FESE Response to ESMA Consultation Paper on the draft technical standards on the Regulation of the European Parliament and of the Council on short selling and certain aspects of credit default swaps – ESMA/2012/30

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. Our response is structured as follows:

- **Response to Consultation Questions**. Please note that we focus exclusively on **sections: II, V and VI.IV.**
- **Additional remarks on specific articles not referred to in the consultation**

2. Response to Consultation Questions

2.1. Agreements, arrangements and measures that adequately ensure that the share or the sovereign debt will be available for settlement (Section II of the consultation)

Q1: Do you agree with the approach of providing an exhaustive list of types of agreement, arrangement and measure that adequately ensure shares or sovereign debt instruments will be available for settlement and setting out the criteria these should fulfil?

We agree with the need to have some guidance for the agreements, arrangements and measures that adequately ensure the instruments whose features are foreseen in articles 12.1 (b) and 13.1 (b) of the proposal for the regulation will be available for settlement. We believe that an indicative list would be helpful. If the list is made exhaustive it would have to be updated on a regular basis to cater for market developments like technological innovation.

We think that that point *f* of the list *"Other claims or agreements leading to physicals exchanges of the shares or sovereign debt"* provides regulators and market participants with an adequate degree of flexibility. However, it may be beneficial to further clarify this point so that the arrangements proposed do ensure that instruments are available for settlement. A failure to do this could be against the objective and spirit of this piece of legislation and would pose additional risk to the financial system. Because of the above, we would advocate that article 5.1 (f) of the ESMA Draft Implementing Standards would be modified accordingly to ensure adequate levels of safety and risk control are guaranteed.

Q2: Do you agree with the proposed list of agreements and enforceable claims and the criteria they should meet? Are there any types of agreements or enforceable claims or criteria which should be added?

As stated above, we believe that point *f* of the list *"Other claims or agreements leading to physicals exchanges of the shares or sovereign debt"* provides regulators and market participants with the desired degree of flexibility.

We do not think that futures and options generally represent an adequate agreement to borrow or other enforceable claim for uncovered short sales. Futures and options typically have a medium to long-term duration (months or years) that largely exceeds that of a naked short sale (some days). Therefore we do not think that futures and options should be part of the list proposed by ESMA. However, we believe that that American-style options (i.e., one that can be exercised at anytime during its life), because of its very nature, should be given due consideration as part of the list of "agreements to borrow or other enforceable claim (…)" proposed by ESMA.

Q4: Do you agree with the proposed list of third parties which may be parties to the arrangements or measures and the criteria proposed by ESMA that they should fulfil?

We believe that Regulated Markets (and more generally trading venues) should not be included on the list of third parties which may be parties to the arrangements or measures to confirm that settlement will take place. Regulated Markets serve as the neutral and transparent platform where buyers and sellers meet to execute transactions in financial instruments. Regulated Markets do not trade on its own account nor do they have any stocks at their disposal to confirm that settlement will take place on a short sale transaction. We believe the responsibility to confirm that settlement of a short sale transaction will take place should lie on the investment firm that accepts to initiate the transaction on its own account or on behalf of an investor, rather than on the venue that merely executes it in a transparent, neutral and non-discriminatory manner.

Q6: Does the fact that a third party should be a distinct legal entity from the entity entering into the short sale entail costs? If so please provide estimates of those costs.

FESE Members consider that the benefits of this proposal are very limited. In line with current market practice, most trading desks rely on in-house resources to ensure the most optimal stock lending arrangement for investors. A failure to provide this service would increase drastically investment costs without producing any obvious benefit for the investor or the market as a whole. Therefore, we believe that ESMA should not interpret the requirement for a third party too strictly. Where trading desks rely on in-house resources, however, certain guarantees need to be ensured (i.e. not to use client assets without permission, not to use the same instrument several times, etc). Instruments made available for stock lending should be part of the firm's own instruments or be made available under the prior consent of the respective holders.

Q7: Do you agree with the approach proposed by ESMA on the standard/same day/liquid shares locate confirmation arrangements and measures and the criteria that they must fulfil?

We agree with the overall approach proposed by ESMA. We particularly welcome the arrangements and measures to be taken in relation to shares included in Article 6.1.b for Standard Same Day Locate. We have some concerns however with article 6.1.b.iv which requires that 'when executed short sales are not covered by purchases in the same day, a prompt instruction is sent by the investor to the third party to procure the shares to cover the short sale to ensure settlement in due time'. Regulated Markets have

different arrangements in place to ensure that such an instruction in the event of failure is not needed. As an example, the German short selling ban foresees flexibility and ensures settlement efficiency[1]. The German ban has shown to be effective (high settlement efficiency). Hence we believe that Article 6.1.b.iv should be removed from the proposal.

Q8: In circumstances other than intraday short selling or short selling on liquid shares, can you suggest any additions to the methods for effective allocation set out in this consultation paper which would provide the necessary comfort that shares can be delivered for settlement in due time?

FESE members consider that the methods for effective allocation set out in this consultation are adequate.

2.2. Information to be provided to ESMA by competent authorities (Section V)

FESE Members suggest that the information to be provided to ESMA by competent authorities regarding the net short positions in shares, sovereign debt and uncovered sovereign CDS should be provided more often than on a quarterly basis. This would help ESMA to adequately monitor the market and to adjust more rapidly to market changes.

2.3. Exemption where the principal venue is located outside the Union/Carrying out the calculations (Section VI.IV)

We note that national competent authorities are responsible for ensuring that the calculations of the turnover of the relevant share are made and that they may delegate the actual calculations to a third party (e.g. to a Regulated Market).

FESE members welcome the thrust of European supervisors on Regulated Markets as a source of reliable turnover statistics. Regulated Markets would be glad to provide this service to competent authorities. In addition, due to the current market fragmentation where up to 40%[2] of the equity market is negotiated OTC, Regulated Markets cannot ensure that these calculations adequately reflect the real turnover in a specific share. If despite these limitations, competent authorities would require Regulated Markets to perform these calculations, some type of agreement or compensation would have to be ensured to cover for the costs incurred upon in performing these calculations. This issue is particularly sensitive in the current market conditions of fierce competition between all types of EU trading venues (Regulated Markets, MTFs, etc).

3. Additional remarks on specific articles not referred to in the consultation

Below we include some comments on two articles not covered in the consultation:

3.1. Article 15 - Buy-in procedures

We note that the provisions in article 15 only cover trades in shares that are cleared through a CCP. This excludes all transactions that are not cleared by CCPs (including OTC transactions and all transactions on regulated markets that are not cleared by a CCP). This can represent up to 40% market share, implying that almost half of the market will be exempted from the legislation. We want to emphasise that transactions cleared by a CCP already follow a strict buy-in regime and in contrast all transactions outside a CCP have no consistent regimes to enforce high settlement efficiency. With the current

[1] For details refer to:
http://www.bafin.de/cln_235/nn_720494/SharedDocs/FAQ/EN/Unternehmen/BoersennotierteUnternehmen/leerverkaeufe/wphg30h/faq__30hwphg__00.html?__nnn=true

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

provisions there will be incentives to perform transactions OTC or on platforms without CCP clearing into non-guaranteed post-trade processes.

Our suggestion
We encourage the Commission and ESMA to clarify in the technical standards that buy-in and fines regimes should apply to all transactions in shares and not only those cleared through a CCP. If this is not possible, we consider that the provision should be deferred until clarification in the upcoming proposal for the CSD Regulation.

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

The proposed Regulation contains a number of restrictions on the holding of CDS positions. In particular:

- The Proposed Regulation would prohibit entering into CDS transactions relating to an obligation of an EU sovereign issuer where those transactions lead to an uncovered position in a CDS (Article 14).
- Member State competent authorities are given the power to limit persons from entering into sovereign CDS transactions or limit the value of sovereign CDS positions that may be entered into by persons in order to address serious threats to financial stability or market confidence (Article 21).

We very much welcome these proposals but believe that ESMA should consider the following particular situations:

Need to ensure a continued clearing service to clients by CCPs in the event of a default.
Some FESE Members active in the CDS clearing business have rules in place which include provisions that allow them to allocate the positions of an insolvent clearing member to other clearing members ("transferee clearing members"). These provisions exist in order **to ensure a continued clearing service to clients in the event of a default**. If a CCP needed to have recourse to this procedure with respect to a position in sovereign CDS, it would be without knowledge of transferee clearing members' underlying sovereign bond holdings. It is therefore possible that in requiring transferee clearing members to fulfil their contractual obligation to take on the position, or part of the position, the Regulated Market would inadvertently be obliging them to assume an uncovered position in sovereign CDS.
This is clearly not a circumstance that the Proposed Regulation was designed to prohibit. We note that the latest Council draft of the European Market Infrastructure Regulation ("**EMIR**") requires CCPs to "*take all the reasonable steps to ensure that it has the legal powers to liquidate the proprietary positions of the defaulting clearing member and to transfer or liquidate the clients' positions of the defaulting clearing member*" (Article 45(4)).

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

Our suggestion

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

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

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

An implicit or explicit exemption as outlined above is essential for CCPs to continue clearing CDS.