FESE Response to ESMA Consultation Paper on the draft technical advice on possible Delegated Acts concerning the regulation short selling and certain aspects of credit default swaps – ESMA/2012/98

1. Introduction

The Federation of European Securities Exchanges (FESE) represents 46 exchanges active in equities, bonds, derivatives and commodities through 21 full members from 30 countries, as well as 7 observer members from European emerging markets. FESE is a keen defender of cross-border competition and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE members operate Regulated Markets (RMs), which provide both institutional and retail investors with transparent and neutral price-formation.

FESE members are glad to have the opportunity to contribute to ESMA's consultation. FESE supports efficient, fair, orderly and transparent financial markets that meet the needs of well protected and informed investors and provide a source for companies where to raise capital.

Below you will find our response to some of the questions included in the consultation.

2. Response to Consultation Questions

VI. Specification of what constitutes a significant fall in value for financial instruments other than liquid shares and draft regulatory standard on the method for calculating the fall (Article 23)

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.
Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward rate agreement or other derivative instrument, including financial contracts for difference? If not, what alternative would you propose?
Q53: What could be an appropriate threshold to define a significant fall in price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

Response to Q51 and 52

One would assume that if an authority applies the short selling restriction foreseen in the legislation to any asset, it would do so also for any related derivative instrument. Therefore, FESE believes there is no need for specific measures for derivatives. Derivatives prices are arbitrage and will not significantly move away from the equilibrium, meaning that it would be ridiculous to suspend the trading of futures contracts based on an excessive fall of the futures price if the underlying asset has not fallen.

Since we understand however that these measures are already set in level 1 of the legislation, we believe that price variation will not be the correct indicator for non delta-1 instruments. The price of options is the premium, the premium is more volatile due to the features of the instrument (not due to a higher response to political or economical events). What would need to change dramatically is

the volatility implicit in the option premium. We note however that this has no link to short selling if the underlying asset price has not fallen significantly.

Important comment on the proposed measures for derivatives

FESE believes that while the proposal in article 23 could work for shares and fixed income, it poses a problem for derivatives markets because of their specific nature. In commodity derivatives short selling contributes to more efficient price discovery and increases liquidity, which in turn facilitates hedging and risk management by market users. For some in the physical market short selling is an essential part of trading on commodity futures markets (see Annex I for an example of the importance and functioning of short selling for commodity markets through an example of the London Metal Exchange).

Please note that FESE does not call for an exemption from the regulation, but rather an understanding of the effect of a short selling ban on the derivatives market.

What do you we propose?

Since the text of the proposal cannot be changed at this point, we propose the following:

- The provisions of article 23 should take into account the specificities of derivatives markets. They should only be applied on a 'comply or explain' basis, after the competent authority has analysed the reasons for the significant fall in price, which could be very diverse and understandable based on market fundamentals.
- Competent authorities should be granted adequate mechanisms to analyse these significant price falls.

Annex I – Example of the importance and functioning of short selling for commodity markets through an example of the London Metal Exchange

The most graphic illustration of this is that selling short on the LME is the natural strategy for a producer of metal who wants to hedge against his price risk. Below is an example:-

- A Chilean copper producer selling 100 tonnes of copper to a European copper consumer for delivery in six months time will agree to sell at the average of the LME cash settlement copper price published during the month of delivery plus whatever premium is agreed between the seller and the buyer.
- This means that the seller and the buyer do not know the exact price that will be paid on delivery. However, the LME copper settlement dates go out to ten years into the future. At the time that the deal is struck the LME will be publishing trading prices for LME copper futures for settlement dates from cash (i.e. two days forward) out to ten years.
- If the copper producer is concerned that the copper price may drop in the next six months he can lock in the current LME future price for six months forward by selling 100 tonnes of six-month LME copper futures contracts. This is an uncovered short: the copper producer will not want to deliver his copper against his LME copper futures contracts because he is contractually obliged to deliver the copper to his European customer.
- The copper producer will close out his price hedge on the LME by buying 100 tonnes of LME copper futures for the same settlement date before his LME copper futures sale contracts expire.
- Similarly, if the European copper consumer is concerned that the copper price will rise during the next six months he can buy six-month LME copper futures contracts with the intention of closing out that price-hedge before it expires. He will equally not want to take delivery of the copper from his LME copper futures because he is already contractually bound to pay the copper producer for 100 tonnes of copper.
- The copper producer and the copper consumer agree to buy and sell copper for six months time on the basis of the average of the LME cash settlement copper price at the time of delivery because it allows each of them to manage their price risk during that six month period. Both may choose to hedge or neither may choose to hedge depending on their perception of their price risk.

LME contracts are based on physical settlement by the transfer of ownership of metal stored in licensed warehouses because this guarantees price convergence as the far futures settlement dates converge on the cash settlement date (i.e. two days from the trade date). The ability to make or take delivery of metal against an LME futures contract on the settlement date means that any divergence between the LME settlement price and the physical metal price can be easily closed. For example, 60% of world production of Grade A copper is good delivery against the LME copper futures contract.

Making delivery of metal into LME listed warehouses and taking delivery of metal from LME listed warehouses is a last resort for the physical producers and consumers of metal. Increases in LME metal stocks are a sign of oversupply in the physical metals markets and decreases in LME metal stocks are a sign of undersupply in the physical metals markets. Large volumes of metal move through LME listed warehouses as a reflection of general changes in supply and demand and also differences in supply and demand between Europe, Asia and North America.