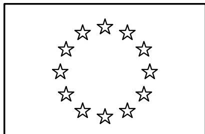

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COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

Accompanying the document

Proposal for a

Commission Delegated Regulation supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of Credit Default Swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events

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1. INTRODUCTION

On 15 September 2010, the Commission published its proposal for a Regulation on short selling and certain aspects of credit default swaps. The Regulation was adopted by the European Parliament and the Council on 14 March 2012. On 24 March 2012 the proposal for a Regulation on short selling and certain aspects of credit default swaps was published in the Official Journal[1]. The Regulation on short selling and certain aspects of Credit Default Swaps will enter into application on 1 November 2012.

The Regulation has two main objectives: (i) to lay down a common regulatory framework for the requirements and powers relating to short selling and credit default swaps (CDS), in particular relating to uncovered short selling and naked CDS and (ii) to ensure a more coordinated and consistent approach by Member States when measures need to be taken in exceptional situations.

The short selling Regulation requires the Commission to specify in a delegated act certain elements that will facilitate compliance by market participants with the Regulation and its enforcement by competent authorities.

This impact assessment should be read in conjunction with the impact assessment which preceded the adoption of the Regulation[2] (the "Level 1 Impact Assessment") and which provides the overall assessment of action in this area and the framework within which the scope and purpose of the delegated act can be understood.

1.1 Procedural issues

The initiative is based on the short selling Regulation, the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union,[3] and the Framework Agreement on Relations between the European Parliament and the European Commission.[4]

Subject to Articles 42 and 43 of the Regulation, the Commission has the power to adopt the Delegated Regulation in accordance with Article 290 of the TFEU. In particular, in accordance with Article 43 of the Regulation, the Commission is under the obligation to adopt the Delegated Acts under Article 2(2), Article 3(7), Article 4(2), Article 5(4), Article 6(4), Article 7(3), Article 17(2), Article 23(5) and Article 30 by 31 March 2012, which the Commission may extend by 6 months.

This Impact Assessment takes into consideration the final report of the European Securities and Markets Authority (ESMA)'s technical advice on possible Delegated Acts concerning the

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1 OJ L86/1, 24.03.12, Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

2 SEC(2010)1050 of 15 September 2010 available at the following website: http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_impact_assessment_en.pdf

3 Communication of 9.12.2009. COM(2009) 673 final.

4 OJ L304/47, 20.11.2010, p.47.

short selling Regulation (the Advice)[5] following the formal request from the Commission services of 24 November 2011. ESMA was invited to consider the earlier Impact Assessment work of the Commission. In addition, ESMA consulted all major stakeholders, including securities regulators, market participants (issuers, intermediaries and investors), and consumers.

1.1.1 Impact assessment steering group

The Steering Group for this Impact Assessment (IASG) was formed by representatives of a number of services of the European Commission in addition to those of the Directorate General Internal Market and Services, namely the Secretariat General, the Legal Service, the Directorate General Economic and Financial Affairs, the Directorate General Competition, the Directorate General Enterprise and Industry, and the Directorate General for Health and Consumers. This Group met twice. The last meeting of the IASG took place on 18 April 2012. The contributions of the members of the Steering Group have been taken into account in the content and shape of this Impact Assessment.[6]

1.1.2 Impact Assessment Board

The Impact Assessment Board analysed this Impact Assessment and delivered its opinion on 27 April 2012 after scrutiny by written procedure. In the course of this procedure the members of the Board provided DG MARKT services with comments to improve the content of the Impact Assessment that led to some modifications to the text. The following changes were made in response to the comments of the Board:

- Clarification of the scope and derived nature of this initiative in relation to the Short Selling Regulation (see section 2.1 background and context which clarifies that the Delegated Regulation sets out technical details not addressed in the level 1 Regulation);
- Clarification in the problem definition itself of all the issues to be addressed in the delegated act (see section 2.6 setting out all the other issues to be specified in the delegated act);
- Clarification of the extent to which ESMA's technical advice has been followed, and explanation where this is not the case (see all sections in sections 2.6 and 5, and in particular sub-section 2.6 and sub-section 5.1 for explanations where ESMA's advice has only been partially followed);
- Improved presentation of the specific objectives and the content of the options for the delegated act (see sections 3 and 4);
- Better separation of the description of the options, the analysis of their impacts and the comparison of the options (see section 4 for the descriptions of the options and section 5 for the analysis of their impacts, with separate sub-sections on comparison of the options);
- Clarification of the implications of the baseline scenario (see sub-section 2.7); and

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[5] See final report ESMA 2012/263 available at: http://www.esma.europa.eu/content/ESMAs-Technical-Advice-possible-delegated-acts-short-selling-and-certain-aspects-CDS

[6] In accordance with the rules for the elaboration of Impact Assessments the minutes of the last meeting of the Steering Group have been submitted to the Impact Assessment Board together with this Impact Assessment.

- Clarification of the comments made by particular stakeholders and a more transparent presentation of stakeholder views (added in all sub-sections in section 5 with a full summary of stakeholder views in annex 3).

1.2 Consultation of interested parties

1.2.1 Consultation of ESMA

In accordance with Article 19 of the ESMA Regulation,[7] ESMA should serve as an independent advisory body to the Commission, and may, upon a request from the Commission or on its own initiative provide opinions to the Commission on all issues related to its area of competence. Moreover, according to Article 8(1)(a) of the ESMA Regulation, ESMA has taken over all existing and ongoing tasks from CESR.[8]

On 24 November 2011, the Commission services sent a formal request for advice (the "Mandate") to ESMA on possible delegated acts concerning the short selling Regulation.[9]

Following receipt of the Mandate, on 7 December 2011 ESMA convened a round table of European and international associations representing various stakeholders. On 15 February 2012, ESMA published a Consultation Paper[10] and received 35 responses.[11] The ESMA Consultation Paper contained targeted questions to stakeholders. The responses came from European and national associations as well as individual asset management firms, banks, investment firms, issuers, regulated markets and trading systems. A summary of the consultation responses is included in annex 3. An open hearing was held by ESMA on 29 February 2012.

2. PROBLEM DEFINITION

2.1 Background and context

The problems and risks linked to short selling which led the Commission to propose the Regulation on Short Selling and Certain Aspects of Credit Default Swaps were considered in the Level 1 Impact Assessment (see summary of this impact assessment in annex 6). The Level 1 Impact Assessment recognised that, according to most economic studies, short selling offers a number of benefits to financial markets, notably in terms of liquidity and efficient price discovery. However, it also acknowledged that short selling poses risks, notably: of negative price spirals which can result in disorderly markets and possible systemic risks, of settlement failure, and of transparency deficiencies for market participants and regulators. Above all, the fact that Member States have taken divergent actions in response to these risks

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[7] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC. OJ L331/84, 15.12.2010, p.84.

[8] Commission Decision 2009/77/EC of 23 January 2009 establishing the Committee of European Securities Regulators, OJ L25, 29.1.2009, p.18.

[9] See link

[10] See consultation paper at http://www.esma.europa.eu/system/files/2012-98.pdf

[11] These are available at: http://www.esma.europa.eu/consultation/Consultation-ESMAs-draft-technical-advice-possible-Delegated-Acts-concerning-regulation#responses

in times of crisis in an uncoordinated manner posed a risk of fragmentation of the internal market.

In light of the analysis of the problem, the Commission set the following general objectives for the Regulation on Short Selling (see annex 7 for full details of the objectives):

1. Prevent **market fragmentation**, thereby increasing the **efficiency of the internal market**.
2. Reduce **systemic risks**;
3. Reduce the **risks to financial stability**;
4. Reduce risks to **market integrity** arising from short selling; and
5. Reduce the scope for regulatory arbitrage and compliance costs.

In conformity with the objectives and the conclusions of the Level 1 Impact Assessment, the proposal for a Regulation presented by the Commission included the following policy options which were retained by the co-legislators in the final text of the Regulation adopted on 14 March 2012 with certain amendments:

- A regime of notification to regulators and disclosure to the public for significant short positions in shares, with thresholds of 0.1% and 0.5%;
- A regime of notification to regulators for significant short positions in sovereign debt, with thresholds to be determined by implementing measures in light of the specificities of sovereign debt markets;
- Certain conditions on uncovered short sales of shares (locate rule and measures vis-à-vis third parties);
- Certain specific conditions on uncovered short sales of sovereign debt (a qualified locate rule), with the possibility for these conditions to be suspended by Member State competent authorities in the event of a significant fall in liquidity relative to the average of the sovereign debt in implementing measures;
- Exemptions for market makers and primary dealers from the transparency requirements and the locate rules;
- Buy-in procedures for settlement failures in shares;
- A power for regulators to temporarily suspend short selling in the event of a significant price fall in a financial instrument on a trading venue during a single day (some aspects of which are to be specified in implementing measures), with powers for ESMA to coordinate and intervene itself by binding mediation if necessary in cross-border cases;
- Powers for national regulators to restrict or ban short selling in exceptional circumstances; and
- Powers for ESMA to coordinate the actions of Member States and to intervene itself in exceptional circumstances with cross-border effects, although with a requirement for an emergency situation to be declared first by the Council for ESMA to intervene on sovereign debt.

In addition to the above provisions, the co-legislators also agreed to add to the Regulation a prohibition on entering into uncovered positions in sovereign CDS, which had not been included in the original Commission proposal, including some safeguards in order to avoid any unintended effect on the liquidity of sovereign debt markets. First, to define covered sovereign CDS so as to include cases of hedging against the risk of a decline in the value of assets or liabilities correlated to the value of the sovereign debt ("proxy hedging"), as well as

hedging against the risk of a default in the sovereign debt itself. Second, to allow a competent authority to temporarily suspend the prohibition on uncovered sovereign CDS where it has objective grounds for believing that its sovereign debt market is not functioning properly and that such a prohibition might have a negative impact on the sovereign CDS market, based on an analysis of indicators specified in the Regulation.

As indicated above, the Regulation adopted by the co-legislators left certain elements of its provisions to be futher specified by the Commission in delegated acts because these were not addressed in detail in the Regulation, or were left outstanding from the Regulation. Of these elements to be addressed in delegated acts, the following key issues are the main subject matter of this impact assessment:

1. Specifying cases which constitute a covered sovereign CDS for the purpose of the prohibition on uncovered sovereign CDS;
2. Specifying notification thresholds for significant short positions in sovereign debt taking into account the specificities of the sovereign debt markets of Member States;
3. Specifying a threshold for the significant fall in the average liquidity of a sovereign debt instrument which allows a Member State competent authority to suspend restrictions on uncovered short sales of sovereign debt; and
4. Setting thresholds for what constitutes a significant price fall for financial instruments other than liquid shares, for the purpose of the power of competent authorities to suspend short selling in those instruments;

In addition to these key issues, a number of other issues are to be specified by the Commission in delegated acts because these were not addressed in detail in the Regulation or were left outstanding. These issues, examined briefly in section 2.5 and in more detail in annex 2, are not subject to detailed impact assesment because no real alternative options are available, or their additional impact when compared with the level 1 impact assessment is marginal, or the difference between the impact of the various options is negliglible - but in all cases these issues are dealt with in line with the general objectives of the Regulation. These issues are:

- the definition of "ownership";
- cases in which a natural or legal person is considered to "hold" a share or debt instrument;
- cases in which a natural or legal person has a net short position;
- the method of calculation of a net short position;
- the method of calculation of long and short positions and uncovered sovereign CDS positions for entities in a group and separate funds managed by the same fund manager;
- the method of calculation of an uncovered sovereign CDS position;
- thresholds for the EFSF/ESM, EIB and for each of the German Länder; and
- the cases which could constitute an adverse event or development.

An overview of the issues to be considered by the Commission in relation to the delegated acts on these issues, and the reasons why they are not analysed in detail, is included in section 2.5 below with greater detail provided in annex 2.

2.2 Issue 1 - specifying cases which constitute a covered sovereign CDS (Article 4)

The Regulation defines an uncovered sovereign CDS as a CDS which does not serve as a hedge in either of the following two situations: a hedge against the risk of the default of the sovereign issuer where the investor holds a long position in the debt of that sovereign issuer; or a hedge against the risk of a decline in the value of the sovereign debt where the investor holds assets or liabilities whose value is correlated to the sovereign debt. In other words, the co-legislators have defined a covered sovereign CDS broadly to encompass also what is known as "proxy hedging", the use of a CDS to hedge a risk in a correlated asset rather than in the debt instrument named in the CDS. Proxy hedging is an important tool for hedging exposures to assets and liabilities for which no CDS is available. The specification of cases which constitute a covered sovereign CDS is important for the clarity of the Regulation, because entering into uncovered sovereign CDS is prohibited in accordance with article 14 of the Regulation.

Article 4(2) of the Regulation empowers the Commission to adopt a delegated act specifying cases in which a sovereign CDS transaction is considered to be hedging against either of the above-mentioned risks. Specifying such cases is necessary, particularly in the case of proxy hedging, to clarify where the boundary lies between legitimate proxy hedging and sovereign CDS positions which are uncovered in accordance with the Regulation. The problem is explained further below.

A wide range of assets or liabilities can in principle be hedged by a sovereign CDS provided that there is a correlation between the value of the assets or liabilities and the value of the sovereign debt.

Example 1

An example of a covered sovereign CDS position could be as follows: an investor might take out a CDS in the sovereign debt of country A because the investor holds a long position in the shares of a majority state-owned bank of country A. Such a CDS may serve as a hedge, for instance when the bank is loss-making and majority owned by country A. In such a case, a default of country A would likely lead to funding difficulties if not bankruptcy for the bank, so there is a correlation between the two. In such an example, the CDS could be deemed to be a legitimate hedge.

An example of a sovereign CDS position which would be uncovered could be as follows: if an investor has a position in the majority state-owned bank of country B and holds a sovereign CDS in country A on the grounds that the sovereign debt of countries A and B are highly correlated. This would be uncovered because it was not the intention of the co-legislators that proxy-hedging could be defined so broadly as to cover cross-country proxy-hedging, even if there is a high correlation between the debts of the two countries. Therefore in this case the holder of the sovereign CDS in country A would be deemed to be uncovered, unless he held other assets in country A which were correlated with the debt of country A.

The Degree of Correlation: One of the key elements for determining whether the sovereign CDS hedges against a loss is the correlation between the "insured" asset or liability and the hedging CDS. The problem is first, how should this correlation be measured and what degree of correlation is required for it to be considered hedging? On the one hand, if correlation is defined too rigidly it is possible that a legitimate hedge could be deemed to be uncovered,

thereby contradicting the objective of market efficiency and the regulatory purpose of permitting CDS hedging where there is a legitimate insurable interest. On the other hand, if correlation is defined too flexibly then almost any hedge could be deemed to be covered. This could lead to different approaches being adopted in different Member States, with some taking a strict interpretation of correlation and others taking a more flexible approach, defeating the objective of achieving a consistent approach. Correlation can in principle be measured quantitatively or qualitatively.

The extent of the insured interest: in addition to the level of correlation, there is also the problem of whether the amount of sovereign CDS is in proportion to the amount of assets or liabilities being hedged. Even if there is a correlation between the assets or liabilities being hedged and the sovereign CDS, a position could still be partially uncovered if the value of the sovereign CDS exceeds the value of the underlying assets.

Example 2
For instance, if an investor takes out a sovereign CDS in the sovereign debt of country A to the value of € 5 million, while only holding assets in the national bank of country A of the value of € 3 million, the difference between the two equates to an uncovered position of € 2 million in the sovereign CDS of country A, running contrary to the "insurable interest" principle.

Hedging over time: A further problem is that the degree to which the sovereign CDS is a proportionate hedge for the underlying assets can change over time, due either to changes in the market value of the underlying or to a change in the size of the underlying position.

Example 3
In the above example, if the investor partially or fully sells off their holding in the shares of the national bank, they will develop a partially or fully uncovered position unless they correspondingly reduce or close out their corresponding sovereign CDS position. This may be difficult to do, because CDS are typically available only in discrete quantums and for fixed durations (most commonly 5 years). It can therefore be difficult to perfectly match the value of the hedged assets over time.

Consistent Supervision: A final issue to be considered in this regard is enforcement since one of the objectives of this legislation is to ensure a consistent approach to the regulation of short selling. Which approach, quantitative or qualitative, would best ensure a consistent approach to defining correlation across juridictions?

2.3 Issue 2 – specifying notification thresholds for short positions in sovereign debt (Article 7)

The requirement for significant short positions in sovereign debt to be notified to competent authorities is set out in article 7 of the Regulation. The Regulation does not specify what the notification threshold shall be, stating only that the threshold shall consist of an initial amount and then additional incremental levels in relation to each Member State and the Union, and these levels are to be specified by the Commission in a delegated act. Article 7(3) requires the Commission to take account of the following criteria in setting the notification threshold: avoiding notifications of positions of minimal value; taking into account the amount of

outstanding issued sovereign debt and the average size of market participants; and taking into account the liquidity of each sovereign bond market.

The issue of determining the appropriate notification threshold for each sovereign issuer in a way which takes into account these criteria can be set out as follows:

- what constitutes a significant short position in sovereign debt should be considered on the basis of these positions' systemic importance. Smaller positions are generally considered to be less systemically important. However, a small position may create a price spiral which results in a systemic impact. Also, many small positions may become systemically relevant in aggregate. In setting these thresholds, it is difficult to take into account the normal average size of positions of market participants as data on this is lacking in the absence of a notification regime. Therefore, the challenge is how to set the initial threshold at a level that ensures that notifications of minimal value are avoided, but that the notifications do provide the necessary information to monitor for systemic risks. Should the first threshold in itself constitute a significant position in the sense of representing a systemic risk in itself? Or should it represent a position of interest to the competent authority because it may signify the first step in an increasing short position which is increasingly significant in terms of its potential systemic effect?
- A € 5 billion short position may not be important relative to a large sovereign issuer, but may be quite significant in relation to a smaller one. Also, short positions may be relatively larger in more liquid markets and may have less impact in such markets as a result.

The second issue is whether to have one or many thresholds. On the one hand, the need not to have notifications of minimal value implies tailoring the thresholds to the specific situation of each sovereign issuer, as one threshold for all might result in too many notifications for some and too few for others. On the other hand, one of the objectives of the Regulation is to ensure a consistent approach and so fewer than 27 thresholds may be required. This would also take account of the fact that the sovereign debts of several Member States share a number of characteristics which means that by applying the criteria the same threshold should be applied to a group of Member States. Could more than one threshold impose a greater compliance burden on natural or legal persons?

2.4 Issue 3 - specifying a threshold for the significant fall in the average liquidity of a sovereign debt instrument which allows a Member State competent authority to suspend the restrictions on uncovered short sales of sovereign debt (Article 13)

Article 13 of the Regulation imposes certain restrictions on uncovered short sales of sovereign debt, but also allows for these restrictions to be suspended temporarily under certain conditions. The restrictions consist of a requirement that the short seller must have either borrowed the sovereign debt, or entered into an agreement to borrow it, or have an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or otherwise has a reasonable expectation that settlement can be effected when it is due. These restrictions can be suspended by competent authorities for six months (renewable) where the liquidity of the sovereign debt falls below a threshold which represents a significant decline relative to the average level of liquidity of the sovereign debt concerned. The parameters and methods for calculating this threshold of liquidity is to be

determined by the Commission in a delegated act which must be defined based on objective criteria specific to the relevant sovereign debt market, including the total amount of outstanding issued sovereign debt.

The rationale for the possibility to suspend the restrictions on uncovered short selling of sovereign debt is the need to avoid that such restrictions could harm the liquidity of sovereign debt at a time when Member States face difficulties to finance their public deficits. The co-legislators therefore agreed to the provision on the understanding that national competent authorities would have the power to suspend the restrictions if a liquidity problem was encountered, as long as this liquidity trigger was objectively defined in advance. The problem is to balance the need for intervention in order to meet the financial stability objective with having a consistent approach across the EU to the ban on uncovered sovereign CDS positions.

The test set for the possibility to suspend the restrictions is "a significant fall relative to the average level of liquidity for the sovereign debt concerned". Competent authorities are not obliged to suspend the restrictions in the event of such a fall, but cannot suspend the restrictions in the absence of such a fall. The question is how to define what a significant fall relative to the average level of liquidity is: how should this be measured, and what is significant? Notably, it is important to specify the parameters and methods to be used by competent authorities in order to harmonise how this provision is applied. This may take the form of a formula to be used when calculating the fall.

Concerning the issue of how to measure a significant fall relative to the average level of liquidity, technical discussions with ESMA have shown that this could be measured in absolute or in relative terms. If a relative approach were to be taken, there are different ways to measure a relative decline:

- as a percentage fall relative to the average (e.g. 30%);
- as a certain percentile relative to the normal distribution (e.g. the 5th percentile), or
- as a certain number of standard deviations from the normal distribution (e.g. two standard deviations)

.

Further issues to be considered in determining the threshold are:

- the period of time over which the average level of liquidity has to be calculated: should falls be measured against the long term, medium term or short term average liquidity? While long term averages may seem appealing, trends in the markets trading environment and the sovereign debt stock may mean that long term averages are not a meaningful comparator for current changes. On the other hand using a short term average may result in the capricious application of the threshold. For instance, if a period of abnormally high trading is followed by a return to normality, this could be seen as a significant drop if the time frame chosen is too short.
- The duration of the period during which a fall relative to that average should be measured. On the one hand the period should be long enough to determine that the fall is statistically significant or not likely to be a one-off. On the other, crisis may strike quickly and a quick reaction by the authorities may be required. Therefore setting the time frame too long may mean that such periods will not be captured or mean that authorities are only able to act after it is too late.

Finally there is the question of what constitutes a significant fall relative to average liquidity: how large should such a drop be? Should significant be interpreted to mean a fall which is sufficiently high relative to the usual volatility, thus restricting the number of occasions on which a competent authority could consider whether to suspend the restrictions? Or should significant be taken to mean a lower fall (which could be expected to occur more often) and therefore give competent authorities more occasions to consider whether to suspend the restrictions?

2.5 Issue 4 - thresholds for what constitutes a significant price fall in financial instruments other than liquid shares for the purposes of temporary suspension of short selling those instruments (Article 23)

The Regulation includes in article 23 a power for competent authorities to suspend short selling in a financial instrument temporarily where the price of that financial instrument on a trading venue has significantly fallen during a single trading day. A competent authority may also otherwise limit transactions in order to prevent a disorderly decline in the value of a financial instrument. The suspension shall apply until the end of the next trading day, which can be extended by a further two days if the fall continues. The Regulation fixes the threshold for a significant price fall in liquid shares at 10%, but fixes no thresholds for other shares and other classes of financial instruments, leaving these to be specified by the Commission in a delegated act taking into account the specificities of each class of financial instrument and the differences of volatility.

This option was analysed in the level 1 impact assessment and was retained because it had the advantage of offering competent authorities a power to help slow a negative price spiral without needing to determine an exceptional situation. Also there is some evidence that circuit breakers provide a cooling off period for investors. The competent authority is not obliged to suspend short selling if it considers that the significant price fall is driven by factors other than short selling, for example the announcement of a sharp fall in profits at the issuer concerned.

The problem to be addressed in the delegated act is to determine what constitutes a significant price fall for financial instruments other than liquid shares, so that the thresholds which are necessary for the Regulation to be applied can be fixed. The issue is how to determine what a significant price fall represents for each type of financial instrument. To be consistent with the objectives of the Regulation, the power of a competent authority to suspend short selling in a financial instrument on a trading venue in the event of a significant price fall should reduce the risk of negative price spirals in that instrument, prevent market fragmentation and ensure a consistent approach by Member State competent authorities.

In this context, the meaning of significant is twofold:

- First it has its **statistical/size meaning** – that is the fall that triggers any threshold should be more than usual volatility. This is closely related to the statistical concept that any fall must be distinguishable from noise; because it is only such a fall that could potentially result in a negative price spiral.
- **Significance in terms of the measure's effect (economic meaning)**: The significance of a fall may also be evaluated in terms of its effect – a fall in price can be said to be

significant if the effects of that fall are likely to be significant in terms of the effect on financial stability and the real economy. Or alternatively a fall in value may be significant because of particular characteristics, which means that a certain fall is likely to have significant knock on effects on that instrument.

Further, thresholds need to be fixed in relation to classes of financial instruments which are traded on a trading venue. Based on annex I section C of the Markets in Financial Instruments Directive 2004/39/EC, and the technical advice of ESMA, thresholds need to be set for the following classes of financial instruments traded on trading venues:

- illiquid shares;
- sovereign bonds;
- corporate bonds;
- money market instruments,
- units in collective investment undertakings (UCITS);
- exchange traded funds (ETFs); and
- derivatives.

In addition, the on-going review of the Markets in Finanical Instruments Directive is expected to introduce new classes of financial instruments. Thresholds may need to be set for those too.

For liquid shares a threshold of 10% has been fixed in the Regulation. Co-legislators considered that this threshold was not appropriate for illiquid shares, since the lower turnover in these shares meant that average volatility was higher and therefore a 10% decline was more common for less liquid shares. Therefore if the same 10% threshold was set for less liquid shares, it would be breached frequently for reasons which were more likely to do with the lack of liquidity than short selling. Thus the Regulation empowers the Commission to set thresholds for instruments other than liquid shares in a delegated act to take account of the specificities of different classes of financial instruments and their volatility.

In relation to sovereign bonds it is problematic to express a significant price fall in percentage terms. This is because there are always different issues of debt outstanding for the same sovereign. These issues together make up a sovereign's national debt. All these issues have a different duration, i.e. their time to maturity or the time when they need to be repaid, and different coupons, i.e. the interest rates paid on them. In addition, they may have different prices, i.e. the amount at which they are sold in the market relative to their nominal value. Both the market price and its interest rate, which together form a bond's yield, need to be taken into account when valuing a bond.

Similarly for corporate bonds it is problematic to set a threshold in percentage terms. This is because in normal circumstances the price of any corporate bond is related to the yields of the sovereign bonds where the company issuing the bond is settled. Investors on fixed income set the price of a corporate bond adding a yield spread which covers the excess of credit risk of the corporate over the sovereign[12]. Therefore in setting a threshold for a significant price fall in corporate bonds, account will have to be taken of the approach taken for sovereign bonds.

Money market instruments are financial instruments which have maturities ranging from one day to one year and are extremely liquid. Some examples of these instruments are federal

[12] ESMA consultation paper on technical advice for delegated acts, p.56.

agency notes, repurchase agreements and certificates of deposit. In setting the threshold for these instruments account will need to be taken of the usual range of volatility for these instruments.

Undertakings for collective investments in transferable securities (UCITS) are forms of collective investment schemes, in which investors pool their money with other investors in order to invest in a variety of assets and securities. Initially all UCITS may be listed although there are some that are not listed. UCITS may be constituted in accordance with contract law as common funds managed by management company, trust law (as unit trusts), or statute self-managed UCITS - investment companies. They must be assessed daily so that the unit holders know the market value of the financial instruments included in the portfolio (the Net Asset Value – NAV). Although the price of a unit in any UCITS may vary freely in the market the price is subject to a rule which keeps the prices close to the NAV of the UCITS[13]. The problem therefore is how to set a threshold for UCITS which takes account of all these factors.

Exchange traded funds are a generic term for investment funds whose value is closely related to that of the underlying assets, and which are traded on an organised platform such as a regulated market or a multilateral trading facility (MTF). The underlying could be bonds, shares, commodities or a combination of those. UCITS and money market funds are the two main examples of ETF's. UCITS may invest only in transferable securities and money market instruments and not more than 10 % of their assets in other transferable securities or money market instruments. Money market funds generally invest in well diversified highly graded debt. Investors in ETF's will always be able to redeem their holdings by exchanging them for the underlying assets, typically by going through an intermediary. Also, it should be remembered that for ETF's, including UCITS, market making is usually carried out by exchanging units for the underlying assets. Here, it is important to bear in mind that the value of an ETF depends almost entirely on the underlying assets. As they will typically hold those assets as part of a diversified portfolio, the significant price fall will need to take into account what is considered a significant fall for their underlying assets.

Derivatives are contracts whose value depends on the performance of an underlying asset, which can be a financial instrument or something else (e.g. a commodity). As a class, derivatives constitute an extremely wide variety of financial instruments with very distinct characteristics. Examples include futures, options and swaps. This diversity means that a single reference threshold is likely to be inappropriate for all the different types of derivative. In addition, the price of a derivative may depend on a variety of factors other than the value of the underlying – such as volatility and the interest rate. This means that their price may change even if the underlying asset has not changed in value. Further their volatility is often non linear and time dependent – for example option prices may become much more volatile relative to the price of the underlying as they approach maturity – while a heavily out-of-the-money option may hardly vary in price even with large changes in the price of the underlying. A second consideration is also that in most cases, if the competent authority were to choose to impose restrictions if the threshold were passed, it would be best to coordinate these restrictions with restrictions imposed on the underlying asset, or there would be a risk for a temporary restriction of short selling on the underlying to be circumvented by a derivative transaction related to that underlying. Ideally any threshold for derivatives should therefore be crossed at a similar time to a significant fall in the underlying. It should also be

[13] ESMA consultation paper on technical advice for delegated acts, p.57.

remembered that the price of a derivative may go up when the price of its underlying goes down (and vice versa).

The problem in choosing a derivatives threshold is therefore to an appropriate threshold for each class of derivative that represents a significant price fall (statistically and economically) and achieves the objective of ensuring market stability in a coordinated fashion with the significant price fall threshold for any relevant underlying.

Technical discussions with ESMA have revealed that competent authorities are concerned that if the thresholds for financial instruments are breached too frequently, this will impose a significant burden on their resources in terms of considering whether to suspend short selling or not. Consultations with competent authorities indicate that they would likely have to take the following types of steps in order to apply this power when the threshold is breached: examine the data on the price movements of the instrument to confirm that the threshold has been breached; consideration of whether there are other fundamental factors which might have caused the decline, such as an announcement of a substantial fall in profits; and consideration of data which might indicate that short selling could have been a factor in the decline. These data might include recent trade data and transaction reports, or data which might reveal an increase in securities lending which could indicate a spike in short selling activity. Considering whether to suspend short selling would therefore require an investment of time by experts at the competent authority to analyse each situation before reaching a conclusion as to whether action was required.

2.6 Other issues to be specified in delegated acts

2.6.1 Definition of "ownership" (Article 2(1), implementing powers in Article 2, paragraph 2)

The Regulation empowers the Commission to specify in a delegated act the definitions, in particular the definition of 'ownership' for the purposes of defining a short sale. ESMA's technical advice is that only the definition of ownership needs to be specified. This is a key concept in securities law which may be addressed in the future Commission proposal for a Securities Law Regulation, so the question is how to specify how this definition should be applied in certain specific short selling cases without prejudice to a possible future harmonisation of Member State legislation. ESMA's advice is that it should be defined according to the civil or securities law applicable to the relevant sale, and has identified additional cases which should not in their view fall within the definition and which should be specified in the delegated act.[14] Further details are set out in annex 2.

Assessment of IA need

A delegated act cannot amend the essential elements of the Short Selling Regulation but can only specify certain elements in order to ensure a uniform application of this Regulation. In view of this legal principle of the Treaty and because of the wording of article 2(2) of the Short Selling Regulation, the Commission can only specify when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale in the Regulation. If these specifications are not made in the delegated act there is a risk of inconsistent application of the Regulation in the cases envisaged, or of application in a way

[14] ESMA's final report on technical advice for delegated acts, p.7.

which would be inconsistent with the objectives of the SSR. Since the specifications envisaged here are limited to ensuring the consistent application of the SSR they have no wider implications for the definition of ownership in other legislative instruments and are without prejudice to any possible harmonisation of the definition of ownership in any future legislative proposal of the Commission. Therefore since the scope of the specifications envisaged here is limited to ensuring the uniform application of the Short Selling Regulation and these specifications aim only to ensure consistency at the application level with the objectives of the Short Selling Regulation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment.

2.6.2 Cases in which a natural or legal person is considered to “hold” a share or debt instrument (Article 3, paragraph 2(a); implementing powers, Article 3, paragraph 7(a))

The Regulation empowers the Commission to specify cases in which a natural or legal person is considered to "hold" a share or debt instrument for the purposes of determining what shall be considered to be a long position relating to issued share capital or issued sovereign debt. ESMA's advice is that a different approach needs to be taken to specify cases which constitute holding for the purpose of short selling than that used for the Transparency Directive. For further details see annex 2.

Assessment of IA need

A delegated act cannot amend the essential elements of the Short Selling Regulation but can only specify certain elements in order to ensure a uniform application of this Regulation. In view of this legal principle of the Treaty and because of the wording of article 3(7)a of the Short Selling Regulation, the Commission can only specify cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of the Short Selling Regulation. If these specifications are not made in the delegated act there is a risk of inconsistent application of the Regulation in the cases envisaged, or of application in a way which would be inconsistent with the objectives of the SSR. Since the specifications envisaged here are limited to ensuring the consistent application of the SSR they have no wider implications for the definition of holding in other legislative instruments and are without prejudice to any possible harmonisation of the definition of holding in any future legislative proposal of the Commission. Therefore since the scope of the specifications envisaged here is limited to ensuring the uniform application of the Short Selling Regulation and these specifications aim only to ensure consistency at the application level with the objectives of the Short Selling Regulation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment.

2.6.3 Cases in which a natural or legal person has a net short position (Article 3, paragraphs 4 and 5; implementing powers, Article 3, paragraph 7(b))

The Regulation empowers the Commission to specify cases in which a natural or legal person has a net short position in shares and in sovereign debt. It also empowers the Commission to specify the method of calculation of such positions. To calculate net short positions in shares and sovereign debt, first the long positions have to be calculated from which short positions are deducted. ESMA therefore offers advice on what cases should constitute long and short positions for this purpose, as well as a non-exhaustive list of financial instruments which confer a financial advantage in the event of an increase in the price of the share or sovereign debt. For further details see annex 2.

Assessment of IA need

The main aspect of this delegated act concerns the definition of "high correlation". In principle, "high correlation" could be defined either by using a qualitative measure or a quantitative measure. ESMA's technical advice is that as the test is one of high correlation, it may be feasible to set a percentage threshold rather than simply relying on a purely qualitative definition. ESMA is aware that there is currently no definition of the term 'highly correlated' elsewhere in EU legislation which could be used as a benchmark in this Delegated Act and recognises that there currently may not be a commonly agreed standard for the level of statistical correlation required. However, ESMA considers that setting a quantitative threshold would provide a clear, objective and measurable standard against which regulators and market participants could judge whether the condition of highly correlated set in the Regulation is or is not met.[15] *It is also relevant that the comparison is one between financial instruments of the same class for which pricing data is generally available. On balance therefore ESMA technical advice is that the use of a quantitative definition and considers that a percentage of 70% would be appropriate for the purposes of calculating a net short position in sovereign debt.*

On the issue of high correlation for sovereign debt issues, there was also a general support for the ESMA draft technical advice in responses to the ESMA consultation. However a significant number of respondents were in favour of using a qualitative, rather than quantitative, method for the determination of high correlation.[16] *Concerning the level of the high correlation threshold in ESMA's draft technical advice issued for consultation, the common view was that 90% was too high.*[17] *The alternative thresholds suggested ranged from 50% to 82%. In relation to the timeframe for the historical measurement of correlation, most respondents were in favour of a shorter period than the 24-month period suggested by ESMA. In light of the responses, ESMA decided to reduce the timeframe and the percentage for high correlation. To keep a sufficiently long timeframe ESMA proposed a 12 month period in its final advice, but to capture the most recent trends this should be calculated in a weighted form giving more weight to the most recent data.*[18] *Further, ESMA proposed a 70% threshold which it considered sufficiently high to be considered as "highly correlated".*[19]

However, the Commission services consider that a 70% is not consistent with the level 1 Regulation requirement for "high" correlation and is too significant a departure from the ESMA draft advice; in this respect the Commission services therefore propose to retain a threshold of 80% for high correlation,[20] *with a buffer of 60%, as a preferred option.*

In view of the limited room for different options left by the need to ensure consistency with the requirement for 'high correlation' in the Regulation, the fact that ESMA's technical advice is broadly consistent with achieving the objectives of the Regulation, and the fact that the Commission services propose to follow ESMA's technical advice except on the final

[15] ESMA's final report on technical advice for delegated acts, p.15.

[16] See responses of banks and asset management companies to ESMA's public consultation, e.g. Response of IMA arguing that "setting a quantitative threshold is inappropriate"

[17] See responses of banks, asset management companies and insurances to ESMA's publication consultation, e.g Response of ABI stating that is "not convinced that the 90% is the correct number as [it] believes it too high"

[18] ESMA's final report on technical advice for delegated acts, p.16.

[19] Ibid, p.16.

[20] See responses of asset management companies to ESMA's public consultation, e.g. Response of Assogestioni considering that "a correlation coefficient of 80% would be appropriate".

correlation figure, it is not considered proportionate to subject this to further impact assessment.

2.6.4 Method of calculation of net short position (Article 3, paragraphs 4 and 5; implementing powers, Article 3, paragraph 7(b))

The Regulation empowers the Commission to specify the method of calculation of net short positions for shares and sovereign debt. ESMA's technical advice is to use the 'delta-adjusted' model for shares and for sovereign debt either a nominal model or a sensitivity adjusted method could be used. For more details see annex 2.

Assessment of IA need

ESMA technical advice recognises that there might be several appropriate methods of calculation of net short positions in relation to the issued sovereign debt of a sovereign issuer. However, the choice essentially comes down to whether to adopt a nominal model, as with shares, or a sensitivity adjusted method to take into account the fact that different issues of sovereign debt have different maturities.

The choice of the methods should be determined by whichever better meets the goal of the Regulation that notification of significant short positions shall provide important information to assist regulators in monitoring whether such positions are creating systemic risk or being used for abusive purposes. A further determining criterion is that the method selected should be straightforward and easy to apply for all market participants.

The advantages of using a sensitivity adjusted method are that it better reflects the fact that taking short positions in issues of different duration will have different market impacts – a short position in Treasury Bills will have less impact than an equivalent position in for example, 10 year bonds. Adjusting positions by "sensitivity" captures adequately the level of risk to changes in yields and the associate interest rate exposure in such circumstances. However, a sensitivity adjusted method is less useful than the nominal method in times of market stress and would inevitably entail more complexity in terms of calculation of positions.

Nominal model and general considerations

In contrast the nominal model offers great simplicity for calculation and might prove very useful when the market in debt instruments is mostly led by events other than interest rate risk (credit risk or distress situation). These are also the kind of situations when the knowledge of short positions becomes more important for regulators. ESMA's technical advice acknowledges that in normal market conditions the usefulness of the nominal information for supervisors is less relevant since it is difficult to grasp the kind of strategy that a market participant is carrying out without a measure of the impact on its position of a yield curve movement. ESMA is also aware that the nominal approach may have the disadvantage of not always accurately reflecting the nature of a position, in particular when it results from the aggregation of debt instruments of different maturities (e.g.: simultaneous sale of a 10 year maturity bond and purchase of a short term debt instrument).[21]

Both methods therefore have their advantages and disadvantages and neither is perfect. The ideal solution might be to be able to apply the method which best suits the prevailing market conditions but ESMA's technical advice considers that such an approach may be difficult to

[21] ESMA's final report on technical advice for delegated acts, p.22.

reconcile with setting one standard around which market participants can design their reporting systems. Taking into account that the purpose of Regulation is to assess the market impact that a net short position is able to produce as well as to obtain complete and accurate information about a person's position, ESMA considers that, on balance, concerning debt instruments, calculating and reporting net short positions in nominal terms better accomplishes both goals.[22] *In this respect positions taken in one part of the yield curve should not be given a greater weight than another.*

Since ESMA's technical advice best ensures consistency wth the objectives of the level 1 Regulation and the Commission services propose to follow the technical advice of ESMA in relation to the methodology, it is not considered proportionate to submit this to further impact assessment.

2.6.5 Method of calculation of long and short positions in shares and sovereign debt, and in uncovered CDS positions, for entities in a group and separate funds managed by the same fund manager (Article 3, paragraphs 3,4 and 5 and Article 4(1); implementing powers, Article 3, paragraph 7(c) and Article 4(2)b)

The Regulation empowers the Commission to adopt delegated acts specifying the method of calculating short and long positions when different entities in a group have long or short positions or for fund management activities relating to separate funds.

Although under the Regulation the notification or disclosure requirements fall on the legal entity in relation to net short positions in shares or sovereign debt, the Regulation empowers the Commission to adopt delegated acts specifying the method of calculating the positions in two specific instances:

a. when different entities in a group have long or short positions;
b. for fund management activities related to separate funds.
In light of the requirements of the Regulation, ESMA's technical advice considers that the objectives are to achieve maximum transparency and avoid non-compliance with notification and disclosure requirements by:

a. concealing an otherwise notifiable or discloseable net short position by using a group structure; and/or
b. diluting an otherwise notifiable or discloseable net short position by allocating such a position through different entities within an organization or to different funds all of which are managed by the person which took the position.

ESMA's final technical advice is that there should be a differentiated approach for different legal entities within a group company on the one hand, and for separate funds managed by one fund management company. For more details see annex 2.

Assessment of IA need
In view of the limited room for different options left by the Regulation, which requires the Commission to construct the reporting regime in such a way as to limit the possibilities for circumvention of reporting on net short positions; and in view of the efforts made by ESMA to simplify its initial technical advice in response to comments by stakeholders, the Commission

[22] Ibid, p.22.

services propose to follow ESMA's technical advice and therefore do not deem it proportionate to subject this to further impact assessment.

2.6.6 Method of calculation of an uncovered CDS position (Article 4, paragraph 1; implementing powers, Article 4, paragraph 2(a))

The Regulation empowers the Commission in a delegated act to specify the method of calculation of an uncovered position in a sovereign credit default swap. ESMA's advice is to use the net CDS position in the calculation; a differentiated approach should be taken for hedging static versus dynamic risks. For further details see annex 2.

Assessment of IA need
ESMA did not modify its technical advice in this area since most of the proposals were supported by respondents. In view of the limited room for different options left by the Regulation and the fact that the advice of ESMA is consistent with achieving the objectives of the Regulation, the Commission services propose to follow ESMA's technical advice and therefore do not consider it to be proportionate to subject this to further impact assessment.

2.6.7 Notification thresholds for short positions in the debt of the EFSF/ESM, EIB and each of the German Länder (Article 7, paragraphs 1 and 2; implementing powers, Article 7, paragraph 3)

The Regulation empowers the Commission in a delegated act to specify the relevant notification thresholds for short positions in sovereign debt in relation to each sovereign issuer. For the purposes of the Regulation, sovereign issuer includes the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM), the European Investment Bank (EIB) and the German Länder. ESMA shall publish on its website the notification thresholds.

ESMA's technical advice is that the notification threshold for the EFSF, ESM and EIB should be 0.1%, based on the size of their outstanding debt. All the German Länder would be included in the 0.1% notification threshold category in light of the size of their outstanding debt (see Annex 4 for data on the outstanding debt of each of the German Länder). For further details see annex 2.

Assessment of IA need
In view of the limited scope for options on this aspect of the delegated act, their expected limited impact given that short selling of the debt of these sovereign issuers is likely to be limited, and the consistency of ESMA's technical advice with the Regulation, the Commission services propose to follow ESMA's technical advice on this issue, and it is therefore not considered proportionate to submit this issue to further impact assessment.

2.6.8 Cases which could constitute an adverse event or development (Articles 18 to 21, 27 and 28, paragraph 2(a); implementing powers, Article 30)

The Regulation empowers the Commission in a delegated act to specify criteria and factors to be taken into account by the competent authorities and by ESMA in determining in which cases the adverse events or developments which can trigger action by the competent authorities or ESMA arise.

ESMA considered in its technical advice the possibility of proposing quantitative rather than qualitative criteria for competent authorities to take into account. However ESMA concluded that a very prescriptive and detailed list of quantitative events could lead to implementation problems regarding the restrictive measures.[23] Consequently, ESMA's technical advice only proposes a non-exhaustive list of qualitative events or acts that might involve a serious threat to the financial stability, market confidence, orderly functioning and integrity of the markets in the EU.[24]

Assessment of IA need

Many respondents to ESMA's consultation decided not to comment on whether they agreed with the qualitative criteria proposed by ESMA. Nevertheless, most of the respondents who provided remarks generally agreed with the need for the competent authorities to have reasonable discretion to address the threats referred to in the document.

Since the criteria suggested above are only indicative and non-exhaustive, and are intended only to be taken into account by competent authorities; and since they have been mostly supported by stakeholders in the consultation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment.

2.7 How would the problem evolve without EU action? The Baseline Scenario

The Short Selling Regulation Impact Assessment considered how the problems linked to short selling and CDS would evolve without EU action and concluded that the problems were likely to remain without a coordinated response and to occur again in the future. The Regulation will enter into application on 1 November 2012 but a number of non-essential elements of the Regulation are required to be specified in delegated acts by the Commission. The baseline question is how the problems would evolve should the Commission not adopt those delegated Acts. As the ensuing sections will show, this impact assessment has concluded that failure to specify certain provisions of the Regulation would result in legal uncertainty for regulators and market participants, an inconsistent approach to the interpretations and application of the Regulation, ineffective supervision, continued regulatory fragmentation and the possible continuation of certain risks associated with short selling which the Regulation seeks to address, such as negative price spirals. This baseline scenario means that without the adoption of a delegated act, in effect the Short Selling Regulation would not be fully applicable. This would be in clear conflict with the intentions of the co-legislators. Nevertheless, the baseline scenario will be used as counterfactual to clarify the impact of the options at level 2 and facilitate the selection of the best option through their comparison with the baseline.

2.8 Subsidiarity and proportionality

According to the principle of subsidiarity (Article 5.3 of the TFEU), action on EU level should be taken only when the aims envisaged cannot be achieved sufficiently by Member States alone and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the EU. Although the problems of lack of transparency, the risk of negative price spirals and settlement failure which can be associated with short selling all have important implications for each individual Member State, their overall impact can only be fully perceived in a cross-border context. This is because short selling a financial instrument

[23] ESMA's final report on technical advice for delegated acts, p.67.
[24] Ibid, p.67.

can be carried out wherever that instrument is listed, or over the counter, so even in markets other than the primary market of the issuer concerned. Further, the sovereign CDS market is by its very nature a highly cross-border, even international, market. Therefore there is a real risk of national responses to short selling and sovereign CDS being circumvented or ineffective in the absence of EU level action.

Further, certain aspects of this issue are already partly covered by the *acquis*, notably: the Market Abuse Directive[25] which prohibits short selling which is used to manipulate the market or in conjunction with insider information; the Transparency Directive[26], which requires the disclosure of significant long positions; and the Markets in Financial Instruments Directive[27]. Therefore a legal instrument on short selling and these existing legal instruments should complement each other, and this can best be achieved in a common effort. Against this background EU action appears appropriate in terms of the principle of subsidiarity.

Also, the Commission's obligation to act has been discussed by the co-legislators when adopting the Short Selling Regulation and they concluded that the Commission should be empowered to adopt delegated acts on the issues highlighted above in order to ensure a harmonised approach across Europe to the application of the Regulation.

3. OBJECTIVES

In light of the issues set out in the problem definition and in line with the high level objectives of the Regulation (see annex 6), the general objective of the short selling delegated act is to ensure that the application of the Short Selling Regulation by market participants and competent authorities is consistent across the EU and consistent with the objectives and requirements of the Short Selling Regulation.

The specific objectives for the short selling delegated act are as follows:

1. Ensure regulators apply the restrictions on uncovered short sales of sovereign debt and the ban on uncovered sovereign CDS positions in a clear and consistent way;
2. Ensure that regulators have clear and consistent powers to temporarily restrict short selling in the event of a significant price fall in financial instruments other than liquid shares;
3. Ensure that regulators and markets obtain useable data on short positions in sovereign debt; and
4. Ensure a coordinated regulatory response by EU Member States to short selling and sovereign CDS.

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[25] The following articles of Directive 2003/6/EC are relevant: Articles 1(2) defining market manipulation, article 2 prohibiting insider dealing and article 5 prohibiting market manipulation.

[26] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L390/38, 31.12.2004

[27] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ L 145, 30.4.2004. MiFID which imposes a general obligation on investment firms to act honestly, fairly, and professionally and in a manner which promotes the integrity of the market, to report transactions and keep records, obligations on platforms to monitor compliance with their trading rules, and monitoring of trading activity by competent authorities

As outlined in the level 1 impact assessment these objectives are consistent with the EU's fundamental goals of promoting a harmonious and sustainable development of economic activities, a high degree of competitiveness, and a high level of consumer protection, which includes safety and economic interests of citizens (Article 169 TFEU).

4. POLICY OPTIONS

The policy options are set out below with more detailed explanation of the content of the options provided where needed.

Policy options on the specification of uncovered positions in a CDS

- No action option

This option is discarded as it would be in clear conflict with the intentions of the co-legislator.

- Option 1 – specify in a qualitative way cases in which a CDS is deemed to be covered.

Under this option, the correlation between the sovereign CDS and related assets or liabilities would be measured by a general qualitative statement describing the degree of correlation, and cross-country hedging through sovereign CDS would not be permitted (except in strictly limited cases), in line with Article 4 and Recital 21 of the Regulation. The conditions for a sovereign CDS to be deemed covered would include a requirement for broad proportionality between the value of the exposure being hedged and of the sovereign CDS, and for any reduction in the exposure being hedged at the initiative of the position holder to be matched by a corresponding reduction in the sovereign CDS position. However, a change in the value of the exposure driven solely by the fluctuation of the market would not require a corresponding change in the sovereign CDS position. To illustrate the cases which are deemed to be covered the qualitative criteria would be supplemented by a non-exhaustive list of assets or liabilities which could be hedged through a sovereign CDS position, provided that the necessary conditions are met. For enforcement, since the correlation test is qualitative, CDS position holders would have to be able to demonstrate to the competent authority that at the time the CDS position was entered into, they held qualifying assets or liabilities which were being hedged by the sovereign CDS position in a way which met the requirement for correlation. If the competent authority was not convinced that this was the case, the holder would be in breach of the regulation and could be sanctioned for holding an uncovered sovereign CDS position.

- Option 2 – specify in a quantitative way cases in which a CDS is deemed to be covered.

Under this option the correlation between the sovereign CDS and related assets or liabilities would be measured by a quantitative test, such as "a correlation of 70%". A sovereign CDS would be deemed to be covered if the value of assets or liabilities being hedged was at least 70% correlated to the value of the sovereign debt of the CDS. The correlation would be measured on a historical basis using data for the 12 months of trading days before the CDS position is taken out, and cross-country hedging through sovereign CDS would not be permitted (except in strictly limited cases), in line with

Article 4 and Recital 21 of the Regulation. To illustrate the cases which are deemed to be covered the quantitative test would be supplemented by a non-exhaustive list of assets or liabilities which could be hedged through a sovereign CDS position, provided that the necessary conditions are met. For enforcement, CDS position holders would only be able to acquire sovereign CDS to the extent that they were hedging assets or liabilities which complied with the correlation test or they would be in breach of the regulation and could be sanctioned for holding an uncovered sovereign CDS position.

- Option 3 – specify cases in which a CDS is deemed to be covered by combining a qualitative and a quantitative approach.

Under this option, a position holder could demonstrate that their sovereign CDS position was covered either by using a qualitative approach, or by using a quantitative approach. Correlation would be demonstrated qualitatively as per option 1, by meeting the threshold of the general qualitative statement describing the degree of correlation. Alternatively the investor could demonstrate correlation quantitatively as per option 2 if the value of assets or liabilities being hedged was at least 70% correlated to the value of the sovereign debt of the CDS. In both cases the correlation would be measured on a historical basis using data for the 12 months of trading days before the CDS position is taken out. Where insufficient data was available a good proxy should be used. The conditions for a sovereign CDS to be deemed covered would include a requirement for broad proportionality between the value of the exposure being hedged and of the sovereign CDS, and for any reduction in the exposure being hedged at the initiative of the position holder to be matched by a corresponding reduction in the sovereign CDS position. However, a change in the value of the exposure driven solely by the fluctuation of the market would not require a corresponding change in the sovereign CDS position. Under this option cross-country hedging through sovereign CDS would not be permitted (except in strictly limited cases), in line with Article 4 and Recital 21 of the Regulation.

Policy options on specification of notification thresholds for net short positions in sovereign debt

- No action option

This option is discarded as it would be in clear conflict with the intentions of the co-legislator.

- Option 1 – specify one common percentage threshold for all Member States, possibly with the addition of a *de minimis* nominal threshold

Under this option, a common percentage notification threshold for all 27 EU Member States would be set in a delegated act for the notification of significant short positions in sovereign debt. This common percentage threshold would be applied by each Member State to its outstanding issued sovereign debt in order to produce a monetary amount, which would constitute the actual reporting threshold. This monetary amount would be updated quarterly to reflect changes in the total amount of outstanding sovereign debt of each sovereign issuer. Natural or legal persons holding short positions in sovereign debt which reached or exceeded this threshold would have to notify these to the relevant competent authority. Additional reporting thresholds would be set at increments of half the initial threshold. A de minimis threshold could be added below which short positions

would not need to be notified even if the monetary threshold was reached, in order to reduce the number of notifications of minimal value.

- Option 2 – specify multiple percentage thresholds (between 2 and 27) to tailor thresholds to each sovereign debt market.

Under this option, multiple percentage thresholds would be specified for notifications of sovereign debt, which could be only 2 thresholds or as many as 27. These percentage thresholds would be set by the Commission taking into account the criteria in article 7(3) of the Regulation so that the percentage threshold would be more tailored to the situation of each Member State. If fewer than 27 thresholds are determined by the Commission, Member States with similar sovereign debt profiles could be grouped into categories with the appropriate percentage threshold set for each category based on the criteria, and then the notification thresholds for each Member State would be published by ESMA. As with option 1, the relevant percentage threshold would be applied for each Member State to its outstanding issued sovereign debt in order to produce a monetary amount, which would constitute the actual reporting threshold. This monetary amount would be updated quarterly to reflect changes in the total amount of outstanding sovereign debt of each sovereign issuer. Natural or legal persons holding short positions in sovereign debt which reached or exceeded this threshold would have to notify these to the relevant competent authority. Additional reporting thresholds would be set at increments of half the initial threshold.

Policy options on specification of method to calculate liquidity threshold for suspending restrictions on uncovered short sales of sovereign debt

- No action option

This option is discarded as it would be in clear conflict with the intentions of the co-legislator.

- Option 1 – a threshold of a fall in monthly liquidity below the 5th percentile over a 12 month period

Under this option, the threshold would be set by reference to the 5th percentile over a twelve month period. This measure consists of sorting the monthly observations of liquidity in ascending order. The rank of the observation that corresponds to the 5th percentile is then calculated and rounded to the nearest integer. Finally the value that corresponds to the observation rank is rounded. If the liquidity of the last month is less than the value of the liquidity of the month with the lowest value of liquidity in the period then there is a significant decline in liquidity. In other words, with a series that goes back 12 months, the 5th percentile will be the liquidity in the lowest month in that series. A twelve month period enables seasonal variations to be taken into account.

- Option 2 – a threshold of 1.6 standard deviations below the average over a 6 month period.

This option consists of calculating the average of 6 monthly observations of liquidity. 1.6 standard deviations is calculated and subtracted from the average. If at the end the value

of the liquidity of the reference month is less than this, there is a significant decline in liquidity. Standard deviation is an alternative way of measuring volatility and is slightly more accurate than the percentile measure since it does not require any rounding. A standard deviation of 1.64 threshold is statistically equivalent to about the 10th percentile.

Policy options on specification of significant price fall for financial instruments other than liquid shares

- No action option

This option is discarded as it would be in clear conflict with the intentions of the co-legislator.

- Option 1 – specify a threshold for financial instruments other than liquid shares: Under this option, a different measure of price and a different nominal threshold would be set for different types of financial instruments (see sub-options below). When the price of a financial instrument on a trading venue has significantly fallen in terms of that measure during a single trading day, the competent authority would consider whether or not to suspend short selling in that financial instrument temporarily. Thresholds need to be set at such a level that they allow competent authorities to intervene in times of market stress. At the same time, they should be set at a sufficiently high level so as not to trigger an unnecessary review. If the threshold is breached too frequently, it will impose a significant burden on the resources of competent authorities to consider whether to suspend short selling or not.

- illiquid/semi-liquid shares sub-option: a 10% threshold for semi-liquid shares (those listed on the main equity index of a Member State and which are the underlying for a listed derivative); a 20% threshold for illiquid shares (those whose share price is above € 0.50 cents); and a 40% threshold for very illiquid shares (with a nominal value below € 0.50 cents).

- sovereign bonds sub-option: an increase of 7% or more in the yield across the yield curve for the relevant sovereign issuer.

- corporate bonds sub-option: an increase of 10% or more in the yield of the bond during a single trading day.

- money market instruments sub-option: 1.5% decrease in the price.

- UCITS sub-option: no threshold to be set, except where UCITS are exchange traded funds (ETFs).

- exchange traded funds sub-option: a 10% decline in the price.

- derivative instruments sub-option: where the underlying is a financial instrument, the threshold would be breached when the threshold for the underlying financial instrument has been breached. For derivatives whose underlying has no threshold (e.g. commodity derivatives), no threshold is to be set at this time, subject to a review by end June 2013.

5. ANALYSIS OF IMPACTS AND COMPARISON OF OPTIONS

5.1 Issue 1 - Policy options on the specification of uncovered positions in a sovereign CDS

No action: No action is not a viable alternative given the legal obligation for the Commission to adopt delegated acts. As outlined in the baseline scenario, should the Commission not adopt a delegated act specifying the cases which constitute covered sovereign CDS, there would be considerable legal uncertainty for market participants and competent authorities about how to apply in practice the Regulation's prohibition on uncovered sovereign CDS. The absence of a delegated act on this aspect could also lead to different interpretations of the Regulation across the EU and therefore inconsistent application and enforcement.

Option 1 (specify in a qualitative way cases in which a sovereign CDS is deemed to be covered):

The main benefit of a qualitative approach is that it is more flexible than a quantitative approach. Hedging involves protecting a position against risk – which can be quantitatively measured – and (Knightian) uncertainty – which cannot be quantitatively measured[28]. Hedging risk can be evaluated by using past historical and current data to estimate the future probabilities and losses that need to be hedged.

Hedging uncertainty involves making a judgement – for example about as to how likely a future risk is to materialise for which past historical quantitative data may not be useful. For example, if a person is seeking to hedge a contract with state-owned company X in country A - if country A has never/not recently defaulted, the probability of default of country A, the increased likelihood of recession and fiscal pressure which would impact on the value of state-owned company X are all matters on which there is no past historical quantitative evidence. Estimating any probability or hedging therefore involves constructing models and making assumptions, which will be governed by qualitative criteria.

In practice, most hedging is likely to involve an element of both risk and uncertainty. When estimating risk in most economic situations quantitative evidence is not a perfect guide to future probabilities and judgements will need to be exercised to compensate for this. Alternatively, all the data necessary to estimate the future probability may not be available, in which case qualitative judgements may need to be made to fill in the gaps.

Similarly, few events have no precedent and so quantitative evidence can be used to supplement qualitative estimates of uncertainty. So in the example above, quantitative evidence for similar companies in countries that have defaulted could be used as a guide for the probability of country X defaulting and causing Company A to breach its contractual obligations.

Another advantage of a qualitative approach is that it leaves a margin of discretion for a competent authority to exercise their judgement in a specific case as to whether a hedge is reasonable or not. In contrast a quantitative approach would imply the more mechanistic

[28] We use the terms risk and uncertainty as per Frank Knight Risk, Uncertainty and Profit (1921).

application of a ratio which, depending on the outcome of the calculation, would mean that the hedge could be accepted or not by the competent authority. Since hedging involves making judgements which are rarely black and white, the binary yes/no outcome of a quantitative correlation test might produce unfair outcomes in cases where judgements of risks are finely balanced.

The main disadvantage of a purely qualitative approach is that it is less precise and objective than a quantitative test and therefore implies less legal certainty for market participants about whether a sovereign CDS position is appropriately covered by correlated assets or liabilities. Another disadvantage is that the degree of discretion in the decisions of competent authorities implied by a purely qualitative approach could result in inconsistent application of the Regulation by competent authorities.

<u>Option 2 (specify in a quantitative way cases in which a sovereign CDS is deemed to be covered):</u>

This option requires that a quantitative measure of correlation is specified for the degree of correlation between hedged assets or liabilities and the relevant sovereign debt. Correlation measures the extent to which volatility in one variable is aligned with another. In vector terms, if volatility between two variables is parallel, there is perfect correlation. If it is orthogonal, there is no correlation. It is therefore at the point where the alignment is less than 45 degrees that the aligned volatility exceeds the unaligned volatility and therefore that the relationship can be considered more correlated than uncorrelated. The cosine of 45 degrees is 70% and hence a threshold of 70% is chosen in determining whether a relationship is correlated for the purposes of the quantitative test.

The main benefit of a quantitative correlation test is that it is precise and offers legal certainty – it offers a 'safe harbour' to market participants who know clearly in advance what is the level of correlation that assets or liabilities need to meet in order to be sure to be deemed covered by a sovereign CDS in conformity with the Regulation. Since the test is objective and can be applied *ex ante* by market participants it should also imply a reduced compliance burden for market participants and a reduced enforcement burden for competent authorities, who will be able to judge more easily against a numerical benchmark whether the requirement for correlation is met.

However, a quantitative approach has the disadvantage that there are cases where a quantitative historical correlation is not a guide to the future because of uncertainty. For example, any past data which is available may show no relationship even if it may be logical to assume that a correlation will exist in the future. The Regulation defines broadly through examples the cases which can be considered to be legitimate hedging, for some of which it would be difficult to demonstrate a quantitative correlation. If a purely quantitative correlation was needed, the risk is that the scope of what is considered legitimate hedging in the Regulation could be narrowed by the delegated act. A further difficulty with the quantitative approach is to define the precise threshold, given that the Regulation only uses the term "correlation" and does not give clear guidance as to how this correlation should be measured.

The main disadvantage of the quantitative approach is that, according to market participants, it could capriciously restrict the use of sovereign CDS as a hedging instrument (see 'impact on stakeholders' below).

Option 3 (specify cases in which a CDS is deemed to be covered by combining a qualitative and a quantitative approach)

This combined option has the advantage of combining the flexibility provided by the qualitative approach for hedging uncertain future risks or in cases where historical data is lacking, with the legal certainty and clarity for competent authorities and position holders provided by a quantitative threshold. The addition of the option to use the quantitative approach as an alternative to the qualitative approach for position holders would give them the possibility to benefit from a safe harbour where they are able to demonstrate correlation quantitatively. This option would also ensure greater consistency between the approaches to enforcement taken by competent authorities by including certain objective elements. This option would not suffer from the macroeconomic costs of option 2 as it would still enable market participants to demonstrate qualitatively that a legitimate hedge existed at the time of entering into the naked sovereign CDS.

It should be noted that option 3 is in line with the only precedent which exists in the European Union today for a ban on entering into uncovered sovereign CDS, which is the German ban. The requirement used in Germany to measure correlation in the case of a covered sovereign CDS is a qualitative one, namely that there has to be "a more than insignificant reduction of the credit risk" in the reference asset or liability. However, a quantitative approach can be used by the position holder to demonstrate correlation, although no threshold is set by the German law and it is for the position holder to perform his own "plausible and verifiable assessment".

Impact on stakeholders

According to stakeholders represented at a meeting convened by ESMA in Paris on 7 December 2011, the uncertainties of hedging make the use of a pure quantitative correlation test inappropriate. Market participants argued that hedging is used for both business risk and economic environment risk, and for hedging uncertainty. In their view, it is difficult to rely on the existence of a quantitative relationship between the sovereign and related assets and liabilities when so many of the variables can change over time and when the future probabilities cannot be estimated. Market participants at the hearing considered that whether a hedge is efficient and correlated or not should be the responsibility of the hedger, for which he should be accountable to the competent authority. If the hedger was not able to justify to the authority that an appropriate degree of correlation existed between their sovereign CDS position and related assets or liabilities, then they would be in breach of the Regulation and could be sanctioned accordingly.

The broad majority of respondents to the consultation by ESMA on their draft technical advice to the Commission, notably representing asset managers, banks and hedge funds, took the view that a qualitative approach should be taken to measuring correlation, and rejected a quantitative approach. These respondents took the view that the delegated act should be broad in nature, rather than prescriptive, and flexible enough to permit the use of sovereign CDS for the purpose of responsible and prudent risk management[29]. They further argued that in the qualitative approach there should be no restriction on cross-country proxy hedging, no requirement for the correlation to be 'consistent' and 'significant' and no condition that a

[29] Response by AFME, ICMA, ISLA and ISDA to the ESMA consultation, 10 March 2012, p. 18.

historic correlation exists[30]. These respondents consider that without these changes, measuring correlation in the way suggested by ESMA's draft technical advice in its consultation paper would risk discouraging investors from investing in European corporates and government debt if they are prevented from hedging their risk appropriately, and would risk increasing systemic risks if investors are forced into inappropriate hedges or do not hedge at all.[31] The respondents argued that the requirement should instead be for the correlation to be forward looking and based on a 'reasonable expectation of future correlation'[32].

However, a minority of respondents agreed with the draft ESMA advice in its consultation paper. The German Issuers Association and Siemens generally agreed with the proposed approach[33]. Also the BME Spanish Exchanges Group agreed with ESMA's proposed approach[34].

In their feedback to the responses of stakeholders, ESMA said in its final technical advice that it continued to advise a qualitative test but amended the wording of the test. ESMA argued that leaving the term ‘correlated’ completely undefined would leave market participants and competent authorities without any common frame of reference and that indicating at least some factors for what is expected would be helpful. ESMA also recognised that hedging risks entails looking to the future and that historic data may not always be relevant or available, so it modified its final advice to take account of other ways in which correlation could be demonstrated. ESMA also accepted that where historic data was used there should be flexibility in the timeframe chosen, provided there was good reason for not selecting the most recent 12 months.[35] While it was for the party entering into the CDS position to be able to justify to the competent authority that the correlation test had been met, ESMA considered that a general ‘in good faith’ test for correlation would be too broad and subjective.

Comparison of the options

Options 1, 2 and 3 are all preferable to no action as they fulfil the legal obligation of the Commission to adopt a delegated act. All three options would introduce greater legal certainty for market participants and competent authorities about how to apply the restriction on entering into uncovered sovereign CDS than no action.

However, option 1 only partially meets the Regulation's objective of granting a clear power for regulators to restrict naked sovereign CDS. Option 1 leaves uncertainty for the competent authority in determining whether the qualitative criteria which a sovereign CDS position must meet to be deemed correlated and therefore covered, are met. A qualitative approach leaves scope for disputes between a competent authority and a position holder as to whether the criteria are fulfilled or not. Option 2 offers a clearer power to competent authorities and therefore fulfils this Regulation's objective better by setting a clear quantitative threshold for correlation which must be met by a sovereign CDS position to be deemed covered. Competent authorities would be able to take enforcement action where a position holder's sovereign CDS did not meet the quantitative correlation test.

[30] Ibid, p. 19.
[31] Ibid, p.19.
[32] Ibid p. 24.
[33] Response by Deutsches Aktieninstitut to the ESMA consultation, 9 March 2012, p. 3. Response by Siemens, 9 March 2012, p. 1
[34] Response by BME Spanish Exchanges to the ESMA consultation, 9 March 2012, p. 4.
[35] ESMA's final report on technical advice for delegated acts, p.40.

Option 1 would only partially meet the objective of ensuring a coordinated response by competent authorities to the ban on naked sovereign CDS. The qualitative criteria of option 1 imply a degree of discretion for competent authorities which could result in different interpretations across the EU and therefore a less consistent approach to applying the ban on naked sovereign CDS. Option 2 on the other hand would provide for a clear and consistent approach to applying the ban by applying the same threshold for correlation across the EU, and therefore option 2 would meet this Regulation's objective more fully.

In terms of enforcement costs for competent authorities and indirect economic costs for market participants, option 1 could be considered somewhat less efficient than option 2 for competent authorities. They would have a greater *ex post* enforcement burden with option 1: in cases of doubt they would have to examine the justifications of sovereign CDS position holders for their hedges, which could be time-consuming especially for complex cases where the correlation is not easily demonstrated. In contrast it could be expected that it would be more straightforward for competent authorities to enforce a quantitative correlation coefficient.

However, in order to respect the conditions set by the Regulation, which provides for a broad range of assets or liabilities to be eligible for hedging, and to deal with cases where a quantitative approach would be impossible to apply due to the lack of data, any quantitative approach in practice would need to include a qualitative approach. The alternative would be to exclude from hedging assets or liabilities which are in principle within the scope, at the risk of leading to the above-mentioned indirect economic costs. Since in practice an element of judgement by competent authorities about what constitutes a legitimate hedge will always be involved, the benefit in terms of reduced enforcement costs of a quantitative approach is likely to be reduced.

In terms of macroeconomic costs, responses from stakeholders to the ESMA consultation suggest that a purely quantitative approach would impose economic costs in terms of reduced investment caused by uncertainty about the possibility to hedge.[36] These macroeconomic costs would not be imposed by option 1 or by option 3. Therefore option 2 appears less economically efficient than options 1 and 3.

The above analysis shows that neither option 1 nor 2 is optimal in terms of effectiveness and efficiency in meeting the objectives of the Regulation. While option 2 is more effective than option 1 in terms of ensuring a clear power for competent authorities and ensuring a consistent approach, it is more inefficient than option 1 in terms of the indirect economic costs due to reduced investment caused by a reduced possibility to hedge risk.

Since option 1 appears to be the most economically efficient option, while option 2 seems to be the most effective option, this suggests that the combination of both options as proposed in option 3 would lead to a more optimal outcome than either option 1 or option 2 alone. Option 3 would be more effective than option 1 in ensuring a consistent approach by competent authorities to enforcement. Option 3 would also be more efficient than option 1 as it would reduce the burden for competent authorities to verify compliance when a quantitative approach to demonstrating correlation was used.

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In light of the above, the preferred option is option 3, as it introduces elements of objectivity and consistency into the qualitative approach which would help to ensure consistent application and legal certainty; at the same time it would not impose the indirect economic costs of a purely quantitative approach.

Option 3 partially takes into account the technical advice of ESMA, which recommends a purely qualitative approach, with the possibility for correlation to be demonstrated in several ways, including by certain objective means such as by providing that assets or liabilities which meet the "high correlation" test for the sovereign debt (i.e. debt of Special Purpose Vehicles or of agencies guaranteed by the sovereign issuer) would automatically qualify. ESMA's technical advice that there should be a requirement for broad proportionality between exposures and the sovereign CDS, and for this to be maintained over time, is also reflected in option 3. However in allowing for correlation to be demonstrated quantitatively as well, option 3 goes beyond the purely qualitative approach recommended by ESMA. The Commission services consider that the benefits of greater legal certainty for position holders and greater consistency in enforcement brought by adding a quantitative approach justify departing from ESMA's advice in this respect.

In the summary tables below, options are weighed against two fundamental criteria: their effectiveness in achieving the Regulation's objectives and their efficiency in terms of achieving these objectives for a given level of resources and costs. The results of the comparison are rated according to the following scale: "+" slightly positive, "++" positive, "-" negative, "--" very negative, "≈" neutral. The benchmark is the implementation of the Regulation without the implementing measure in question.

- ***Table 1: specification of uncovered positions in a sovereign CDS - comparison of options***

	Effectiveness		Efficiency
	Clear powers for regulators	Ensure a coordinated response	Achieves objectives for given level of costs
No action	0	0	0
Option 1: qualitative approach	+	+	+
Option 2: quantitative approach	++	++	- -
Option 3: combination of qualitative and quantitative thresholds for correlation	++	++	++

5.2 Issue 2 - Policy options on specification of notification thresholds for net short positions in sovereign debt

<u>No action:</u> No action is not a viable option given the legal obligation for the Commission to adopt harmonising delegated acts. As outlined in the baseline scenario, should a delegated act not be adopted specifying the thresholds for notification of short positions in sovereign debt, it would be impossible for this very important requirement of the Regulation to be applied since no such thresholds are set in the Regulation. This would pose the risk either of competent authorities not receiving notifications of short positions in sovereign debt and

thereby missing data with potential systemic significance, or of interpreting the requirements of the Regulation in widely differing ways to the detriment of consistency in the internal market and to the cost of market participants.

Option 1 – specify one common percentage threshold for all Member States, possibly with the addition of a *de minimis* nominal threshold

The main advantage of setting a common percentage threshold for sovereign debt notifications was initially thought, in an ESMA consultation paper, to be that it would be more straightforward for market participants to apply the same percentage threshold for all sovereign debt markets, as is the case for shares. This could be expected to impose a lower compliance burden for natural or legal persons taking short positions in sovereign debt across the EU than applying multiple different percentage thresholds depending on the sovereign issuer. However several respondents to the ESMA public consultation argued that there is no reduced compliance burden from having a single percentage threshold since this is converted into a monetary amount for each Member State based on their total outstanding debt, and therefore each threshold will in practice be different[37]. The addition of a *de minimis* threshold would have the advantage of reducing the number of low value notifications of little value to competent authorities which could arise for certain large markets if the single percentage threshold was set at a level more appropriate for smaller markets.

On the other hand the main disadvantage of a common percentage threshold is that it applies a 'one size fits all' approach which could result in either excessive notifications of little value for large sovereign debt markets, or few or no notifications for small markets. As ESMA has argued, this would not be in line with the intention of the Regulation to enable authorities to identify and monitor those short positions likely to have some impact on the sovereign debt of each issuer and which might contribute to creating systemic risks or potential market abuse.[38] A common percentage threshold would also seem to be difficult to reconcile with the criteria set out in article 7(3) of the Regulation which state that the Commission must ensure that the thresholds do not require notifications of little value and take into account the average size of short positions, as well as the liquidity and size of each sovereign debt market. These criteria could be taken to imply an approach to the determination of notification thresholds which is more tailored to the situation of each Member State than can be achieved with a common threshold.

Option 2 – specify multiple percentage thresholds (between 2 and 27) to tailor thresholds to each sovereign debt market.

This option has the advantage that the notification thresholds would be more closely tailored to the specific characteristics of each sovereign debt market as the thresholds would take greater account of the size of the outstanding debt and the liquidity of the market. The notifications would therefore provide neither too much information for competent authorities nor too little, thereby maximising the value of the information for monitoring the development of possible systemic risks. This option also has the advantage of being fully in line with the requirements set in the Regulation for the Commission to take account of these criteria.

[37] See response by Hedge Fund Standards Board to ESMA consultation, p. 8. Also response by AIMA, p. 18.
[38] ESMA's final report on technical advice for delegated acts, p.48.

The main disadvantage of this option was initially considered by ESMA in its consultation paper on draft technical advice to be that having multiple thresholds would mean more complexity for market participants taking short positions in the sovereign debt of several issuers to comply with, which was felt to be likely to have implications for the administrative burden.[39] However, as stated above several respondents to ESMA's public consultation have argued that in practice having multiple percentage thresholds would not greatly increase complexity and the compliance burden as in any case the threshold would have to be converted into a monetary amount.[40]

Impact on stakeholders

Most stakeholders who responded to the consultation by ESMA on draft technical advice to the Commission did not comment on the advice relating to notification thresholds for sovereign debt. Of the minority who did comment, most broadly agreed with ESMA's technical advice that multiple thresholds should be set with Member States grouped into three categories. These respondents felt that having more than one percentage threshold would better reflect the heterogeneity of issuers whereas 27 different percentage thresholds would make the structure complex and could make control and supervision more difficult[41]. However, while broadly supporting the approach one respondent representing the hedge funds industry proposed instead of categorisation an alternative calculation methodology to take greater account of liquidity[42]. The response by the one association agreed with the approach but felt that the lowest threshold proposed in ESMA's technical advice should be increased from 0.1% to 0.2%[43]. Despite being asked by ESMA, no respondents were able to provide data on the estimated number of notifications of short positions in sovereign debt or the compliance costs associated with these notifications. Ongoing compliance costs for notifications of short positions in sovereign bonds were estimated to be in the order of €5 million a year in the level 1 impact assessment[44].

ESMA stated in its feedback to the consultation responses that complete data information on all the criteria to be taken into account when setting the thresholds, as stipulated in the Regulation, was not available.[45] There is, for instance, no available information on the average size of positions held by market participants relating to the sovereign debt of sovereign issuers. Data on liquidity in terms of turnover is not complete either as much of the trade in sovereign bonds takes place OTC. Considering the general support expressed by the respondents for ESMA's draft technical advice on this issue, ESMA did not modify its final technical advice concerning the setting of notification thresholds based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer, or the number of threshold categories. ESMA recalled that the Regulation provides for a review in 2013 which would provide an opportunity to review the appropriateness of the reporting thresholds for sovereign debt.[46]

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[39] ESMA's consultation paper on technical advice for delegated acts, p.44.

[40] See responses of banks and asset management companies to ESMA's public consultation, e.g. Response of EFAMA suggesting to "set a corresponding monetary amount"

[41] See responses by Spanish Stock Exchange Group, HFSB and BAI.

[42] See response by AIMA, p. 18.

[43] See response by Swedish Securities Dealers association, p. 4.

[44] Impact assessment on the proposal for a Regulation on short selling and certain aspects of Credit Default Swaps, p. 72.

[45] ESMA's final report on technical advice for delegated acts, p.49.

[46] Ibid, p.49.

Comparison of the options

Both options 1 and 2 are preferable to no action as they fulfil the legal obligation of the Commission to adopt a delegated act. Both options 1 and 2 would ensure competent authorities receive information on short positions in sovereign debt and would ensure a coordinated approach.

Option 2 would be more effective than option 1 in ensuring that competent authorities get the right amount of useable data on short positions, since under option 2 the thresholds would be more tailored to the specific situation of each Member State than under the single percentage threshold of option 1. Even allowing for the possible inclusion of a de minimis threshold under option 1, option 2 would also be more efficient than option 1 since competent authorities would receive fewer low value notifications under option 2 and they would therefore lose less time sifting through information of little systemic relevance. For market participants, it would appear from stakeholder responses that option 2 would in practice not impose a more significant compliance burden than option 1. Both options 1 and 2 would ensure a coordinated response by competent authorities as the thresholds would be fixed by the Commission and would be published for each Member State by ESMA on their web site.

In light of the above, the preferred option is option 2, limited to two categories of thresholds (0.1% and 0.5%), as it would achieve the optimal balance between reflecting the diversity of Member States sovereign debt positions and ensuring that competent authorities receive useable and valuable information. Option 2 would also appear to be more consistent with the criteria set out in article 7(3) of the Regulation specifying that the thresholds set in the delegated act must avoid notifications of positions of minimal value; take into account the amount of outstanding issued sovereign debt and the average size of market participants; and take into account the liquidity of each sovereign bond market. Option 2 is fully in line with the final technical advice of ESMA.

- ***Table 2: specification of notification thresholds for net short positions in sovereign debt***

	Effectiveness		Efficiency
	Ensure CAs get data on short positions	Ensure a coordinated response	Achieves objectives for given level of costs
No action	0	0	0
Option 1: common % threshold	+	+	≈
Option 2: multiple (two) % thresholds	++	+	+

5.3 Issue 3 – Policy options on specification of method to calculate liquidity threshold for suspending restrictions on uncovered short sales of sovereign debt

<u>No action</u>: Article 13 of the Regulation permits the restrictions on uncovered short sales of sovereign debt to be suspended temporarily by competent authorities for six months (renewable) when there is "*a significant decline relative to the average level of liquidity of the sovereign debt*". Sovereign debt funding difficulties, are typically accompanied by falls in

liquidity, this power is intended as a tool to help Member States restore liquidity in a stressed debt market. It is therefore primarily intended to meet the financial stability objective

However there is also a need to ensure a consistent approach across the EU. Competent authorities are not obliged to suspend the restrictions in the event of a fall, but will need to consider whether to suspend. If the threshold is often breached, in particular when there is no threat to financial stability, then this will create uncertainty in the market about whether restrictions will be lifted. On the other hand, given the significance of the financial stability objective, authorities should have the ability to act pre-emptively to head off any sovereign debt liquidity problem. Therefore the threshold needs to be set at a level that would allow them to suspend restrictions before a fall in liquidity damaged sovereign debt sustainability. The advantage of this option is that, given the importance of the financial stability objective, this judgement should be left to the competent authorities to determine.

However the disadvantage is that it would result in uncertainty for market participants and competent authorities about how and when to consider whether to suspend restrictions on short sales. The absence of a delegated act would also lead to different interpretations of "*significant*" and therefore inconsistent application and additional market uncertainty.

<u>Option 1: a threshold of a fall in monthly liquidity below the 5th percentile over a 12 month period.</u>

The first alternative is that a uniform threshold should be applied across member states (taking into account the differences in liquidity in their markets). This threshold should be applied by reference to the whole outstanding sovereign debt since in the face of a liquidity crisis, the competent authorities would in most circumstances want to suspend the prohibition for all outstanding sovereign debt as opposed to just for a few issues.

Liquidity in bond markets can be measured by a number of variables – for example bid-ask spreads, trade sizes, trade frequencies and trade volume[47]. Trade volume – the total nominal value of bonds traded - is preferred as it is simple to apply and is easy to obtain compared with other measures, notably those involving orders.

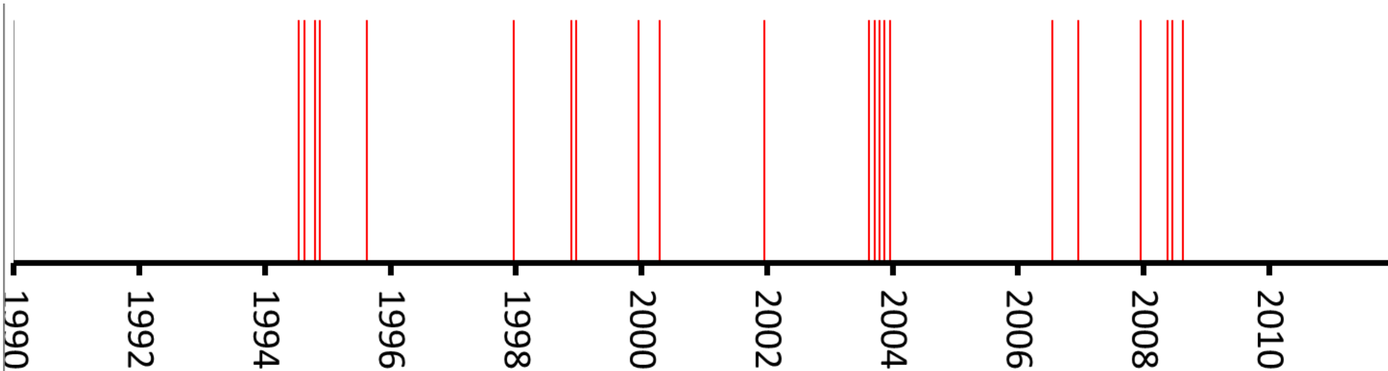
The threshold needs to be calibrated for *"significant decline relative to <u>the average level</u> of liquidity for the sovereign debt concerned."* A simple measure of the average could be used but this would not take into account differences between the volatilities of liquidity between different member states and over time. Instead a measure that takes into account difference in (past) volatility could be used. One such measure is the ranked percentile – in this option the 5th percentile of the monthly volume traded in the last x months. This measure consists of sorting the monthly observations of liquidity in ascending order. The rank of the observation that corresponds to the 5th percentile is then calculated and rounded to the nearest integer. Finally the value that corresponds to the observation rank is rounded. If the liquidity of the last month is less than the value of the liquidity of the month with the lowest value of liquidity in the period then there is a significant decline in liquidity. In other words, if we have a series that goes back 12 months, the 5th percentile will be the liquidity in the lowest month in that series. The advantage of this metric is that it is simple to calculate, produces a threshold that will not necessarily change every month and is not unduly influenced by outlier months.

[47] See e.g. "*Dynamic Sources of Sovereign Bond Market Liquidity*" Kucuk, Ugur N.

The reference period for making the comparison also needs to be determined. This may either be set as a short period which would mean that comparisons are made with more recent history but would have the disadvantage of meaning that the threshold its self would be relatively volatile. Alternatively a longer period could be used which would mean that the threshold would reflect longer term normal volatility. However liquidity is dependent on a variety of factors, such as the stock of outstanding debt, which may change considerably over a period of years. Option 1 uses a 12 month period as the frame of reference which has the advantage of balancing these factors and would ensure that the period over which the average is calculated is reasonably representative and would enable seasonal variations in liquidity (e.g. during the summer holidays or the Christmas/New Year period) to be taken into account.

Finally the level of the percentile needs to be chosen. Choosing the 5th percentile would in theory and assuming an independent and normal distribution of the data, mean that the threshold could be expected to be crossed once every 12 months.

Figure 1 - Frequency of 5% percentile threshold trigger for a representative country over a 20 year period.



Option 2: A threshold of 1.6 standard deviations below the average over a 6 month period.

The alternative option is a measure which consists of calculating the average of 6 monthly observations of liquidity. 1.6 standard deviations is calculated and subtracted from the average. If at the end the value of the liquidity of the reference month is less than this, there is a significant decline in liquidity. Standard deviation is an alternative way of measuring volatility and the advantage of this measure is that it is slightly more accurate than the percentile measure since it does not require any rounding. However a potential disadvantage is that a standard deviation of 1.64 threshold is statistically equivalent to about the 10th percentile and so this represents a lower threshold that would be breached more often.

The advantage of the shorter reference period is that it would result in an easier calculation and a calculation of a threshold that is more closely compared to the prevailing circumstances. However one disadvantage of using such a short period is the risk of basing the decision on a period which may not be properly representative of the usual level of trading in the sovereign debt. Another disadvantage of using the standard deviation is that execeptionally values in the reference period would continue to raise the standard deviation.

In a persistent liquidity crisis, this could make it less likely for the threshold to be be crossed. One possibility would be to exclude a certain number of ouliers before performing the calculation. However this type of adjustment is already partially achieved by using the percentile methodology in Option 2.

Impact on Stakeholders – Compliance and Administration Costs
The administration costs of these measures are small compared to the potential benefits in terms of avoiding sovereign debt market liquidity problems. Nonetheless the standard deviation threshold in option 2 would change every month whereas the percentile threshold of option 1 would only change intermittently making it easier to administer.

Most complianace and adminstarative costs are determined by the relative frequency of the threshold being triggered; the crossing of a threshold does not mean the authority is obliged to suspend restrictions but the authority may need to consider whether to do so. This is likely to impose costs since it will require high level decision making and most likely co-ordination with other governmental authorities, such as the Debt Management Office as well as fact finding in the market itself.

While potentially large, these administrative costs are not likely to be substantial compared to the potential benefits of the objectives of Article. However more importantly the discretion conferred on whether to impose restrictions whenever this threshold is crossed will impose costs on market participants since they will need to consider whether they have to change market strategies, respond to the likely price movements etc. This uncertainty will be increased if the threshold is crossed relatively frequently - in particular because market participants' will need to anticipate the different ways in which discretion is exercised by all the relevant member states. These costs will rise the more frequently the threshold is crossed, in particular if it is frequently crossed but restrictions are not always imposed. A threshold that is crossed relatively infrequently will ensure greater consistency in the exercise of discretion and so reduce uncertainty and the associated costs for member states.

This analysis of the impact on stakeholders appears to be consistent with the responses to the consulation: where a view was expressed, option 1 was unanimously endorsed in responses to the ESMA consultation.[48]

Comparison of the Options
The merits of the three options were compared in terms of effectiveness and efficiency; in terms of effectiveness the two main criteria were the effectiveness of the options in enabling authorities to mitigate any liquidity crisis and how effective the option is in ensuring a consistent approach across member states and market certainty. Efficiency is measured in terms of the costs to stakeholders – which is driven primarily by how often consideration needs to be given whether to suspend restrictions once the threshold is crossed.

Competent authorities are not obliged to suspend the restrictions in the event of a fall, but need to consider whether to suspend. If the threshold is often breached, in particular when there is no threat to financial stability, then this will create uncertainty in the market about whether restrictions will be lifted. On the other hand, given the significance of the financial stability objective, authorities should have the ability to act pre-emptively to head off any sovereign debt liquidity problem. Therefore the threshold needs to be set at a level that would allow them to suspend restrictions before a fall in liquidity damages sovereign debt

[48] See response of BME, p.7.

sustainability. Given that the article already confers discretion on authorities about whether to restrict short sales, not specifying what this significant threshold is would render the article almost entirely discretionary and therefore renders the article in effect empty.

Both options 1 and 2 are therefore preferable to no action as they ensure consistency and enhance market certainty whereas no action does not materially improve on the current regulatory situation.

In terms of choosing between options 1 and 2, the most decisive factor is how regularly the threshold would be crossed. Most significant costs arise in relation to the relative frequency of the threshold being triggered since this is when competent authorities will need to consider whether to suspend restricitions and when market participants will need to anticipate them. More importantly the frequency of crossing the threshold will determine the degree to which a consistent approach accorss Member States can be achieved and the extent to which the article reduces market uncertainty.

Adopting option 1 and choosing the 5th percentile would, assuming an independent and normal distribution of the data, mean that the threshold could be expected to be crossed once every 12 months. However it seems likely that variations in liquidity will not be independently distributed; if a Member State's debt suffer a shock to liquidity in one month, that shock is likely to affect liquidity in subsequent months. It is therefore likely that there will be clustering in the triggering of the thresholds.

Therefore this threshold was modelled against real sovereign debt liquidity histories for a sample of Member States. An illustrative example is illustrated in figure 1, which shows this clustering and illustrates how threshold triggers under option 1 only occur relatively intermittently, often in clusters, that correspond to potential liquidity shocks when the competent authority might want to consider whether to suspend the restrictions to enhance liquidity.

By contrast the disadvantage with the threshold under option 2 is that it may be crossed every 6 months and, given that restrictions may be imposed for 6 months or more, this could result in the continuous suspension of restrictions if authorities so chose, thereby defeating the objective of achieving consistency across member states.

In addition the longer 12 month reference period under option 1 means that the comparision period is more representative of typical liquditity, whereas the 6 month period under option 2 would mean that the threshold would frequently be calculated by reference to atypical periods of liquidity.

Therefore in terms of effectiveness in allowing member states to mitigate the effects of any liquidity crisis, both option 1 and 2 are equally effective since both would give member states the power to act when required. However Option 2 would be less effective in terms of ensuring market certainty since the threshold would be crossed more frequently, meaning a less consistent approach would result. In addition it would be less efficient due to the increased costs greater uncertainty and a more inconsistent approach would impose on market participants.

Table 3: comparison of options

	Effectiveness		Efficiency
	Mitigation of Debt Liquidity/Sovereign Debt crisis	Market Certainty Consistent Approach	
No action	0	0	0
Option 1: 5% percentile threshold over 12 months	+++	+++	+++
Option 2: : 1.6 standard deviations over 6 months	+++	++	++

On the basis of this comparison, option 1 is preferred: a significant fall in the average liquidity of a sovereign debt instrument will be deemed to have occurred if the liquidity in any month falls below the 5th percentile of monthly liquidity in the preceding 12 months. Option 1 is in line with the final technical advice of ESMA[49]and the responses to the consultation.

5.4 Issue 4 - Policy options on specification of significant price fall for financial instruments other than liquid shares

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt delegated acts. As outlined in the baseline scenario, should the Commission not adopt a delegated act specifying what constitutes a significant price fall for financial instruments other than liquid shares, competent authorities would not be able to apply in practice the power granted to them under the Regulation to temporarily prohibit or restrict short selling or otherwise limit transactions in a financial instrument in case of a significant price fall. This would run against the Regulation's overall goal of reducing the risks of negative price spirals arising from short positions.

Option 2 (individual thresholds for each class of financial instruments):

We shall consider the advantages and disadvantages for different measures and thresholds for each type in turn. This includes both illiquid and semi-liquid shares, but also all other financial instruments as defined in MiFID: sovereign bonds, corporate bonds, money market instruments, UCITS, exchange traded funds, and derivative instruments. It should be remembered that the threshold for each instrument will apply to all markets in Europe. As trading activity differs across markets, the threshold should be set in such a way that it captures significant falls in all markets, while not leading to too many unnecessary reviews in others. Also, the power to temporarily restrict short selling does not preclude competent authorities from taking general measures when they consider this to be necessary.

The data analyses presented here are not intended to establish the normal volatility of each instrument based on historic data, but rather seek to establish a measure for the total number of outliers. It should be remembered that the objective of setting these thresholds is not to empower competent authorities to intervene whenever the price of an instrument moves

[49] ESMA's final report on technical advice for delegated acts, p.50.

outside its normal volatility simply in the statistical sense. Rather, they should be able to act when price moves are significant both in statistical terms and in terms of its effect.

Non-liquid shares: Within the group of non-liquid shares, there are shares which are hardly traded at all, and shares which are traded more frequently. It is therefore necessary to distinguish between illiquid and semi-liquid shares. Semi-liquid shares are not blue chips themselves, but are relatively less liquid shares which are included in major indices. Illiquid shares show larger price movements during a trading day than liquid shares do, because illiquidity means buying and selling has a stronger impact on the price. Because larger price movements are more common for illiquid shares, this larger volatility means that the threshold will need to be set higher than for liquid shares. Otherwise, the threshold would be triggered in too many cases that are not exceptional in these markets. Also, for shares with a very small nominal value, also known as penny stocks, large percentage movements are less unusual. As their nominal value is smaller, for instance a one cent movement of their price is in percentage terms larger than for shares with a high nominal value.

Small and medium-sized enterprise (SME) shares are typically illiquid or semi illiquid and setting an appropriate threshold is important to ensure that this sector is not adversely effected and remains an important source of growth.

ESMA technical advice suggests that the thresholds for non-liquid shares is set in the same way as for liquid shares, namely as a percentage drop in the share price. The ESMA technical advice proposes three thresholds for non-liquid shares: a 10% threshold for semi-liquid shares, a 20% threshold for illiquid shares, and a 40% threshold for penny stocks (with a nominal value below 50 cents).[50] It considers these levels of price falls to be significant and beyond the usual level of volatility for the type of stock in question. ESMA has also considered setting a 30% threshold for penny stocks. Already in its consultation,[51] ESMA presented on page 55 the results of a test run applying 10%, 20%, and 30% thresholds in five countries mainly on shares admitted to trading on regulated markets. Using recent data captures a relatively turbulent economic period, and therefore allows the identification of outliers within such a period. The numbers indicate that in such times the competent authorities are not overwhelmed with false positives, and have the power to act when needed. The number of instances when a 10% threshold was triggered for semi-liquid shares ranged from 7 to 67 annually. Illiquid shares excluding penny stocks triggered the 20% threshold between 1 and 20 times annually. Estimates from Deutsche Börse indicate that a 20% threshold would be crossed about 200 times a year by illiquid shares, while a 30% threshold would be triggered by illiquid shares 63 times a year in one of their market segments.[52] Finally, penny stocks triggered a 30% threshold between 2 and 99 times a year in the ESMA test run. Deutsche Börse notes that shares with a below 50 cent value commonly have a double digit spread.[53] This indicates that it is not uncommon for these shares to move in multiples of 10% within a day. In its final technical advice ESMA suggested replacing the 30% threshold for penny stocks in favour of a 40% threshold.[54]

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[50] ESMA's final report on technical advice for delegated acts, p.57.
http://esma.europa.eu/consultation/Consultation-ESMAs-draft-technical-advice-possible-Delegated-Acts-concerning-regulation

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[52] See response of Deutsche Börse, p.2

[53] Ibid, p.2.

[54] ESMA's final report on technical advice for delegated acts, p.57.

Data provided by BaFin on shares on the three major German stock exchanges Berlin, Frankfurt and Stuttgart from October to December 2011 show that the 10% threshold was breached a total of 237 times (101 for Berlin, 86 for Frankfurt and 50 in Stuttgart).[55] The 20 % threshold was breached 29 times (20, 4 and 5 times respectively) and the 40 % threshold 197 times (29, 126 and 37 times respectively). For penny stocks, data provided by the AMF on the last quarter of 2011 show that penny stocks would have triggered a 20 % threshold 23 times, a 30 threshold 10 times, and a 40 % threshold never.[56] Other types of shares would have triggered these thresholds 11, 2 and 3 times respectively. The German and French numbers are data comparing the daily drop with the last price in the trading session the day before. Certain shares can be traded only once a week and even less. These numbers may therefore be higher in practice, as the last closing price may have been established in a trading session which took place earlier.

The disadvantage of this approach for shares is that competent authorities would need to assess which shares are considered to be semi-liquid and which ones are liquid. They would have to keep the market informed of this so that market participants can know when to expect possible measures. Also, the value of penny stocks may change, moving a share from the higher to the lower bracket and back. This will be addressed by considering the value of the stock at the end of the previous trading day

Bonds, both sovereign and corporate: For bonds, both sovereign and corporate, price movements of individual bonds issued by the same company or government are not generally the same. When only some issues show price changes, this is typically the result of investors rearranging their portfolios changing the maturities of the debt they hold. Only when a development affects all issues of a sovereign or corporate issuer can the market be said to be distressed. Setting the threshold on an individual instrument basis would therefore also capture situations when the market is not distressed. In addition, it would mean that a competent authority would need to assess price movements in a host of individual issues. As a result, the competent authority would need to make a large number of individual decisions, rather than being able to take one decision relating to the issuer.

In its technical advice, ESMA therefore proposes to measure the significant drop for bonds in terms of a percentage change in the yield across the yield curve. A yield curve shows the relationship between interest rates and the maturity of issued bonds. For instance, the yield on a bond which matures in five years may be 1.5 percent, while the yield on a bond from the same issuer which matures in ten years may be 2.5 percent. The yield curve shows this relationship for all outstanding debt of an issuer over time. ESMA initially considered setting a 5% threshold. Based on an overview of EU sovereign debt markets, ESMA considers that an increase of 7% or more in the yield across the yield curve (i.e. to move from a YTM of 5.00% to 5.35%) would be an appropriate trigger for sovereign bonds.[57]

Data provided by the competent authorities show the total number of times the yield curve in their respective country would have crossed a 3% and a 5% threshold in 2011. Again, using recent data captures a relatively turbulent economic period. The numbers indicate that in such times the competent authorities are not overwhelmed with false positives, and have the power to act when needed. These data are for 10 year, 5 year and 2 year bonds together.

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[57] ESMA's final report on technical advice for delegated acts, p.58.

	3% threshold	5% threshold
France	14	4
Germany	25	10
Portugal	8	2
Spain	11	2
Sweden	18	4

For corporate bonds, ESMA's technical advice is to apply a similar measure. The yield of any corporate or financial bond is related to the yields of the sovereign bonds where the company is based. Investors in fixed income set the price of a corporate bond adding a yield spread which covers the excess of credit risk of the corporate over the sovereign. ESMA initially considered a 7% threshold. Taking into account the different spreads on interest rates for corporate bonds of different categories of credit risk, which have a range from minus some basis points (bp) to more than 500 bp (non-investment grade), and the threshold set for sovereign bonds of 7%, ESMA considers a 10% or more increase in the yield of the bond during a single trading day is a potential sign of distress.[58]

The disadvantage of setting the yield threshold for bonds as a percentage, is that for low-yield bonds, a percentage threshold translates into a lower threshold in terms of basis points.[59] A drop of 10 to 20 basis points is not uncommon,[60] and would be triggered relatively more often for low yield bonds. Secondly, central bank intervention may move the yield curve of all outstanding bonds.[61] Bond ratings may also be relevant in this regard, as Deutsche Börse notes that sub investment grade bonds often have such a wide spread, that a single buy or sell followed by another buy or sell could lead to a 5% threshold being triggered.[62] However, differentiating investment grade from non-investment grade bonds would run against the aim of reducing overreliance on credit rating agencies. Also, competent authorities would not be obliged to restrict short selling when the threshold is crossed, and would take central bank intervention into account when doing so.

Money-market instruments: these have maturities ranging from one day to one year and are extremely liquid. They include commercial paper but not treasury bills. Because they are comparably liquid as shares, but less volatile, a 1.5% decrease in their price would be the appropriate measure.

Exchange traded funds (ETF's): these are a diverse set of instruments in themselves. Some ETF's are equivalent to shares,[63] and are valued based on the Net Asset Value (NAV) of their underlying. Because ETF's are very liquid, ESMA technical advice is to apply the same threshold value as for shares: a decrease of 10% or more in the price during a single trading day.[64] Other ETF's, however, are not like shares at all. As they contain a derivative component to change their valuation, their price does not behave the same as that of shares. Leveraged ETF's use derivatives and debt to increase their return when the underlying moves. A reverse ETF is structured in such a way that the investor benefits from a decline in the

[58] ESMA's final report on technical advice for delegated acts, p.59.
[59] See response of AIMA, p.20.
[60] See response of AFME, ISDA, ICMA, ISLA, p.40 and response of HFSB, p.11.
[61] See response of AIMA, p.20 and response of HFSB, p.11.
[62] See response of Deutsche Börse, p.3.
[63] See response of AIMA, p.20.
[64] ESMA's final report on technical advice for delegated acts, p.60.

underlying. Therefore, leveraged and reverse ETFs should be treated as derivatives, which will be discussed below.

UCITS: Due to their regulatory structure, ESMA's technical advice is to consider UCITS as a separate case. Any holders of units are able to sell them to the Management Company directly or in the market. Although the price of a unit of any UCITS may vary freely in the market, the price is subject to a rule which keeps the prices close to the NAV of the UCITS. Consequently, the prices do not move away from the NAV and the interest of selling short the units themselves is small. Under these circumstances, ESMA's technical advice is not to set a threshold for a significant price fall threshold for this type of financial instruments.[65] This is true for all UCITS which are not ETF's. When they are an ETF, they can more readily be sold short and the general rules for ETF's should apply.

Many respondents to the consultation, including EFAMA, HFSB, IMA, BME, and Deutsche Börse agree that it is not appropriate to set a threshold for UCITS. Deutsche Börse notes that 99 percent of all ETF's listed in Frankfurt are UCITS and urges not to apply a threshold to all UCITS including ETF's.[66]

Derivatives are a very broad category of financial instruments, ranging from put and call options on shares, interest and exchange rate swaps, to commodity derivatives. They cannot be sold short in the same way as negotiable securities, but competent authorities could seek to otherwise limit transactions in these instruments. For present purposes, they can be grouped into two categories; those related to financial instruments for which a threshold has been established, and those related to other variables. It would be possible to set a separate threshold for derivatives based on the price of the derivative, i.e. the premium. However, for derivatives with a financial underlying, this could lead to the situation where short selling in, e.g., a share would be suspended, but not the entering into a short position through derivatives related to that share. Also, the price of the derivative may vary based on changes in the value of the underlying. This would not reflect distress in the derivative market, but rather a change in the market for the underlying.

ESMA advises to set the threshold for derivatives whose sole underlying financial instrument is a share or bond for which a significant fall in value has been specified by reference to the threshold for the underlying.[67] A significant fall in value in the derivative occurs when the underlying financial instrument has reached its fall in value as established according to the regulation, irrespectively of the size or the direction of the actual change in value of each of the different related derivatives. This threshold would apply to all derivatives which have proved to pose risks during the recent financial crisis, including options on shares, and CDS on government bonds.

The advantage of this approach is that it would stop market participants from seeking to build up short positions through derivatives when short selling of the underlying instrument is prohibited. The disadvantage is that it would leave competent authorities without a basis for action when they want to restrict transactions in the derivatives market only, but this situation is relatively unlikely to occur, as derivatives prices are a form of arbitrage which tend to move around the equilibrium.[68] If action were taken only with respect to the derivative in such cases, this could negatively impact the market of the underlying.

[65] ESMA's final report on technical advice for delegated acts, p.59.
[66] See response of Deutsche Börse, p.3.
[67] ESMA's final report on technical advice for delegated acts, p.61.
[68] See response of FESE, p.1.

For derivatives which are referenced to an instrument for which no threshold has been specified, ESMA advises not to set a threshold.[69] This is due to the multiplicity and complexity of derivatives in this category. In addition, even if thresholds would be devised, there is a lack of data on the number of times these thresholds would trigger them. It would therefore be very difficult to set appropriate thresholds. As noted under the baseline scenario, not setting a threshold means that competent authorities would not be able to apply this power in practice. The Commission services therefore propose to leave the discretion to apply this power to competent authorities under their general intervention powers. In addition, the Commission services propose to reconsider setting a threshold for these instruments as part of its review of the short selling regulation in 2013.

ESMA initially considered to rely on margins that are required by central clearing counterparties (CCP's) on those products that are centrally cleared. The disadvantage of this approach, as pointed out by many consultation responses, is that different CCP's may set different margin requirements for the same derivative.[70] Also, they will base their margin requirements on different sets of historical data, with one CCP using a longer time horizon than another. As a result, setting a fixed discount factor may pick up more noise, depending on the time horizon the CCP uses for calculating the margin requirements.

For derivatives where the underlying is a commodity, it is important to bear in mind that the main function of these markets is for producers and consumers to hedge their positions. The main aim of regulatory measures in these markets should be to ensure that they serve the real economy. There will be market participants hedging a long position in the underlying with a short position in the derivatives market. The threshold for determining whether the derivatives market is distressed would therefore require taking into account the situation in the underlying market.

Impact on stakeholders

The majority of respondents agreed with ESMA’s draft technical advice for three categories of illiquid shares and supported the EUR 0.50 cut off point for penny shares. A majority of respondents indicated that the thresholds ESMA considered in its consultation paper, notably the 30% threshold for penny stocks, were too low.[71] In response to these concerns and based on additional data provided on both the UK and German markets, ESMA's final technical advice suggests a 40% threshold for penny stocks.[72]

The large majority of respondents to ESMA's consultation agreed that for sovereign bonds the best measure to trigger action by a competent authority should relate to an increase in the yield across the yield curve for the sovereign issuer during a single trading day.[73] As for the value of this threshold, the majority of respondents believe that an increase of 5% is too low. In response to these concerns and based on additional data received from debt management agencies, ESMA proposes a 7% threshold.[74] For corporate bonds, the majority of respondents also believe that an increase of 7% is too low to trigger action by a competent authority.[75] As

[69] ESMA's final report on technical advice for delegated acts, p.61.
[70] ESMA's consultation paper on technical advice for delegated acts, p.60.
[71] See response of MFA, p.23 stating that "the proposed thresholds are set at such low levels that they are likely to interfere with legitimate market operations".
[72] ESMA's final report on technical advice for delegated acts, p.57.
[73] See response of AFME, ISDA, ICMA, ISLA, p.40
[74] ESMA's final report on technical advice for delegated acts, p.58.
[75] See response of ABI, p.9 and response of SSDA, p.4.

the threshold for corporate bonds is set by reference to that for sovereign bonds, ESMA notes that an increase of 10% or more in the yield is considered to be outside the usual range of volatility while representing a significant fall in the price.[76]

Having considered the responses to the public consultation, ESMA has revised its proposal for money-market instruments. It therefore advises to use the price as the appropriate value, and considers a 1.5% price fall of a money-market instrument during a single trading day to be the appropriate measure of a fall in value of a money-market instrument.[77]

As the feedback from the consultation was supportive, ESMA did not modify the advice in relation to units in collective investment undertakings.[78]

Some respondents believe that it is not necessary to have a threshold for ETFs while others respondents favour having a threshold as ETFs are basically equivalent to liquid shares.[79] Having considered the responses to the public consultation, ESMA did not modify the advice in relation to ETFs.[80]

Some respondents do not believe that there is any need for specific measures for derivatives, as it is only necessary to take measures in relation to the underlying financial instrument.[81] Having considered the responses to the public consultation, ESMA did not modify the advice where the derivative instrument has a sole underlying financial instrument that is traded on a trading venue and for which a significant fall in value is specified.[82] A significant fall in value in that derivative instrument occurs when the underlying financial instrument has reached its fall in value.

Respondents to the Consultation Paper pointed out that no one threshold would be appropriate for all derivatives. Many respondents to the consultation questioned ESMA's proposal in the consultation paper to derivative instruments that do not have a sole underlying financial instrument that is traded on a trading venue. The respondents rejected the approach to rely on margins that are required by central clearing counterparties (CCP) on those products that are centrally cleared, as derivative instruments may be cleared by more than one CCP and different margin rates may apply.[83] In relation to commodity derivatives a number of respondents pointed out that for some in the physical market short selling on commodity futures markets is an essential part of trading activity.[84]

An important risk highlighted by competent authorities is that they could be overwhelmed with instances of significant drops for which they would have to consider taking measures if thresholds are set too low. Therefore, specific attention needs to be paid to assessing the cost of compliance with this provision in terms of labour costs for competent authorities. If these costs are too high, they would impinge upon competent authorities' carrying out other market surveillance tasks. Competent authorities would have to take the following steps in order to apply this power when the threshold is breached: examine the data on the price movements of

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[76] ESMA's final report on technical advice for delegated acts, p.59.
[77] Ibid, p.59.
[78] Ibid, p.59.
[79] See for the first approach response of Deutsche Börse, p.4 and for the second one response of AIMA, p.20.
[80] ESMA's final report on technical advice for delegated acts, p.60.
[81] See response of FESE, p.1.
[82] ESMA's final report on technical advice for delegated acts, p.61.
[83] See response of UBS, p.38.
[84] See response of FESE, p.2.

the instrument to confirm that the threshold has been breached; consider whether there are other fundamental factors which might have caused the decline, such as an announcement of a substantial fall in profits; and consider data which might indicate that short selling could have been a factor in the decline. This data might include recent trade data and transaction reports, or data which might reveal an increase in securities lending which could indicate a spike in short selling activity. Considering whether to suspend short selling would therefore require an investment of time by experts at the competent authority to analyse each situation before reaching a conclusion as to whether action was required or not. Competent authorities have expressed concern that if this process is not carried out thoroughly, they could face pressure from the issuer of the financial instrument to suspend short selling and even be confronted with a judicial review of their failure to act.

It is difficult to estimate the total number of times the thresholds are likely to be breached. For shares and bonds, a rough estimate can be made on the basis of data supplied by ESMA. Deutsche Börse's trading volume represents 11.45% of total equity trading in Europe.[85] If the distribution of price moves is similar across Europe, the 86 trigger events per quarter on their systems would translate to about 750 trigger events across the EU. Similarly, the four trigger events for the 20% threshold would translate to about 35 across Europe. Finally, the 126 triggers for penny stocks would translate to 1100 triggers across Europe. However, this last category the 0 trigger events in the French data suggest the distribution cannot be assumed to be uniform across Europe, presumably due to the number of small caps in each country. Therefore, a number of 550 would be a prudent estimate.

With regard to bonds, as noted above France, Germany, Portugal, Spain and Sweden together estimate 22 triggers annually. As these countries together represent about 40 percent of EU outstanding debt, the total number of triggers in the EU would be about 55. Estimates show in the region of 27% of daily traded debt relates to non government bonds compared to 73% for government bonds[86]. The total number of triggers for government and corporate debt in the EU would as a result be about 75.

For the purpose of providing a rough estimate of compliance costs, the total number of triggers for shares and bonds would be assumed to be 5415 annually.

Whenever a trigger is passed, a competent authority would need 3 hours of an associate's time to check, amongst other things, previous short positions reports, look at whether there have been any announcements, what the volatility of the stock has been recently, what transactions reports reveal about activity and, if necessary, talk to some market makers to get market colour and produce and present a report and answer questions as necessary. In addition, it would need 30 minutes of a Manager's time to review the material in addition to an appropriate legal review which would take perhaps 1 hour.

A decision on whether to impose measures would require a senior executive decision, which would need to be made either by a senior executive/director or an appropriate committee.. This might take around ½ hour to review materials and ½ hour to discuss. There may also be a requirement to consult with other external affected government agencies and possibly other international regulators, Informing ESMA will take about 5 minutes. In the 1 in 100 cases where there is case for triggering the suspension power, additional time would be involved at

[85] http://thomsonreuters.com/products_services/financial/financial_products/equities_derivatives/europe/market_share_reports/#tab2

[86] Electronic Trading of Bonds in Europe: Weathering the Storm, Celent, October 2009

higher decision making level and greater dialogue with ESMA and other regulators, at least 3 hours for those cases.

For mid-level staff, we can assume a costs of 60,000 euros. Assuming 250 working days in a year and 8 hour days, this comes down to 30 euros an hour. For senior staff, a cost of 80,000 euros per year. Based on the same assumptions, this works out to 40 euros an hour. The total monitoring costs would thus be 5415 multiplied by 3 hours times hourly wage for a mid-level staffer equals about 487.350 euros. The costs for managers and legal review would be 5415 multiplied by 1.5 hours times senior staff hourly wages equals 324.900. Total monitoring costs thus amount to 812250. For the decisions to be taken at mid level and senior management this will impose costs of 5415 times 1 hour times 40 euros, equals 216.600 euros to decide not to take action. For the cases where there is case for using the suspension power, an additional 6.498 euros need to be added. The total costs for competent authorities thus amount to 1.035.348. These costs are considered to be well justified and can readily be born by competent authorities.

Of greater importance is the costs imposed on stakeholders during this process. Market participants would need to consider and if necessary anticipate the likely decision and this uncertainty could significantly increase.

The preferred sub-options are all in line with ESMA's final technical advice and the responses to the consultation.

- ***Table 4: specification of significant price fall for financial instruments other than liquid shares - comparison of options***

	Effectiveness		Efficiency
	Clear powers for regulators	Break price spirals	
Option 1: No action	0	0	0
Option 2: Tailored	++	++	+

6. CHOICE OF LEGAL INSTRUMENT FOR THE DELEGATED ACTS

The main aim of the delegated act is to specify provisions in the Short Selling Regulation in order to ensure consistent implementation and application of the Regulation across all Member States. This is important in order to ensure that the objectives of the Regulation can be achieved. In view of the choice of a Regulation as a legal instrument, the only option available is for the delegated act to take the form of a Delegated Regulation. A Regulation, as part of a single rulebook, guarantees uniform rules, provides market participants, competent authorities and other stakeholders with directly applicable rules and ensures full market integration.

7. MONITORING AND EVALUATION

The lack of quantitative information about short selling can largely be attributed to the lack of regulation until now. With the entry into force of the Regulation, in particular the notification and disclosure requirements, competent authorities across the EU will have much improved access to data on significant short positions in shares and for the first time will have reliable data on short positions in sovereign debt. Since the Regulation provides for an early report to the European Parliament and the Council by end June 2013 to review the impact and appropriateness of certain key provisions of the Regulation, it will be necessary for competent authorities, market participants and the Commission to monitor the effective application of the Regulation and evaluate the practical impact that it has. In view of the significant role the Regulation grants to ESMA, the review report which ESMA must submit to the Parliament, Council and Commission by 31 December 2012 into the staff and resources needs arising from the assumption of its duties under the Regulation will also be significant.

The specific issues which the Commission is required to report on by 30 June 2013 are:

a. the appropriateness of the notification and disclosure thresholds under Articles 5, 6, 7 and 8;
b. the impact of the individual disclosure requirements under Article 6, 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 in Chapters II and III;
e. the appropriateness of the restrictions on the uncovered sovereign credit default swaps and
f. the appropriateness of any other restrictions or conditions on short selling or credit default swaps.

As part of its preparatory work for this report the Commission expects to consult notably with ESMA and competent authorities on their practical experience in applying the Regulation, as well as to consider feedback from market participants and evaluate any published studies on the economic impact of the provisions of the Regulation.

ANNEX 1 - GLOSSARY OF TERMS

Short Sales[87]

What is a short sale? A short sale is generally the sale of a security you do not own (or that you will borrow for delivery). Short sellers believe the price of the security will fall, or are seeking to hedge against potential price volatility in securities that they own. If the price of the security drops, short sellers buy the security at the lower price and make a profit. If the price of the security rises, short sellers will incur a loss. Short selling is used for many purposes, including to profit from an expected downward price movement, to provide liquidity in response to unanticipated buyer demand, or to hedge the risk of a long position in the same security or a related security.

Example of a short sale: For example, an investor believes that there will be a decline in the stock price of Company A. Company A is trading at €60 a share, so the investor borrows shares of Company A stock at €60 a share and immediately sells them in a short sale. Later, Company A's stock price declines to €40 a share, and the investor buys shares back on the open market to replace the borrowed shares. Since the price is lower, the investor profits on the difference -- in this case €20 a share (minus transaction costs such as commissions and fees). However, if the price goes up from the original price, the investor loses money. Unlike a traditional long position — when risk is limited to the amount invested — shorting a stock leaves an investor open to the possibility of unlimited losses, since a stock can theoretically keep rising indefinitely.

How does short selling work? Typically, when a person sells short, their brokerage firm will loan them the securities. The securities they borrow come from either the firm's own inventory, the margin account of other brokerage firm clients, or another lender. The person is then able to sell these borrowed securities knowing that s/he will have to replace them at an arranged later date. If the securities which are borrowed pay a dividend, the person must generally pay the dividend to the owner from which the securities were borrowed.

Large institutional investors and hedge funds will typically have standing arrangements in place with specialist brokers and investment firms who offer an established and arranged facility to borrow securities. These are referred to as Prime Brokers and for a fee will manage the lending and administration of the securities as well as other services, e.g. cash management. Other market participants such as settlement systems also offer facilities that enable investors to ensure that the securities are covered and will be available when settlement is due.

Uncovered or "Naked" Short Sales: In an uncovered short sale, the seller does not borrow or arrange to borrow the securities prior to executing the trade. If the seller is then unable to source the securities before the physical settlement date they will be unable to deliver to the buyer (known as a "**failure to deliver**" or "fail").

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[87] Explanations are adapted *inter alia* from *Key points about Regulation SHO,* Division of Market Regulation, Securities and Exchange Commission, 11 April 2005. http://www.sec.gov/spotlight/keyregshoissues.htm

Failures to deliver can result irrespective of if the seller physically has the securities or not and there may be some legitimate reasons for a fail. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, which may happen even if the seller physically holds the security. Further, a fail may also result from an uncovered short sale when a market maker, in response to a customer order, sells a very thinly traded and illiquid security. If the market maker subsequently encounters difficulty in obtaining the security they may be unable to settle.

Credit Default Swaps

A **Credit Default Swap** (CDS) is a derivative which is sometimes regarded as a form of insurance against the risk of credit default of a corporate or government (or sovereign) bond. In return for an annual premium, the buyer of a CDS is protected against the risk of default of the reference entity (stated in the contract) by the seller. If the reference entity defaults, the protection seller compensates the buyer for the cost of default.

In addition to short selling on cash markets, a **net short position** can also be achieved by the use of derivatives, including Credit Default Swaps (CDS). For example, if an investor buys a CDS without being exposed to the credit risk of the underlying bond issuer (a so-called "naked CDS"), he is expecting, and potentially gaining from, rising credit risk. This is equivalent to short selling the underlying bond.

Other Terms

A **Central Counterparty** (CCP) is an entity that acts as an intermediary between trading counterparties and absorbs some of the settlement risk. In practice, the seller will sell the security to the central counterparty, which will simultaneously sell it on to the buyer (and vice versa). If one of the trading parties defaults, the central counterparty absorbs the loss.

A **Derivative** is a security whose price is dependent upon, or derived from one or more underlying assets. Examples of derivatives include Options, Futures, CDS, and Contracts for Difference. The underlying assets can be diverse, however common examples include shares, bonds, commodities and interest rates.

Primary Market Operations are transactions performed by dealers to provide liquidity to issuers of new securities such as sovereign debt and for the purposes of stabilisation schemes (i.e. share issues intended to stabilise a share price). Stabilisation schemes are defined under the Market Abuse Directive.

A **Market Maker** is a firm that will buy and sell a particular security on a regular and continuous basis by posting or executing orders at a publicly quoted price. They ensure that an investor can always trade the particular security and in doing so enhance liquidity in that security.

Prime Brokers, or firms offering **Prime Brokerage** services, are firms which offer specialist bespoke services to, generally, large institutions and hedge funds. Prime brokerage covers a range of services, including securities borrowing and

administration, and cash management. Many large investment banks provide Prime Brokerage services.

A **Multilateral Trading Facility** (MTF) is an electronic system which facilitates the exchange of securities between counterparties. The securities may include derivatives and instruments which do not have a main market, as well as traditional securities.

A **Trading Venue** is an official venue where securities are exchanged; it includes MTFs and regulated markets (e.g. typical stock exchanges).

A **Long Position** refers to the ownership or holding of a security or entering into another financial transaction which confers a financial advantage in the event of an increase in the price or value of that security.

A **Short Position** refers to the selling of a security which has not been closed or otherwise entring into a transaction which confers a financial advantage in the event of an fall in the price or value of that security

A **Net Position** is the difference between a short position and a long position. If the short position is greater than the long position the result will be a **Net Short Position**; if the long position is greater than the short position the result will be a **Net Long Position.**

ANNEX 2 - ASSESSMENT OF NEED FOR DETAILED IA FOR SPECIFIC DELEGATED ACTS

- **Issue 1 – Definition of "ownership" (Article 2(1), implementing powers in Article 2, paragraph 2)**

The Regulation empowers the Commission to specify in a delegated act THE definitions, in particular the definition of 'ownership' for the purposes of defining a short sale.

ESMA technical advice

Although the empowerment gives the Commission the power to specify any of the definitions in article 2(1) of the Regulation if needed, ESMA's technical advice is that only the definition of ownership needs to be specified. Rather than seeking to give a more precise definition of ownership in a delegated act, and given that this is a key horizontal concept which may be addressed in the future Commission proposal for a Securities Law Directive, ESMA rather advises that it should be defined according to the civil or securities law applicable to the relevant sale. ESMA has also identified additional cases which should not in their view fall within the definition and which should be specified in the delegated act.

The first is the sale of financial instruments transferred under a securities lending agreement, if the transferor recalls and receives the financial instrument within the standard settlement period of that sale. ESMA's technical advice is that the seller may not own the shares or debt instruments from a civil law or securities law point of view, but does from an economic one. If in addition he recalls the securities so that settlement can be effected when it is due, the exclusion of such cases from the definition of a short sale also involves no risks as regards the timely settlement of the transaction in the concerned financial instruments.

The second case which ESMA's technical advice should also be specified is that of shares purchased in the morning and sold in the afternoon. ESMA's technical advice is that a sale should in such a case be deemed a sale, and not a short sale. This is an issue because under the civil law or securities law of some Member States, the ownership of a financial instrument is not transferred immediately after the sale of that financial instrument. The buyer receives ownership only when the settlement has taken place and the financial instrument is booked to his account. During that time (usually 2 or 3 days) the purchaser has the "economical ownership". During this period, he is able to sell the securities in all Member States. In some Member States, the purchaser is legally considered to sell his "entitlement" to the financial instrument. It is a common market practice to be able to sell securities that one has purchased without having yet received delivery of those securities. Without the ability to do so, financial markets would not work properly, because it would be impossible to buy and sell securities within a short timeframe. Therefore ESMA's technical advice is that the possibility to sell financial instruments before the settlement has taken place, without the transaction being considered to be a short sale, must be maintained.

The third case which ESMA' technical advice should be specified is the case where the investor exercises an option or similar claim and this results in the delivery of the shares so that settlement can be effected when it is due.

Assessment of IA need

A delegated act cannot amend the essential elements of the Short Selling Regulation but can only specify certain elements in order to ensure a uniform application of this Regulation. In view of this legal principle of the Treaty and because of the wording of article 2(2) of the Short Selling Regulation, the Commission can only specify when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale in the

Regulation. If these specifications are not made in the delegated act there is a risk of inconsistent application of the Regulation in the cases envisaged, or of application in a way which would be inconsistent with the objectives of the SSR. Since the specifications envisaged here are limited to ensuring the consistent application of the SSR they have no wider implications for the definition of ownership in other legislative instruments and are without prejudice to any possible harmonisation of the definition of ownership in any future legislative proposal of the Commission. Therefore since the scope of the specifications envisaged here is limited to ensuring the uniform application of the Short Selling Regulation and these specifications aim only to ensure consistency at the application level with the objectives of the Short Selling Regulation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment.The specifications are in line with ESMA's technical advice.

- **Issue 2 – Cases in which a natural or legal person is considered to "hold" a share or debt instrument (Article 3, paragraph 2(a); implementing powers, Article 3, paragraph 7(a))**

The Regulation empowers the Commission to specify cases in which a natural or legal person is considered to "hold" a share or debt instrument for the purposes of determining what shall be considered to be a long position relating to issued share capital or issued sovereign debt.

ESMA's technical advice

ESMA's technical advice considers that holding a share or debt instrument should mean:

- ownership of the instrument, and

- without having ownership, having a legally enforceable claim to be transferred ownership in cases not mentioned in Article 3(2)(b) of the Regulation according to the respective civil law or securities law applicable for the relevant sale.

ESMA's advice considers that the meaning of holding a position under the Regulation differs from the approach taken under the Transparency Directive, considering that both the objectives of the two legislative texts and the scope of the financial instruments covered are different and that the method of calculation under the Regulation follows the netting approach.

A long position (Article 3(2)(a) of the Regulation) is composed of holding a share or a sovereign debt instrument and entering into a transaction in instruments whose value increases with the price of the share or sovereign debt (Article 3(2)(b)).

Assessment of IA need

A delegated act cannot amend the essential elements of the Short Selling Regulation but can only specify certain elements in order to ensure a uniform application of this Regulation. In view of this legal principle of the Treaty and because of the wording of article 3(7)a of the Short Selling Regulation, the Commission can only specify cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of the Short Selling Regulation. If these specifications are not made in the delegated act there is a risk of inconsistent application of the Regulation in the cases envisaged, or of application in a way which would be inconsistent with the objectives of the SSR. Since the specifications envisaged here are limited to ensuring the consistent application of the SSR they have no wider implications for the definition of holding in other legislative instruments and are without prejudice to any possible harmonisation of the definition of holding in any future legislative

proposal of the Commission. Therefore since the scope of the specifications envisaged here is limited to ensuring the uniform application of the Short Selling Regulation and these specifications aim only to ensure consistency at the application level with the objectives of the Short Selling Regulation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment. The specifications are in line with ESMA's technical advice.

- **Issue 3 – Cases in which a natural or legal person has a net short position (Article 3, paragraphs 4 and 5; implementing powers, Article 3, paragraph 7(b))**

The Regulation empowers the Commission to specify cases in which a natural or legal person has a net short position in shares and in sovereign debt. It also empowers the Commission to specify the method of calculation of such positions, and this is addressed under issue 4.

ESMA's technical advice

Net short position in shares

1) **Long positions.** To calculate net short positions in shares, first the long positions in shares have to be calculated from which short positions are deducted. ESMA therefore offers advice on what cases should constitute long positions for this purpose.

ESMA's technical advice is that long positions should encompass, in addition to shares "held" in accordance with the approach outlined under issue 2, also the case where a long position is held in a share through a basket of shares (to the extent that the share in question is represented in the basket).

ESMA's technical advice is also that the delegated act should specify a non-exhaustive list of financial instruments, other than shares, which fall under the meaning of long positions through exposure to instruments which confer a financial advantage in the event of an increase in the price of the share. ESMA's technical advice that the following instruments should be in such a non-exhaustive list:

- options
- covered warrants
- futures
- index related instruments
- contracts for difference
- shares/units of exchange traded funds
- swaps
- spread bets
- packaged retail or professional investment products
- complex derivatives
- certificates linked to shares
- global depositary receipts

In this context it is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

ESMA also recommends that instruments that give a claim to shares not in issue should not be taken into account as long positions when calculating a net short position. In particular subscription rights, convertible bonds and other comparable instruments do not constitute long positions according to ESMA.

2) **Short positions.** ESMA's technical advice is that in addition to short sales of shares as defined in the Regulation and specified in the delegated act, short positions in shares should also encompass a short sale of a basket of shares (to the extent that the share in question is represented in the basket).

ESMA 's technical advice considers that the above non-exhaustive list of financial instruments should also be taken into account in calculating a short position where they confer a financial advantage in the event of a decrease in the price or value of the share.

Net short position in sovereign debt

1) **Long positions.** To calculate net short positions in sovereign debt, first the long positions in sovereign debt have to be calculated from which short positions are deducted. ESMA technical advice therefore considers what cases should constitute long positions for this purpose.

In addition to sovereign debt "held" as defined above, ESMA also considers that the delegated act should specify a non-exhaustive list of financial instruments, other than sovereign debt, which fall under the meaning of long positions as they confer a financial advantage in the event of an increase in the price of the sovereign debt. ESMA technical advice consdiers that the following instruments should be in such a non-exhaustive list:

- options
- futures
- index related instruments
- contracts for difference
- swaps, especially sovereign credit default swaps
- spread bets
- complex derivatives
- certificates linked to sovereign debt

In this context it is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

Long positions in 'highly correlated' sovereign debt

Article 3(5) of the Regulation allows long positions in sovereign debt of one EU issuer to be included in the calculation of a long position in the sovereign debt of another EU issuer provided that their pricing is highly correlated.

ESMA's technical advice therefore considers that, assuming a high correlation exists, all net holdings of sovereign debt of the correlated sovereign issuer should be included in the calculation of the long position. However, debt instruments from issuers outside the union should not be included.

ESMA's technical advice considers that for assets where there is a liquid market price, "high correlation" should be measured on a historical basis using data for the 12 month period

before the position in the sovereign debt is taken out. For assets for which there is not a liquid market price or where there is not a sufficiently long price history, a good proxy should be used. Such a good proxy could be another debt instrument, whose remaining maturity is similar to the one to calculate.

ESMA's technical advice considers that high correlation should be assumed when the correlation coefficient between the price of the debt instrument of another sovereign issuer and the price of the given sovereign debt is at least 70.

If the position subsequently ceases to meet the test of high correlation based on the 12 month timeframe, then the sovereign debt of the previously highly correlated sovereign issuer can no longer be taken into account in calculating a long position.

ESMA's technical advice considers that provision would need to be made for periods when there might be temporary fluctuations in the level of correlation between the price of the sovereign debt of different sovereign issuers. To cater for such situations ESMA envisages that there could be a temporary buffer period during which a lower level of correlation would be acceptable. So it could be acceptable for a period of three months that a level of at least 50% was met. Clearly, if the level of correlation fell below the prescribed measure for more than this buffer period or if the level of correlation fell below the lower reference level, the test of highly correlated would no longer be met.

2) Short positions

ESMA's technical advice is that in addition to short sales of sovereign debt as defined in the Regulation and specified in the delegated act, short positions in sovereign debt should also encompass a short sale of a basket of sovereign debt instruments (to the extent that the sovereign debt instrument in question is represented in the basket).

ESMA's technical advice considers that the above non-exhaustive list of financial instruments should also be taken into account in calculating a short position where they confer a financial advantage in the event of a decrease in the price or value of the sovereign debt.

It is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

ESMA's technical advice considers that CDS referenced to the sovereign issuer have to be included in calculating net short positions in sovereign debt. Sales of CDS (i.e. exposures to the credit of a sovereign issuer) should be counted as long positions while purchases of CDS should be counted as short positions.

If a sovereign CDS position is hedging a risk other than the referenced sovereign debt, the value of the hedged risk cannot be treated as a long position for the purposes of calculating whether a person has a net short position in the issued sovereign debt of a sovereign issuer.

Assessment of IA need

The main aspect of this delegated act concerns the definition of "high correlation". In principle, "high correlation" could be defined either by using a qualitative measure or a quantitative measure. ESMA's technical advice is that as the test is one of high correlation, it may be feasible to set a percentage threshold rather than simply relying on a purely qualitative definition. ESMA is aware that there is currently no definition of the term 'highly correlated' elsewhere in EU legislation which could be used as a benchmark in this Delegated Act and recognises that there currently may not be a commonly agreed standard for the level of statistical correlation required. However, ESMA considers that setting a quantitative threshold would provide a clear, objective and measurable standard against

which regulators and market participants could judge whether the condition of highly correlated set in the Regulation is or is not met. It is also relevant that the comparison is one between financial instruments of the same class for which pricing data is generally available. On balance therefore ESMA technical advice is that the use of a quantitative definition and considers that a percentage of 70% would be appropriate for the purposes of calculating a net short position in sovereign debt.

On the issue of high correlation for sovereign debt issues, there was also a general support for the ESMA draft technical advice in responses to the ESMA consultation. However a significant number of respondents were in favour of using a qualitative, rather than quantitative, method for the determination of high correlation. Concerning the level of the high correlation threshold in ESMA's draft technical advice issued for consultation, the common view was that 90% was too high. The alternative thresholds suggested ranged from 50% to 82%. In relation to the timeframe for the historical measurement of correlation, most respondents were in favour of a shorter period than the 24-month period suggested by ESMA.

In light of the responses, ESMA decided to reduce the timeframe and the percentage for high correlation. To keep a sufficiently long timeframe ESMA proposed a 12 month period in its final advice, but to capture the most recent trends this should be calculated in a weighted form giving more weight to the most recent data. Further, ESMA proposed a 70% threshold which it considered sufficiently high to be considered as "highly correlated".

However, the Commission services consider that a 70% is not consistent with the level 1 Regulation requirement for "high" correlation and is too significant a departure from the ESMA draft advice; in this respect the Commission services therefore propose to retain a threshold of 80% for high correlation, with a buffer of 60%, as a preferred option.

In view of the limited room for different options left by the need to ensure consistency with the requirement for 'high correlation' in the Regulation, the fact that ESMA's technical advice is broadly consistent with achieving the objectives of the Regulation, and the fact that the Commission services propose to follow ESMA's technical advice except on the final correlation figure, it is not considered proportionate to subject this to further impact assessment.

- **Issue 4 – Method of calculation of net short position (Article 3, paragraphs 4 and 5; implementing powers, Article 3, paragraph 7(b))**

The Regulation empowers the Commission to specify the method of calculation of net short positions for shares and sovereign debt.

ESMA technical advice

In relation to shares

ESMA's technical advice recommends using the "delta adjusted model" for calculating long and short positions in shares as proposed by ESMA/CESR in May 2010 in the document "Technical details of the pan-European short selling regime" (CESR/10-453). This model has been already implemented by some jurisdictions and it is operating satisfactorily. Positions shall be calculated by taking into account transactions in all financial instruments (inside or outside a trading venue) that confer a financial advantage in the event of a change in price or value of the share. Any derivative and cash position would be accounted for on a delta adjusted basis.

Any transaction that confers a financial advantage in the event of a change in price or value of the share held as part of a basket, index or exchange traded fund (ETF) shall be included when calculating the position in each individual share. Positions on these financial instruments shall be calculated taking into account the weight of that share in the underlying basket, index or fund.

A net short position is calculated then by netting long and short delta adjusted positions in a given issuer.

<u>In relation to the issued sovereign debt of a sovereign issuer</u>

ESMA's technical advice is 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 issued sovereign debt of a sovereign issuer.

Cash positions and positions in derivatives (bond futures, options on bond futures, other derivatives, etc.) shall be taken into account using their nominal amount. Options and other derivative instruments shall be then adjusted by their delta.

Nominal positions in bonds issued in other currencies than the Euro shall be converted to Euros using “bona fide” practice taking the last reliable updated spot currency price available. The same principle applies to other financial instruments.

Any economic interest or position that creates a financial advantage to the issued sovereign debt of a sovereign issuer held as part of a basket, index or exchange traded fund (ETF) shall be included when calculating the position in each individual debt of a sovereign issuer. Positions on these financial instruments shall be calculated taking into account the weight of that “sovereign exposure” in the underlying basket, index or fund.

Calculations for sovereign debt instruments with high correlation follow the same methods of calculation of long positions in debt instruments of a sovereign issuer. Long positions in debt instruments of a sovereign issuer the pricing of which are highly correlated to the pricing of the given sovereign debt can be taken into account for calculation purposes. When these positions no longer meet the test of high correlation then they shall not be taken into account to offset short positions.

Nominal long positions of sovereign CDS shall be included in the calculation as short positions. In calculating an investor sovereign CDS position its net positions should be used (i.e. sales of CDS in the referenced sovereign counted as long positions). Positions intended to be covered or hedged through the purchase of a sovereign CDS that are not sovereign bonds (like any other assets, liabilities or any other kind of counterparty default risk) will not be taken into account as long positions.

The net short position is calculated then by netting nominal delta adjusted equivalent long and short positions in the issued sovereign debt of a Member State.

As for the issued sovereign debt of a sovereign issuer it is defined in article 2(1)(i) of the Regulation and means the total of sovereign debt issued by a sovereign issuer that has not been redeemed.

The net short position expressed as a percentage of the total issued sovereign debt of a sovereign issuer is then obtained by dividing the nominal net short position by the total issued sovereign debt of a sovereign issuer.

Calculation of positions needs to take into account changes in correlations and in the total sovereign debt of a sovereign issuer. Persons entering into short positions should be able to

calculate net position changes arising from any changes in correlations and total sovereign debt of a sovereign issuer.

Only long positions in debt instruments of a sovereign issuer of an EU Member State the pricing of which is highly correlated to the pricing of sovereign debt of an EU sovereign issuer shall be taken into account to offset short positions in highly correlated issued sovereign debt. A given long position of a highly correlated debt can only be used once to offset a short position in cases where the investor maintains several short positions of different sovereign issuers (the same amount of the long position cannot be applied several times to net off different short positions taken in highly correlated sovereign debt).

Investors with multiple allocations of long positions of highly correlated debt across several different sovereign issuers should be in a position to have records that show their allocation methods.

Assessment of IA need

ESMA technical advice recognises that there might be several appropriate methods of calculation of net short positions in relation to the issued sovereign debt of a sovereign issuer. However, the choice essentially comes down to whether to adopt a nominal model, as with shares, or a sensitivity adjusted method to take into account the fact that different issues of sovereign debt have different maturities.

The choice of the methods should be determined by whichever better meets the goal of the Regulation that notification of significant short positions shall provide important information to assist regulators in monitoring whether such positions are creating systemic risk or being used for abusive purposes. A further determining criterion is that the method selected should be straightforward and easy to apply for all market participants.

The advantages of using a sensitivity adjusted method are that it better reflects the fact that taking short positions in issues of different duration will have different market impacts – a short position in Treasury Bills will have less impact than an equivalent position in for example, 10 year bonds. Adjusting positions by "sensitivity" captures adequately the level of risk to changes in yields and the associate interest rate exposure in such circumstances. However, a sensitivity adjusted method is less useful than the nominal method in times of market stress and would inevitably entail more complexity in terms of calculation of positions.

<u>*Nominal model and general considerations*</u>

In contrast the nominal model offers great simplicity for calculation and might prove very useful when the market in debt instruments is mostly led by events other than interest rate risk (credit risk or distress situation). These are also the kind of situations when the knowledge of short positions becomes more important for regulators. ESMA's technical advice acknowledges that in normal market conditions the usefulness of the nominal information for supervisors is less relevant since it is difficult to grasp the kind of strategy that a market participant is carrying out without a measure of the impact on its position of a yield curve movement. ESMA is also aware that the nominal approach may have the disadvantage of not always accurately reflecting the nature of a position, in particular when it results from the aggregation of debt instruments of different maturities (e.g.: simultaneous sale of a 10 year maturity bond and purchase of a short term debt instrument).

Both methods therefore have their advantages and disadvantages and neither is perfect. The ideal solution might be to be able to apply the method which best suits the prevailing market conditions but ESMA's technical advice considers that such an approach may be difficult to reconcile with setting one standard around which market participants can design their

reporting systems. Taking into account that the purpose of Regulation is to assess the market impact that a net short position is able to produce as well as to obtain complete and accurate information about a person's position, ESMA considers that, on balance, concerning debt instruments, calculating and reporting net short positions in nominal terms better accomplishes both goals. In this respect positions taken in one part of the yield curve should not be given a greater weight than another.

Since ESMA's technical advice best ensures consistency wth the objectives of the level 1 Regulation and the Commission services propose to follow the technical advice of ESMA in relation to the methodology, it is not considered proportionate to submit this to further impact assessment.

- **Issue 5 – Method of calculation of long and short positions in shares and sovereign debt, and in uncovered CDS positions, for entities in a group and separate funds managed by the same fund manager (Article 3, paragraphs 3,4 and 5 and Article 4(1); implementing powers, Article 3, paragraph 7(c) and Article 4(2)b)**

The Regulation empowers the Commission to adopt delegated acts specifying the method of calculating short and long positions when different entities in a group have long or short positions or for fund management activities relating to separate funds.

Although under the Regulation the notification or disclosure requirements fall on the legal entity in relation to net short positions in shares or sovereign debt, the Regulation empowers the Commission to adopt delegated acts specifying the method of calculating the positions in two specific instances:

a. when different entities in a group have long or short positions;

b. for fund management activities related to separate funds.

In light of the requirements of the Regulation, ESMA's technical advice considers that the objectives are to achieve maximum transparency and avoid non-compliance with notification and disclosure requirements by:

a. concealing an otherwise notifiable or discloseable net short position by using a group structure; and/or

b. diluting an otherwise notifiable or discloseable net short position by allocating such a position through different entities within an organization or to different funds all of which are managed by the person which took the position.

The concept of investment strategy is foreseen in the Regulation under Article 3(7)(c) in order to cater for the specific cases to be considered in the method of calculation. An investment strategy that is pursued by an investor, regarding a particular issuer, is implemented by taking positions through transactions in various financial instruments issued by this particular issuer or that relates to that issuer. Ultimately, an investment strategy is either being long or short on a particular issuer.

ESMA's technical advice

In its draft technical advice ESMA issued for consultation, ESMA initially proposed a three-layer approach for funds and groups incorporating also reporting at the level of the "decision-maker". This was widely criticised as inappropriate by respondents to the ESMA consultation, mainly for reasons of administrative cost and inconsistency with the level 1 Regulation.

In light of the feedback received, ESMA considerably reviewed its approach with the objective to limit the complexity and to avoid (as much as possible) double counting of positions that are notified or disclosed. The concept of decision maker was abandoned by ESMA in its final technical advice.

ESMA's final technical advice is that there should be a differentiated approach for different legal entities within a group company on the one hand, and for separate funds managed by one fund management company. To take account of different investment strategies, these are defined as having either a net short or a net long position in an issuer.

For entities within a group, ESMA's final technical advice is that:

- each legal entity within the group with a notifiable or disclosable position would report it;
- the group company would then aggregate all the net short and long positions across all legal entities within the group, except those performing fund and/or portfolio management, and if the result of aggregation represents a notifiable net short position, this would be reported by the group.

For fund management activities related to several funds or managed portfolios, the ESMA final technical advice is in essence as follows:

- Each individual fund should calculate should calculate its net short positions, irrespective of its legal form, and for each managed portfolio;
- The fund management company should aggregate the net short positions of all the funds and portfolios under its management for which the same investment strategy is pursued in relation to a particular issuer; any resulting notifiable net short positions should be reported by the fund management company on their behalf.

Where different legal entities within a group have long or short positions in relation to a particular issuer, ESMA's final advice is as follows:

- Each legal entity within the group shall calculate its net short positions, and shall report (or the group on its behalf shall report) any notifiable net short position in a particular issuer;
- The net short and long positions of all legal entities within the group and of the group itself shall be aggregated and netted, with the exception of the positions of management entities that perform management activities. The group shall report any resulting notifiable net short positions.

<u>Reducing duplicative reporting of short positions</u>

A corollary of the approach outlined above for entities within a group, intended to limit the scope for avoidance of disclosure, is that the same net short position may be considered more than once in the calculation within a group. In order to address this concern ESMA's technical advice is that reporting should be carried out in the following way by entities within a group: where a legal entity crosses a reporting threshold and the group does not, the entity should report; if the group crosses a threshold and not the entity, the group should report; and if the group and legal entity cross a threshold at the same time the group should report on its position and also the position of the legal entity.

Assessment of IA need

In view of the limited room for different options left by the Regulation, which requires the Commission to construct the reporting regime in such a way as to limit the possibilities for circumvention of reporting on net short positions; and in view of the efforts made by ESMA to simplify its initial technical advice in response to comments by stakeholders, the Commission services propose to follow ESMA's technical advice and therefore do not deem it proportionate to subject this to further impact assessment.

- **Issue 6 – Cases in which a sovereign CDS is considered to be covered (Article 4, paragraph 1; implementing powers, Article 4, paragraph 2(a))**

Dealt with in detail in the body of the IA report

- **Issue 7 – Method of calculation of an uncovered CDS position (Article 4, paragraph 1; implementing powers, Article 4, paragraph 2(a))**

The Regulation empowers the Commission in a delegated act to specify the method of calculation of an uncovered position in a sovereign credit default swap.

ESMA advice

As regards calculating the value of the sovereign CDS position, it is necessary to decide whether the position should be the net one (i.e. deducting any sales by the position holder of the relevant sovereign CDS from the purchased CDS) or the gross. The argument in favour of using the net position is that if a market participant has sold protection via a CDS referencing a sovereign debt issuer, it is exposed to risk related to that sovereign issuer. It is reasonable to hedge its risk by purchasing sovereign CDS and to treat its own purchases as offsetting its sales (in the same way that a short position in shares offsets a long position and should be deducted in calculating the net position). The net approach would be consistent with the objective of the Regulation and the approach taken in relation to short positions in shares and sovereign debt. ESMA's technical advice is therefore that the net position is used.

How is the value of the assets/liabilities which the sovereign CDS is intended to hedge to be calculated? ESMA considers that there should be different methods for assessing the size of the risk position depending on the nature of the hedging strategy. For ‘static’ hedges dealing with default risk (e.g. where the sovereign CDS position is hedging against a direct exposure to the sovereign) the notional value of the assets/ liabilities would be a suitable choice as well as being easy to compute. The metric would be the straightforward jump to default measure (i.e. how much you would lose if the entity defaults).

However, sovereign CDS positions are also used to hedge dynamic risks (e.g. swap positions). Using the notional value of the assets/liabilities is not suitable for assets/liabilities which are explicitly market value adjusted. For these cases, using the notional values alone would not reflect the fact that the exposure of the position holder could increase during the lifetime of the contract (e.g. due to currency fluctuations). In addition, the value of an asset may be more (or less) volatile than the value of the sovereign debt referenced. So it would be reasonable to apply an adjustment factor to take into account the relative volatilities (risk adjusted values). Thus the CDS position could be risk adjusted (e.g. “beta-adjusted”) to translate this risk into the same terms as the risk associated with the assets and liabilities

which it is intended to hedge. For example, an asset valued at € 10m whose beta with the referenced sovereign debt is 1.2 could be hedged by a €12m CDS position. A sensitivity approach should be used in calculating the effect of the hedge as well as the sensitivity of the asset/liability. This makes calculations more complicated but provides that the value of the sovereign CDS position permitted is more closely tied to value of the hedged asset and reflects the purpose of the hedge.

How should indirect exposures (e.g. through indices, funds, etc.) be treated? Recital 21 explicitly makes clear that indirect exposures (through indices, funds, special purpose vehicles etc) should be taken into account when considering the assets/liabilities which a sovereign CDS is used to hedge. ESMA considers there is no sensible alternative here to taking those exposures into account in proportion to the extent that the reference asset/liability is represented in the index, fund etc.

Having calculated the value of portfolio of assets/ liabilities to be hedged (risk adjusted as appropriate), there would be an uncovered position if the value of the sovereign CDS position being used as the hedge exceeded this value.

In determining the size of an uncovered sovereign CDS position in circumstances where a competent authority has temporarily suspended the restriction on holding such positions, the value of the sovereign CDS position should be calculated on the same basis as that used for determining whether an investor holds a net short position in relation to the sovereign debt instruments of a sovereign issuer.

Assessment of IA need

ESMA did not modify its technical advice in this area since most of the proposals were supported by respondents.

In view of the limited room for different options left by the Regulation and the fact that the advice of ESMA is consistent with achieving the objectives of the Regulation, the Commission services propose to follow ESMA's technical advice and therefore do not consider it to be proportionate to subject this to further impact assessment.

- **Issue 8 – Notification thresholds for short positions in the debt of sovereign issuers which are EU Member States (Article 7, paragraphs 1 and 2; implementing powers, Article 7, paragraph 3)**

Dealt with in detail in the body of the IA report as issue 2.

- **Issue 9 – Notification thresholds for short positions in the debt of the EFSF/ESM, EIB and each of the German Länder (Article 7, paragraphs 1 and 2; implementing powers, Article 7, paragraph 3)**

The Regulation empowers the Commission in a delegated act to specify the relevant notification thresholds for short positions in sovereign debt in relation to each sovereign issuer. For the purposes of the Regulation, sovereign issuer includes the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM), the European Investment Bank (EIB) and the German Länder. ESMA shall publish on its website the notification thresholds.

The Commission is required to take into account certain criteria in doing so, namely to:

(a) ensure that the thresholds are not set at such a level as to require notification of positions which are of minimal value;

(b) take into account the total amount of outstanding issued sovereign debt for each sovereign issuer, and the average size of positions held by market participants relating to the sovereign debt of the sovereign issuer; and

(c) take into account the liquidity of each sovereign bond market.

ESMA's technical advice

ESMA's technical advice considers that two categories of percentage thresholds should be established for notifications of significant short positions in the debt of sovereign issuers: 0.1% and 0.5% of the outstanding sovereign debt. In the absence of data on the average size of positions held by market participants, ESMA's technical advice is that these categories should be established based on the following criteria:

a. An initial threshold of 0.1 % applicable where the total amount of the outstanding issued sovereign debt is 0 to 500 billion Euros;

b. A threshold of 0.5 % applicable where the total amount of the outstanding issued sovereign debt is above 500 billion Euros or where there is a liquid futures market.

The incremental levels would be:

a. each 0.05 % above the initial notification threshold of 0.1 % (0.15 %, 0.2 %, 0.25 % etc);

b. each 0.25 % above the initial threshold of 0.5 % (0.75 %, 1 %, 1.25 % etc).

Assessment of IA need

In light of ESMA's technical advice, the EFSF, ESM and EIB would be included in the 0.1% category, based on the size of their outstanding debt.

All the German Länder would be included in the 0.1% notification threshold category in light of the size of their outstanding debt (see Annex 4 for data on the outstanding debt of each of the German Länder).

In view of the limited scope for options on this aspect of the delegated act, their expected limited impact given that short selling of the debt of these sovereign issuers is likely to be limited, and the consistency of ESMA's technical advice with the Regulation, the Commission services propose to follow ESMA'S technical advice on this issue, and it is therefore not considered proportionate to submit this issue to further impact assessment.

- **Issue 10 – Calculation method for the liquidity threshold for a Member State to suspend restrictions on naked short selling of sovereign debt (Article 13, paragraph 3; implementing powers, Article 13, paragraph 4)**

Dealt with in detail in the body of the IA report as issue 3

- **Issue 11 – Determining thresholds for a significant price fall in financial instruments other than liquid shares (Article 23; implementing powers, Article 23, paragraph 7)**

Dealt with in detail in the body of the IA report as issue 4

- **Issue 12 – Cases which could constitute an adverse event or development (Articles 18 to 21, 27 and 28, paragraph 2(a); implementing powers, Article 30)**

The Regulation empowers the Commission in a delegated act to specify criteria and factors to be taken into account by the competent authorities and by ESMA in determining in which cases the adverse events or developments which can trigger action by the competent authorities or ESMA arise.

ESMA technical advice

ESMA considered the possibility of setting quantitative rather than qualitative criteria for competent authorities to take into account. However ESMA concluded that a very prescriptive and detailed list of quantitative events could lead to implementation problems regarding the restrictive measures. ESMA saw with quantitative criteria a risk of a deferred decision that may make them ineffective, and also feared that quantitative criteria may be perceived to be somehow misleading if market participants presume that ESMA or competent authorities would only act when these quantitative indicators or events are met. Consequently, ESMA's technical only proposes a non-exhaustive list of qualitative events or acts that might involve a serious threat to the financial stability, market confidence, orderly functioning and integrity of the markets in the EU.

The criteria proposed by ESMA's technical advice include, for example: any indication of serious financial instability or uncertainty concerning an EU Member State or of a systemically important financial institution operating within the EU; unsubstantiated rumours about a rating action regarding or the possibility of a default by any EU Member State or a systemically important financial institution operating within the EU; or substantial selling pressures and unusual volatility causing significant downward spirals in any financial instrument related to any EU systemically important financial institution operating within the EU and sovereign issuers as the case may be.

ESMA's technical advice is that the list of criteria and factors should be non-exhaustive and general. It should cover those situations which can cause risks and threats to financial stability without offering unlimited discretion for competent authorities and ESMA for taking action. However it is essential to make sure that competent authorities and ESMA can take steps before the risk situation spreads.

Assessment of IA need

Many respondents to ESMA's consultation decided not to comment on whether they agreed with the qualitative criteria proposed by ESMA. Nevertheless, most of the respondents who provided remarks generally agreed with the need for the competent authorities to have reasonable discretion to address the threats referred to in the document.

Since the criteria suggested above are only indicative and non-exhaustive, and are intended only to be taken into account by competent authorities; and since they have been mostly supported by stakeholders in the consultation, they are not deemed to have a significant impact and it is not considered proportionate to submit them to further impact assessment. The criteria proposed are in line with ESMA's final technical advice.

ANNEX 3 - SUMMARY OF ESMA CONSULATATION ON SHORT SELLING

ESMA held a public consultation on its draft technical advice on possible short selling delegated acts between 15 February and 9 March 2012. Responses to the public consultation on possible delegated acts were received from asset management firms, banks, investment firms, issuers, regulated markets and trading systems (see list below).

Summary of the responses

Some 41 contributions were received, of which 35 were authorised for publication, including 7 from regulated markets and trading systems, 2 from issuers, 20 from investors (banks, asset and pension management firms, investment services) and 6 from others (e.g. chamber of commerce, associations of market participants).

Contributions received from stakeholders varied in detail; most elaborated comments were provided by banks and associations representing market participants, mainly investment firms.

There was a fair degree of consistency in the responses.

Although there was general support for ESMA's draft technical advice, the following concerns were repeatedly raised:

- Most responses expressed the view that the period given for the consultation was far too short. According to the majority of the respondents, market participants had not been given enough time to prepare their responses and to properly assess the impact of ESMA's draft technical advice.

- On the calculation of short positions in sovereign debt the majority of responses argued that the quantitative test for high correlation was too restrictive. There was opposition especially for the level of correlation proposed, considering it too high, but also for the exclusive use of historical data as the basis of demonstrating high correlation.

- On the geographic restriction on the use of sovereign CDS for hedging many responses expressed their strong concerns. They argued that the ban on cross-country hedges represented a disproportionate restriction on the operation of the EU Single Market.

- On the uncovered sovereign CDS the majority of respondents welcomed the proposed qualitative approach to measuring correlation but felt that the requirement for historical data and for consistent significant correlation was inappropriate. Also the mandatory time limit within which CDS holders should offload a proportion of their position when it became partially uncovered was felt to inappropriate and needed readjustment.

- On the reporting of short or long positions for different entities in a group at various different levels, many responses argued that this requirement is unnecessary complex and impose significant compliance costs on firms. They proposed instead a disclosure obligation at either group or legal entity basis.

1. Ownership

There was general support for ESMA's draft technical advice on specification of the meaning of ownership, while expecting further harmonisation of the ownership concept through the upcoming Securities Law Directive. A small minority of respondents argued that the reference to ownership

under the respective "civil" or "securities laws" was too restrictive and might lead to confusion. The vast majority was also satisfied with the exclusions advised by ESMA. Further most responses argued that there was no need for more clarification on definitions of Art. 2(1) except for a specification for the definition of CDS and a request for a list of issuers considered to be sovereign issuers to be published by ESMA.

2. Holding

There was broad support for ESMA's specification of cases which constitute holding a short or long position. However some respondents expressed their opposition, considering an alignment of position calculation under the Transparency Directive with the Short Selling Regulation necessary. Although they recognised that the purpose of the legislative acts mentioned above was different, they considered a uniform approach appropriate. Further one respondent proposed to include also exclusivity lending arrangements and recalls in the definition of "holding" since they result in an enforceable claim to transfer ownership.

3. Having a net short position and method of calculation

Many responses expressed their opposition towards the method of calculation of sovereign debt short positions. They strongly disagreed with ESMA's proposal to adopt a quantitative measure in order to demonstrate that a debt instrument is "highly correlated" to the given sovereign debt. However, the majority of respondents noted that, if a quantitative threshold should be applied, this should be significant lower than 80-90% considering these levels inappropriate. Considering the question of measuring correlation based on a historical data of 24 months, most responses argued that this should only be one possible way to demonstrate correlation but not the only one. One respondent clearly stated that it had been unable to locate any examples where the suggestion correlation level had been fulfilled. They proposed to simplify the approach by requiring the investor to demonstrate that it was reasonable to expect future correlation. Some responses invited ESMA to clarify further its approach by publishing a list of sovereign issuers. Concerning the most appropriate calculation method for sovereign debt instruments, there was no common position among the respondents, with half of them expressing their support to the nominal method in order to increase simplicity and the other half considering the sensitivity-adjusted more appropriate.

There was broad support on the calculation method of positions for shares. The vast majority of respondents argued in favour of the delta adjusted method proposed by ESMA. However there was strong criticism for ESMA's position to exclude convertible bonds and subscription rights from being incorporated in the calculation of a long position. According to them, such exclusion would give an inaccurate market view of net short positions, resulting in an exaggerated disclosure of short position and harming thus market clarity.

4. Netting and aggregation

The vast majority of the respondents expressed their strong opposition to ESMA's draft technical advice concerning the reporting of short or long positions for different entities in a group. They considered the approach unnecessarily complex, requiring high organisational efforts and increasing the compliance costs while not adding much value. They underlined the inconsistency with the Regulation whose aim was to assess, through the disclosure of short positions, the economic exposure of an entity as a whole. Further, most of the respondents stressed the fact that this approach would result often in double reporting, obstructing effective market monitoring and impeding supervisors' work. They also expressed concerns that a detailed disclosure of short positions by individual fund

managers could be perceived as a negative firm opinion on a given company, while disclosure by the most influential managers could lead to market distortion. The majority of the respondents proposed thus to abandon this approach and report instead at a legal entity or group level.

On the definition of a group for the purpose of this Regulation, most respondents argued in favour of using the one under Article 2.1 of the Transparency Directive.

5. Uncovered CDS

There was broad support for ESMA's qualitative approach to the issue of uncovered CDS. However strong opposition was expressed about the imposition of a geographical limitation, the requirement of a "consistent" and "significant" correlation and the use of historical data as only basis of demonstrating correlation.

The vast majority of the respondents raised concerns about the prohibition of cross-border hedging. The respondents reasoned that the proposal ignored the multitude of sovereign debt examples in one Member State being correlated with assets in another. They argued that this limitation was not justified by the Regulation itself, narrowing the corresponding provision of Article 4 and Recital 21 of the Regulation. In their view, this ban represented a barrier to the Single Market and to the Treaty-based free movement of capital but would also discourage cross-border investment flows. Further, the geographical limitation was inconsistent with Article 375 of the Commission proposal on Capital Requirement Directive IV, which neither prohibited the use of proxy hedging nor the one of cross-country hedging.

On the indication that the correlation should be "significant" and "consistent", most responses expressed their disagreement, proposing the removal of these adjectives. In their view, the Regulation did not provide a mandate for any particular degree of correlation.

Concerning the exclusive use of historical data to prove correlation, the majority of the respondents were very sceptical. They claimed that the proposed correlation test was very difficult to implement and too narrow, as many cases exist, where factors other than the historical correlation may be better indicators. They stressed that from an investor perspective, future correlation was more important than the historical one, since CDSs are used for hedging future circumstances. Some of the respondents proposed to simplify the correlation test by considering a position as covered when the buyer is able to demonstrate it entered into the transaction on the basis of a good faith judgement.

On the issue of a position becoming partially uncovered due to market fluctuations, most responses argued that the position should be allowed indefinitely. They stated that a time limit would be disproportionate, since the positions in the above context resulted from market fluctuations and not from a desire to speculate, and that it would increase volatility in the markets. However some of the respondents were in favour of different time limits, proposing 10 days (as applicable under German law), 30 days, 3 months or "as soon as practicable".

There was broad support for the proposal to not consider a position, obtained involuntarily as a result of a central counterparty (CCP) clearing, as falling under the scope of the Regulation.

On the list of illustrative cases of a risk eligible to be hedged by a CDS positions, the majority of the respondents argued in favour of a non-exhaustive list, giving further examples to add in the list such as "trade finance exposures".

Concerning the use of net CDS position in the calculations, there was broad support for ESMA's draft technical advice; only two respondents suggested the use of beta-adjusted net CDSs positions.

6. Levels of the notification thresholds for sovereign debt position

The vast majority of the respondents did not have any comments on this issue. From the few responses received on that question, most supported the introduction of notification thresholds. However some expressed concerns about this policy choice, endorsing instead the use of fixed monetary amounts either per issuer or to be applied to all issuers. One respondent proposed the creation of a list of entities considered to be "sovereign issuers" to enhance clarity in the financial markets. Further, there was support for ESMA's draft technical advice to group sovereign issuers into categories for the purpose of setting the notification thresholds.

7. Liquidity thresholds

The vast majority of the respondents decided not to answer the questions related to liquidity thresholds. From the responses received on that issue, there was broad support for ESMA's approach in relation to the parameters and methods for calculating the liquidity thresholds of the sovereign debt. One respondent only requested the clarification that reaching the threshold would only give the right and not the obligation to suspend restrictions on short sales.

8. Significant fall in value

a. Illiquid shares

Most responses agreed with ESMA's draft technical advice to create three different threshold categories for illiquid shares. However strong opposition was raised concerning the percentages set for these categories. They argued that the percentages proposed, especially the 10% threshold for semi-liquid shares, were too low and may be triggered too frequently to be useful markers.

b. Sovereign bonds

There was broad support for ESMA's proposal to use an increase in the yield for the sovereign bonds. Criticism came mainly from 2 respondents, one arguing that it would be preferable to use a significant fall in value figure and the other suggesting the definition of different thresholds for different rating classes and maturities. However opposition was expressed concerning the percentage of yield increase, most of the respondents considering it too low.

c. Corporate bonds

The vast majority of respondents did not have any comments concerning this question. From the few responses received, 2 endorsed ESMA's approach and 2 argued that the percentage was too low and failed to represent a "significant" fall in price.

d. Money market instruments

There were only 2 responses raising this issue, one being in favour of ESMA's approach and the other against it.

e. UCITS

There was little response to this question. Most of those agreed with ESMA's approach while only one respondent argued in favour of applying this approach to both UCITS and UCITS which were ETFs. Concerning the question of a trigger threshold, the few responses received on that issue considered such a threshold inappropriate.

f. ETFs

Most responses, from the few received on this question, expressed their opposition to the percentage proposed arguing either that it was too high or that the same criteria should apply to ETF as for other stocks.

g. Options, futures, swaps, forward rate agreements and other derivative instruments

The majority of the responses argued that there was no need for measures for derivatives due to their specific nature, disagreeing thus with ESMA's proposal. Accepting though that a ban of derivatives' short selling falls also within the scope of the Regulation adopted, they required the competent authorities to undertake a balancing exercise to ensure that such a ban was proportionate in all circumstances. They argued further that one "catch-all" threshold, if the derivative was not centrally cleared and there was no underlying traded, was not appropriate.

9. Adverse events or threats

The majority of the respondents decided not to address this issue. Although there was broad support for the qualitative approach taken by ESMA, many respondents regretted the absence of clarity due to imprecise wording. They argued that the examples provided went too far and were too vague to be the basis for a competent authority decision. Broad criticism was expressed for the example of “unsubstantiated rumours” since it was difficult for an authority to determine when a rumour was substantiated or not. Further one respondent proposed the introduction of quantitative indicators to the list of qualitative factors.

List of contributors to public consultation

Regulated markets, exchanges & trading systems – Total 7

BME - Spanish Exchanges

Deutsche Börse Group

FESE

ICE Futures Europe and ICE Clear Europe

London Stock Exchange Group

London Metal Exchange

NYSE Euronext

Investors and Associated Bodies – Total 24

AFME ICMA ISDA ISLA Joint Submission

AIMA

Allianz SE

Association française des marchés financiers (AMAFI)

Association of British Insurers

Assogestioni

Assosim

Bank of America Merrill Lynch

BlackRock

Bundesverband Investment und Asset Management (BVI)

CNMV Advisory Committee

Deutsche Bank

EFAMA

Euroclear S.A

European Banking Federation (EBF)

German Banking Industry Committee

Hedge Funds Standards Board

Intesa Sanpaolo

Investment Management Association

Managed Funds Association

State Street Corporation

Swedish Securities Dealers Association

The Royal Bank of Scotland Group

UBS AG

Issuers – Total 2

Deutsches Aktieninstitut e.V

SIEMENS AG

Others – Total 2

AmCham EU

City of London Law Society Company Law Committee

ANNEX 4 - SOVEREIGN DEBT OUTSTANDING AND RELATIVE THRESHOLDS

Total Debt Outstanding end of 2010	Euro	Alternative percentage thresholds					
		0,025%	0,050%	0,100%	0,250%	0,500%	1,000%
Estonia	0	0	0	0	0	0	0
Latvia	1 932 000 000	483 000	966 000	1 932 000	4 830 000	9 660 000	19 320 000
Bulgaria	3 647 000 000	911 750	1 823 500	3 647 000	9 117 500	18 235 000	36 470 000
Malta	3 989 000 000	997 250	1 994 500	3 989 000	9 972 500	19 945 000	39 890 000
Luxembourg	4 000 000 000	1 000 000	2 000 000	4 000 000	10 000 000	20 000 000	40 000 000
Cyprus	7 833 000 000	1 958 250	3 916 500	7 833 000	19 582 500	39 165 000	78 330 000
Lithuania	8 721 000 000	2 180 250	4 360 500	8 721 000	21 802 500	43 605 000	87 210 000
Slovenia	11 741 000 000	2 935 250	5 870 500	11 741 000	29 352 500	58 705 000	117 410 000
Romania	18 012 000 000	4 503 000	9 006 000	18 012 000	45 030 000	90 060 000	180 120 000
Slovakia	25 749 000 000	6 437 250	12 874 500	25 749 000	64 372 500	128 745 000	257 490 000
Czech Republic	53 634 000 000	13 408 500	26 817 000	53 634 000	134 085 000	268 170 000	536 340 000
Hungary	71 896 000 000	17 974 000	35 948 000	71 896 000	179 740 000	359 480 000	718 960 000
Finland	75 152 000 000	18 788 000	37 576 000	75 152 000	187 880 000	375 760 000	751 520 000
Denmark	92 647 000 000	23 161 750	46 323 500	92 647 000	231 617 500	463 235 000	926 470 000
Ireland	93 498 000 000	23 374 500	46 749 000	93 498 000	233 745 000	467 490 000	934 980 000
Sweden	128 000 000 000	32 000 000	64 000 000	128 000 000	320 000 000	640 000 000	1 280 000 000
Portugal	151 775 000 000	37 943 750	75 887 500	151 775 000	379 437 500	758 875 000	1 517 750 000
Austria	162 956 000 000	40 739 000	81 478 000	162 956 000	407 390 000	814 780 000	1 629 560 000
Poland	167 273 000 000	41 818 250	83 636 500	167 273 000	418 182 500	836 365 000	1 672 730 000
Greece	286 455 000 000	71 613 750	143 227 500	286 455 000	716 137 500	1 432 275 000	2 864 550 000
Netherlands	306 470 000 000	76 617 500	153 235 000	306 470 000	766 175 000	1 532 350 000	3 064 700 000
Belgium	341 192 000 000	85 298 000	170 596 000	341 192 000	852 980 000	1 705 960 000	3 411 920 000
Spain	540 639 000 000	135 159 750	270 319 500	540 639 000	1 351 597 500	2 703 195 000	5 406 390 000
Germany	1 065 252 000 000	266 313 000	532 626 000	1 065 252 000	2 663 130 000	5 326 260 000	10 652 520 000
France	1 228 971 000 000	307 242 750	614 485 500	1 228 971 000	3 072 427 500	6 144 855 000	12 289 710 000
United Kingdom	1 257 308 000 000	314 327 000	628 654 000	1 257 308 000	3 143 270 000	6 286 540 000	12 573 080 000
Italy	1 526 334 000 000	381 583 500	763 167 000	1 526 334 000	3 815 835 000	7 631 670 000	15 263 340 000

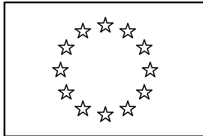
Source: Responses from members of the EFC - Sub-Commitee on EU Government Bonds and Bills Markets (2011)

ANNEX 5 - OUTSTANDING DEBT OF GERMAN FEDERAL STATES.

German federal states		Alternative percentage thresholds						
	Total Debt Outstanding (in €)	0,010%	0,025%	0,050%	0,100%	0,250%	0,500%	1,000%
Berlin, State of	37 175 696 652	3 717 570	9 293 924	18 587 848	37 175 697	92 939 242	185 878 483	371 756 967
Hessen, State of (Hesse, State of)	27 306 526 720	2 730 653	6 826 632	13 653 263	27 306 527	68 266 317	136 532 634	273 065 267
Hamburg, State of (Freie und Hansestadt Hamburg)	4 984 108 212	498 411	1 246 027	2 492 054	4 984 108	12 460 271	24 920 541	49 841 082
Rheinland-Pfalz, State of	19 413 851 726	1 941 385	4 853 463	9 706 926	19 413 852	48 534 629	97 069 259	194 138 517
Baden-Wuerttemberg, State of	17 053 736 418	1 705 374	4 263 434	8 526 868	17 053 736	42 634 341	85 268 682	170 537 364
Saarland, State of	1 497 523 838	149 752	374 381	748 762	1 497 524	3 743 810	7 487 619	14 975 238
Schleswig-Holstein, State of	8 498 780 398	849 878	2 124 695	4 249 390	8 498 780	21 246 951	42 493 902	84 987 804
Thuringen, State of	2 295 809 003	229 581	573 952	1 147 905	2 295 809	5 739 523	11 479 045	22 958 090
North Rhine-Westphalia, State of (Nordrhein-Westfalen)	78 320 644 541	7 832 064	19 580 161	39 160 322	78 320 645	195 801 611	391 603 223	783 206 445
Bavaria, State of (Bayern)	10 147 091 433	1 014 709	2 536 773	5 073 546	10 147 091	25 367 729	50 735 457	101 470 914
Brandenburg, State of	10 682 238 155	1 068 224	2 670 560	5 341 119	10 682 238	26 705 595	53 411 191	106 822 382
Lower Saxony, State of (Niedersachsen)	30 740 631 237	3 074 063	7 685 158	15 370 316	30 740 631	76 851 578	153 703 156	307 406 312
Bremen, State of	1 996 452 066	199 645	499 113	998 226	1 996 452	4 991 130	9 982 260	19 964 521
Saxony, State of (Sachsen-Freistaat)	929 854 387	92 985	232 464	464 927	929 854	2 324 636	4 649 272	9 298 544
Saxony-Anhalt, State of (Sachsen-Anhalt)	11 153 817 725	1 115 382	2 788 454	5 576 909	11 153 818	27 884 544	55 769 089	111 538 177
Mecklenburg-Vorpommern	0	0	0	0	0	0	0	0
Sum of all federal states	1 382 392 638 037	138 239 264	345 598 160	691 196 319	1 382 392 638	3 455 981 595	6 911 963 190	13 823 926 380
								0
Germany, Federal Republic of	1 107 000 000 000	110 700 000	276 750 000	553 500 000	1 107 000 000	2 767 500 000	5 535 000 000	11 070 000 000

Source: ESMA technical advice

ANNEX 6 - EXECUTIVE SUMMARY OF SHORT SELLING REGULATION IMPACT ASSESSMENT



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels,
SEC(2010)

COMMISSION STAFF WORKING DOCUMENT

accompanying the

Proposal for a

REGULATION

ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS

SUMMARY OF THE IMPACT ASSESSMENT

{COM(2010) xxx}
{SEC(2010) xxx}

1. PROBLEM DEFINITION

At the height of the financial crisis in autumn 2008, competent authorities in the United States and several EU Member States adopted exceptional measures to restrict or ban short selling in some or all shares. They acted due to concerns that at a time of considerable financial instability, short selling was aggravating the downward spiral in the prices of shares, notably in financial institutions, in a way which could ultimately threaten their viability and create systemic risks. The measures adopted by Member States were divergent as the European Union lacks a specific legislative framework for dealing with short selling issues.

In March 2010, concerns were expressed by some governments also about the possible role played by derivative transactions, notably Credit Default Swaps (CDS), in relation to the prices for Greek sovereign bonds. A number of Member States have adopted temporary or permanent restrictions at national level on short selling and CDS.

Short selling is the sale of a security that the seller does not own, with the intention of buying back an identical security at a later point in time to be able to deliver the security. It can be divided into two types: "covered" short selling where the seller has made arrangements to borrow the securities before the sale and "naked" short selling where the seller has not borrowed the securities when the short sale occurs. In addition to short selling on cash markets, a net short position can also be achieved by the use of derivatives, whether they are traded on exchanges or over-the-counter (OTC).

A Credit Default Swap (CDS) is a derivative which acts as a form of insurance against the risk of credit default of a corporate or a government. In return for an annual premium, the buyer of a CDS is protected against the risk of default of a given reference entity by the seller. If the reference entity defaults, the protection seller pays the buyer the par value of the instrument in exchange for physical delivery of the reference instrument, although settlement may also be by cash.

Risk of negative price spirals

Short selling can lead to more efficient price formation by preventing the prices of securities from reflecting only the views of the most optimistic investors. However, especially in distressed markets when financial confidence is lacking, there is a risk of short selling creating the impression that there is more supply on the market than there really is, and thereby inciting others to sell ('herding behaviour'). This can lead to excessive downward pressure on the price of securities. The risk of negative price spirals becoming self-fulfilling, which can lead to disorderly markets and even systemic risks, is the main concern of regulators with regard to short selling.

In addition to short selling on cash markets, derivative transactions such as CDS can also be used to secure an economic short position. Buying a CDS without holding an underlying insurable interest ('naked CDS') is economically equivalent to short selling a bond, as the buyer benefits if the price of the CDS goes up. Several governments and regulators in Europe have expressed concerns with regard to CDS

and their interaction with bond markets, and the fear that this could cause mispricing on bond markets and thus higher funding costs for governments.

Risk of settlement failure associated with naked short selling

The risk of the short seller failing to deliver the shares to the buyer by the settlement date, as well as a risk of increased price volatility, are the main risks associated by some regulators with naked short selling. Data on settlement failures is very limited, but suggests low levels in Europe. A majority of regulators said either that they have little experience of naked short selling or of related settlement problems, or that the risks were limited and could be addressed by settlement discipline. However, some regulators do perceive a risk of settlement failure, as well as a greater risk of increased price volatility, with naked short selling which should be addressed. These regulators expressed concern that in extreme cases naked short selling can put enormous pressure on share prices, which can endanger the stability of the financial system. This is because naked short selling enables the seller to sell, in principle, an unlimited number of shares in a very short space of time as they do not have to first borrow or locate the shares.

Transparency deficiencies

In most EU Member States there are currently no disclosure requirements for short selling or CDS transactions, so these Member States have no direct access to data on the short positions held in their jurisdictions; although as a result of the financial crisis, a number of Member States have introduced different short selling disclosure requirements. Regulators have expressed concern that this situation makes it difficult for them to detect the build-up of positions which could have implications for the stability of markets. Disclosure to the regulator could help regulators to identify when this is occurring, and deter aggressive strategies which could contribute to disorderly markets.

There is also a risk of information asymmetries between informed short sellers and other less informed market participants. Disclosure to the market provides information to other market participants about the price movements which short sellers expect and this could improve the efficiency of price discovery. Transparency to the market would also ensure that more information about the opinions that investors hold on a particular security would be made available to all investors

Concern has also been expressed by some regulators that speculators may be driving down the prices of government bonds by using Credit Default Swaps (CDS). The concern of these regulators is that in the absence of information about sovereign derivative and bond transactions it is more difficult for them to detect the build-up of positions which could cause financial instability, as well as possible market abuse.

Regulatory arbitrage and increased compliance costs

The fragmented responses of Member States to issues relating to short selling leave scope for regulatory arbitrage, as investors could seek to circumvent restrictions in one jurisdiction by carrying out transactions in another. This regulatory fragmentation could also lead to increased compliance costs for market participants,

especially those operating on several markets, who would have to set up different systems to comply with different requirements in different Member States.

2. THE BASELINE SCENARIO AND SUBSIDIARITY

If no action is taken at EU level the problems defined above are likely to remain without a coordinated response and to occur again in the future. The European Commission considers that the solutions proposed respect the principle of subsidiarity. First, because there is a real risk of national responses to short selling and CDS being circumvented or ineffective in the absence of EU level action. Second, such uncoordinated measures are also more costly to market participants. Finally, certain aspects of this issue are already partly covered by the *acquis*, notably: the Market Abuse Directive, the Transparency Directive, and the Markets in Financial Instruments Directive. Therefore a proposal on short selling and these existing legal instruments should complement each other.

3. OBJECTIVES

In light of the analysis of the risks and problems above, the general objectives of the legislative proposal on short selling are to reduce the risks to financial stability, systemic risks and risks to market integrity arising from short selling and to prevent market fragmentation, thereby increasing the efficiency of the internal market. .

Reaching these general objectives requires the realisation of the following more specific policy objectives:

Reduce the risks of negative price spirals arising from short positions (including those obtained through CDS)

Increase the transparency of short positions (including those obtained through CDS);

Reduce settlement risk linked with 'naked' short selling; and

Reduce the scope for regulatory arbitrage and compliance costs.

4. POLICY OPTIONS

The policy options are grouped according to the operational objectives which flow from the above-mentioned specific objectives.

Policy options to ensure regulators have clear power to restrict or ban short selling or CDS in distressed markets

Option 1 – take no action at EU level.

Option 2 – introduce a power for national competent authorities to temporarily restrict short selling in a financial instrument admitted to trading on an organised market whose price has fallen by a specified quantitative threshold, e.g. 10% ('circuit breaker').

Option 3 – introduce a rule that prohibits short selling of a financial instrument admitted to trading on an organised market except at a price above the last traded price of the instrument, or at the last traded price if that price was higher than the price in the previous trade (an 'uptick rule').

Option 4 - introduce a ban on 'naked CDS' (i.e. entering into a CDS contract without having an underlying insurable interest). Compatible with 2 and 3.

Option 5 – grant national competent authorities the power to temporarily restrict or ban short selling of some or all financial instruments or CDS transactions in exceptional situations, with coordination by ESMA in accordance with article 6a(5) of Regulation ??/EC establishing ESMA, and without prejudice to ESMA's powers under article 10 of this Regulation. Compatible with 2, 3 and 4.

Option 6 – introduce a permanent ban on short selling of all financial instruments capable of being sold short. Compatible with 4.

Option 7 - introduce permanent restrictions or ban on CDS. Compatible with 2, 3 and 6.

Policy options to ensure regulators and markets obtain data on short positions (including through CDS).

(1) Option 1 - take no action at EU level

Option 2 - introduce a system of flagging of short sale transactions so that regulators can identify which transactions are 'long' and which are 'short'.

Option 3 - notification of short positions to the regulator. Compatible with 2.

Option 4 - disclosure of short positions to the public. Compatible with 2 and 3.

Option 5 - aggregated disclosure of short positions (i.e. individual short positions of investors are not disclosed). Compatible with 2, 3 and 4.

Option 6 - disclosure of individual significant net short positions. Compatible with 2, 3 and 4.

Option 7 - exemption from disclosure requirements for market making activities and certain primary market operations. Compatible with 2-6.

Policy options to ensure certain requirements at the point of trading and strengthen settlement discipline

(1) Option 1 - take no action at EU level.

(2) Option 2 - introduce a requirement that before entering into a short sale, a person must have borrowed the share, entered into an agreement to borrow the share or have other arrangements which ensure that he will be able to borrow the share at the time of settlement (locate rule)

(3) Option 3 – introduce EU rules on settlement discipline so that persons engaging in short sales which result in a failure to deliver face appropriate penalties, with buy-in procedures and fines in case of settlement failures. Compatible with 2.

(4) Option 4 - introduce a ban on naked short selling

(5) Option 5 - exemption for market making activities and certain primary market operations. Compatible with 2, 3 and 4.

Policy options to ensure a coordinated response by EU member states to short selling and CDS

This objective should be met by the above three categories of targeted options. In addition, the choice of legal instrument should also aim to ensure coordinated national responses.

5. ASSESSMENT AND COMPARISON OF THE OPTIONS

The different policy options were tested against the criteria of their effectiveness and efficiency in achieving the related objectives. The comparison of policy options lead to the following conclusions:

Clear powers: the preferred option is a combination of option 5 (emergency powers), and option 2 (circuit breaker). A combination of the two options would give regulators an instrument to impose a short term ban on short selling on organised markets in the event of a significant price decline as well as the possibility to impose a temporary ban of a longer duration, capturing derivatives as well, in the event of an exceptional situation.

Transparency: the preferred option is a combination of options 2, 3, 4, 6 and 7. By combining options 3 and 4, the objective of transparency for both regulators and the market would be achieved fully. In addition, a higher threshold for notification to the market would mitigate any impact on liquidity, while ensuring that regulators obtain the data they require. Option 6 (individual disclosure) should also be part of the preferred option, as it meets the objectives more fully by providing the market with more detailed transparency. Option 2 (flagging) would complement disclosure very effectively by providing regulators with real time data on all short positions, thereby capturing intraday positions and helping regulators with enforcement. Finally, option 7 (market making and primary market operations exemption) would ensure that the important liquidity provision function of these activities would be able to continue, which would mitigate any potential impact on liquidity of disclosure.

Settlement discipline: the preferred option is a combination of options 2, 3 and 5. If options 2 and 3 were combined, settlement discipline would be reinforced both by requirements at the point of trading and by buy-in procedures and fines, thereby meeting very effectively the related operational objective. By combining option 5 with options 2 and 3, the potential negative impact on liquidity would be mitigated by a harmonised exemption for market making, and so would the

potential for regulatory arbitrage and compliance costs associated with different exemptions across the EU.

Coordinated response: non-legislative cooperation is discarded because it would not provide an effective solution to uncoordinated national actions leaving scope for regulatory arbitrage and higher compliance costs. A Regulation should be preferred to a Directive as it is immediately applicable, would ensure uniform rules throughout the EU and those concerned by its provisions would be able to depend on them immediately.

6. IMPACTS OF THE PREFERRED OPTIONS

	Impact on stakeholders	Effectiveness	Efficiency
Options 2 + 5 **(circuit breaker and powers in exceptional situations)**	*(+++) regulators gain powers to ban short selling/CDS in exceptional situations and short term* *(+++) issuers' share price can be supported by a temporary ban on short selling in distressed markets* *(0) governments: reduced volatility on sovereign bond markets, but risk of negative effects on liquidity* *(- -) financial institutions may be temporarily restricted from short selling & face compliance costs*	*(+++) achieves objective 1 fully* *(+++) Objective 4: fully met* *(+++) avoids unduly negative effects on market efficiency*	*(-) reduced compliance costs due to coordinated EU approach; any effect on liquidity temporary*
Options 2+ 3 + 4 +6 + 7 **(flagging, notification to regulator and disclosure to market of individual net short positions, with exemption for market makers and primary market dealers)**	*(+++) regulators: full transparency on short positions* *(+++) issuers: access to data on significant short positions and full benefit of liquidity provided by market makers* *(+++) individual investors: information asymmetries eliminated and liquidity provided by market makers maintained* *(+++) governments: liquidity in sovereign bonds not impaired* *(-) financial institutions: compliance costs and likely to reduce short selling to avoid disclosure to public, but can continue market making activities*	*(+++) Objective 2:fully met* *(+++) Objective 4: fully met* *(++) limits unduly negative effects on market efficiency*	*(-) ongoing compliance costs; impact on market liquidity mitigated by thresholds and exemption*
Options 2+3+5 **(locate rule, and settlement discipline with exemption for market makers and primary market dealers)**	*(+++) regulators can sanction naked short selling* *(+++) issuers: number of shares sold short cannot exceed the number issued or available to borrow, liquidity not impaired due to market maker exemption* *(+++) governments: number of government bonds sold short cannot exceed the number issued or available to borrow, liquidity not impaired due to market maker exemption* *(+) some financial institutions may have to adapt their compliance systems, but market making exempt*	*(++) Objective of reducing settlement risk achieved by rules at the point of trading and settlement discipline* *(+++) Objective 4: met in full* *(+) Contributes to reducing risk of negative price spirals*	*(-) some ongoing compliance costs although many already operate locate rule; impact on liquidity mitigated by market maker exemption*

7. MONITORING AND EVALUATION

The Commission will monitor how Member States are applying the changes proposed in the legislative initiative on short selling. The evaluation of the legislative

measure could take place three to five years after its entry into force, in the context of a report to the Council and the Parliament on the appropriateness of the reporting and public disclosure thresholds.

ANNEX 7 - OBJECTIVES AS SET OUT IN SHORT SELLING REGULATION IMPACT ASSSESSMENT

In light of the analysis of the problem in the Short Selling Regulation impact assessment, the Commission set the following general objectives for the Regulation:

1. Prevent market fragmentation, thereby increasing the efficiency of the internal market.
2. Reduce systemic risks;
3. Reduce the risks to financial stability;
4. Reduce risks to market integrity arising from short selling; and
5. Reduce the scope for regulatory arbitrage and compliance costs.

As set out in the Level 1 Impact assessment, these can then be divided into the following specific and operational policy objectives:

Specific policy objectives

1. Reduce the risks of negative price spirals arising from short positions (including those obtained through CDS);
2. Increase the transparency of short positions (including those obtained through CDS);
3. Reduce settlement risk linked with 'naked' short selling; and
4. Reduce the scope for regulatory arbitrage and compliance costs.

Operational objectives

1. Ensure regulators have clear power to restrict or ban short selling or CDS in distressed markets;
2. Ensure that regulators and markets obtain data on short positions (including through CDS);
3. Ensure certain requirements are introduced at the point of trading and strengthen settlement discipline;
4. Ensure a coordinated response by EU Member States to short selling and CDS.