market makers.

The Commission services representative mentioned two additional issues. He sought ESME views on the possibility to receive aggregated information from the market on short positions without flagging of orders. He also wondered if it is possible to develop "high level principles" on settlement. Answering to the first question one member gave an example of how the regulator could aggregate disclosure of data on short positions, on the basis of direct reporting received from the market (so that market participants would report their short positions in excess of a specified threshold directly to the regulator, which would then aggregate that information and publish it anonymously).

Members agreed that when discussing possible measures on short selling it is essential to agree on a common definition of short selling in the first place, and to choose either broader economic notion or physical notion of short selling. Members were also of the view that rules on short selling should be applicable to the whole equities markets and criticised any selective approach, i.e. introducing rules on short selling aimed at a specific industry branch, like hedge funds. The plenary was of the view that possible rules should be internationally consistent. One member gave an example of a company whose shares due to its public listing were hit by short selling because its home regulator introduced the ban on short selling with some delay after the majority of the competent authorities had done so.

One member stressed the fact that differences between national rules on short selling stemmed from the fact that national governments pursued different goals, e.g. prevention of price falling or prevention of the settlement failure. Therefore, when talking about the measures on short selling it is essential to know what their purpose is.

All the ESME members expressed their support to the conclusions of the report, which they considered as very balanced. The report was approved.

3. Transparency Directive - transparency of holdings of cash-settled financial instruments

The Chairperson informed the ESME members that the contract for the external study on the operation of the Transparency Directive was signed with Mazars (following an open call for tenders) in December 2008. The work of the contractor started in January 2009 and will end on 31 October 2009.

The ESME member involved in the study announced that he will refrain from taking part in any work related to the Transparency Directive carried out by the ESME in order not to give rise to any potential conflict of interest. In practical terms this means that he will leave the meeting room during the discussion of the points related to the transparency directive. All other ESME members agreed to such a solution.

The rapporteur of the working group dealing with transparency of holdings of cash-settled derivatives reported about the progress of the work so far. The working group has identified some substantial issues that need to be addressed:

- (i) the disproportional relations between control (legal interest) and economic interest leading to either empty voting (legal interest > economic interest) or to hidden ownership: (economic interest > legal interest);
- (ii) the possible negative consequences (for shareholder as well as issuing company) resulting from lack of transparency (e.g. no efficient pricing in capital markets due to insufficient information; no transparency on large holdings, large transactions, possible conflicts of interest and free float of a share; avoidance of the launch of mandatory bid at an equitable price; no take over premium and no real exit for minority shareholders);
- (iii) the question of the robustness of the Transparency Directive, which has already been addressed in previous ESME reports;
- (iv) the question of creeping control via large minority holdings;
- (v) the notification of positive and negative positions in one share by one investor; and
- (vi) the relationship between market abuse directive and transparency directive.

The subgroup is also preparing an inventory of cases where lack of transparency around cash-settled derivatives appeared as well as an inventory of instruments used in those cases (noting that in many cases, these instruments are used for other purposes, such as avoiding stamp duties etc).

Some members expressed the view that the Transparency Directive should be modified in order to target methods used to circumvent its rules. This would be a policy to develop at EU level. The question is which is the kind of transparency that is needed and by whom. A possibility would be to ask for transparency on the instruments, as such, without the link to the potential control of the shares. A member suggested looking at the US disclosure rules on cash-settled derivatives, which appear to be efficient. A member underlined that the question of transparency on OTC derivatives should be carefully addressed since derivatives are used for other purposes than to gain control. This was agreed on by others. Another member suggested that the possible weakness might be more with the takeover bids directive rather

than with the Transparency Directive. Some members also raised the question of the need for greater harmonisation of the Transparency Directive rules on disclosure of holdings. A member also underlined that it is rather expensive for investors to deal with different national systems even if they differences are not very extensive..

The Commission services agreed that the Transparency Directive rules on major holding disclosures are relatively old in their conception, and referred to the on-going review of the directive. It also mentioned an ongoing external study on cost of compliance with the Transparency Directive (and other financial services rules) that intended to calculate the cost increase for asset managers complying with several national disclosure rules at the same time. This study will be available soon.

Upon request by the rapporteur for other members to provide input, it was agreed that Ms Sirel and Mr Holland will join Ms Kapteyn, Ms Chamberlain and Messrs. Bates, Müller and Di Noia in the subgroup.

4. MiFID

a. Availability of post-trade data in equities in the EU

On 18 September 2008 the Commission services asked ESME to proceed to a fact finding exercise on whether there is an appropriate level of access to post-trade data in equities in the EU (“Market Data”).The rapporteur of the subgroup on data availability presented the draft report. The report focussed on data availability on post trade transparency in equities in the EU.

The general questions addressed to ESME were:

- Under what terms is trade data in equities currently made available?
- How is general data availability affected by such terms (including fees) and what effect does this have on market participants?

The overall conclusion of the report is that the availability of post-trade data in equities in the EU appears to be good. Market data users have sufficient choice of market data products and delivery methods for their needs at reasonable cost. All members of the subgroup were thanked for their contribution. Some written comments had been provided and were discussed during the meeting. The report, pending changes agreed at the meeting, was approved by the ESME members.

b. Pre-trade transparency: availability of data and application of waivers

Based on the issues raised in relation to pre-trade transparency in the report on data availability (see above under point 4a), as well as taking into account other issues related to availability of pre-trade transparency data, ESME members were asked to look into the issue of pre-trade transparency.

The work stream would deal with three elements:

- Terms and conditions under which pre-trade transparency data is available. This part would have a scope comparable to that of the report on post trade transparency.
- Assessment of current waivers for pre-trade transparency obligations (Article 18 and 20 of the MiFID implementing Regulation). The drafting group should consider whether the current waivers are appropriate for supporting price discovery and efficient market functioning.
- Fact finding on trading venues (other than regulated markets) not categorised as multilateral trading facilities or systematic internalisers. Apparently some systems fall between these categories and are subsequently not subject to pre-trade transparency obligations.

Further specification on the content of this work stream will be circulated shortly. ESME members would be invited to join the relevant subgroup and appoint a rapporteur.

5. Product standardisation

In the context of discussions of standardisation held by G20 and other fora, ESME members were invited to discuss this issue and present their opinions. The Commission services asked the ESME members for their views on the drivers of a debate on standardisation in financial markets (more centralised clearing, higher liquidity, help in valuation, more transparency etc), their views on current market developments and thoughts on who should drive further standardisation (industry, standard setting bodies, supervisors or policy-makers).

ESME members recalled that top-down standardisation is generally unwelcome in financial markets, as is any regime of product licensing by regulators. Innovation should be upheld, even though some questioned whether it had gone too far. Some members drew attention to the fact that efforts towards more standardisation should not detract from more urgent priorities such as better and less fragmented supervision and enforcement. Others viewed such a development as an important consideration in returning confidence to various markets.

Members noted and welcomed various standardisation initiatives going on in the markets. However, there was little discussion on how to take stock or further build on these. Some members pointed out that investor protection should not be the driving factor in the debate as MiFID provides for suitability and appropriateness checks even in the case of highly tailor-made instruments. One member noted that pursuing a debate on standardisation raises the question of the adequacy of the information on products required by the Prospectus Directive.

One member observed that endless product variability may be a difficult proposition to sustain in the present situation. In the future, he noted, the wider central clearing of standardised credit derivatives may well be accompanied by higher capital charges for non-standardised contracts.

The Commission services concluded that innovation is crucial but there are issues to be addressed in the current context. The need for greater standardisation is politically popular and it could be a useful complement to other means, e.g. via conduct of business and prudential rules, to address excessive complexity. The issue may be revisited in subsequent ESME meetings taking into notably G20 conclusions.

6. OTC derivatives: improving supervisory oversight and investor protection

The Commission services provided some background elements concerning work carried out by the Commission services on this issue: the Commission Communication for the Spring European Council 'Driving European recovery' identifies certain gaps in the regulatory system that need to be filled in order to increase transparency and ensure financial stability. The report on derivatives and other complex structured products has been listed as a basis for the Commission to come up with appropriate initiatives to increase transparency and ensure financial stability with respect to these instruments.

The Commission services presented a number of questions in order to obtain the ESME input into the report on transparency and stability in derivatives and complex structured markets due in summer 2009. The questions cover the desirability of implementing transaction reporting, position reporting and reporting to clients on the evolution in underlying assets:

1. Considering CESR's ongoing work aiming at expanding transaction reporting to OTC derivatives, should MiFID be amended to reflect this?
2. Should the obligation extend explicitly to other excluded instruments as well?
3. Which derivatives should be covered by position reporting – exchange traded or also OTC?
4. Who should report - the firm, exchange, or clearing house?
5. Considering the recent principles for RMBS transparency and disclosure by the European Securitisation Forum, could its standardised post-issuance principles for reporting to investors on the evolution of underlying assets in RMBS be amendable to other instruments?
6. Which ones?

ESME members' questions revolved around the purpose of such initiatives, the need to weigh costs against benefits and on some of the relevant elements to consider under the three themes. Many of members questioned the appropriateness of such a discussion. One member also noticed that reporting of OTC transaction will clearly entail significant additional costs and will raise a large number of technical issues. Replies from individual ESME members are expected by 17 April.

7. AOB

The Chairperson reminded ESME members to contribute to two questionnaires related to collection of data and opinions on operation of the Prospectus Directive and the Market Abuse Directive. She thanked those who have already sent their contributions.