

ESMA Call for evidence

Evaluation of the Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of CDS

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Comments by AMAFI

1. Association française des marchés financiers (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

2. The Association welcomes the opportunity to answer the survey conducted by the European Securities and Market Authority (ESMA) for the evaluation of the Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps (hereafter referred to as the Regulation).

Among its comments below, AMAFI would like to draw attention to the one related to the definition of market making for the use of the exemption (see § 12 below). This aspect is the most critical of all.

A. Transparency and reporting requirements

Q1: Do you consider that the initial and incremental notification/publication thresholds for net short positions in shares and sovereign debt have been set at the correct levels? If not, what alternative thresholds would you suggest and why?

3. The reporting threshold of 0.2% may be set too low in practice but the real issue lies with the 0.5% publication threshold. Considering that convertibles are not included in the position calculation, firms may cross the publication threshold while they actually hold a compensating position in convertibles. Such publications can generate a tremendous amount of noise in the financial press and serious concerns by the issuer concerned, reflecting badly on the firm and having potentially damaging effects on the market of the financials instruments concerned because of the rumours it may trigger.

4. Firms should therefore be allowed to provide some explanations when publicly disclosing the crossing of the 0.5% threshold. If such possibility is not provided for, disclosures should be delayed until the market is closed to avoid unnecessary strain on the financial instruments concerned and potentially hurt markets' integrity.

Q4: Do you have any comments on the method of calculating net short positions in shares and sovereign debt (e.g. the requirement to duration adjust cash positions in sovereign debt)?

5. As mentioned by ESMA in its Q&A concerning the implementation of the Regulation, pursuant to Part 2 of Annex II of the Delegated Regulation n° 918/2012 of 5 July 2012, for the calculation of the net short position in a sovereign debt, positions held through derivative instruments in the sovereign issuer should be delta adjusted and cash positions should be nominal value duration adjusted (NDVA).

6. However, AMAFI considers that both cash positions and derivatives positions should be duration adjusted (the derivatives position should therefore be delta and duration adjusted). Failing that, it is easy for a market participant to circumvent the notification requirements through the use of derivative instruments. Let's take an example :

XYZ wants to take a significant short position on the German issuer around the 10y tenor. He has the choice between two positions which carry the same market risk:

- a) A short position of DBR 1.5% 02/15/23 on a nominal of EUR 3,500,000,000 (with a modified duration of 9.163)
- b) A short position of 27458 EURO-BUND FUTURE MAR13 (with a delta of 1)

Despite the fact that these positions are exactly the same in terms of market risk, according to the calculation method mandated by ESMA's Q&A:

- a) The first position will have a NVDA of $9.163 * 3,500,000,000 = 32,070,500,000$ – as a consequence, this position triggers the first notification level
- b) The second position will have a NVDA of $27458 * 100,000 = 2,745,800,000$ – as a consequence, this position does not trigger (and by very far) the notification level

As a consequence, if XYZ wants to avoid any notification, it will use futures instead of bonds. Note that the fund can take a much important short position – up to 10.6 times this position – without having to notify at all.

On the other hand, if the NVDA of this futures position were both delta and duration adjusted, the NVDA would become: $27458 * 100,00 * 8.739 / 0.732 = 32,780,800,000$ [8.739 is the modified duration of the cheapest-to-deliver, and 0.732 is the concordance factor of the cheapest-to-deliver].

This example shows that when the futures position is both delta and duration adjusted, the NVDA is very close the NVDA of an equivalent bond position, so that it cannot be used to circumvent the notification requirement. The same calculation applies to any derivative on bond (bond future, option on bond futures, bond forward, options on bond, etc.).

7. Incidentally, the case of CDS is different, because a CDS cannot be considered as a derivative on a specific bond since the maturity of the CDS and the maturity of the bond can be significantly different. As a consequence, the modified duration of an underlying bond cannot be used for this calculation. In the case of a CDS, the calculation of the equivalent of a modified duration needs to be derived from the PvBp of the CDS position.

Q6: Do you consider that reporting mechanisms are operating efficiently? If not, explain why and how they could be improved.

8. Reporting to each Member State's regulator and/or Treasury is inefficient. This requires at a minimum the holding of 27 different identification number and passwords (since in some Member States reporting is due to the national Treasury as regards sovereign bonds). Considering that the reporting time is set at 3.30 pm, it is essential not to wait for the need of a disclosure to occur to obtain the IDs and passwords, hence a cumbersome process to organise ex ante and to permanently maintain.

Also, although reporting templates have been proposed by ESMA, each regulator uses its own template.

It would be a lot more efficient to have a unique template and a unique repository for reporting, either ESMA or the home competent authority that could transfer the reporting to the relevant competent authority or a unique web-site address shared between competent authorities.

9. Concerning the requirement to make notifications and disclosures before 3:30 PM on the trading day following that on which was created the net short position such timing set amidst the trading session is inadequate considering the impact the reporting can have on markets, as mentioned above in § 4. In addition, it does not allow for sufficient time to aggregate the positions of the different systems serenely, creating useless and counterproductive strains and pressures.

It should be noted as well that 3.30 PM is the local time of the competent authority, which, depending on the time zone in which the firm is established, lengthens or shortens the time available to prepare the reporting: a firm in France can report until 4.30 PM to the FSA but one in the UK will need to report before 2.30 PM to the AMF. This observation also calls for setting the reporting time after the trading session.

10. Finally, contact details for short selling reporting at each regulator would be extremely useful, as before deciding on reporting a short position that will be made public, questions may arise that need checking beforehand with the competent authority concerned.

B. *Restrictions on short selling of shares and sovereign debt*

Q8: Have you observed any improvements in settlement performance (either your own or that of counterparties) since the Regulation became applicable?

11. As regards shares, member firms have noticed some improvements concerning the number of outstanding fails.

Q13: Are there any changes which could be made to the conditions for entering into a short sale which would improve the efficiency of the arrangements without undermining the purpose of the measures? Please explain any changes you would propose.

12. The definition of liquid shares used for the purpose of the "locate rule" is based on the liquidity of the market, while it is the liquidity of the securities lending market which should be taken into account, which can be dramatically different.

Q14: Do you have any other comments on the existing restrictions or their operation since 1 November 2012?

13. ESMA's website is sometimes not accessible, making it impossible to access the list of liquid shares and update accordingly the firms' internal systems. It is important that the website be reliable.

C. Exemptions

Q25: Do you have any other comments on the provisions of the Regulation concerning exemptions or on how they have operated since 1 November 2012?

14. Despite the recent publication of ESMA's guidelines on the market making exemption (ESMA/2013/158), there are still some considerable uncertainties regarding the scope of the notion of "market making" under the Regulation.

ESMA has extended the condition of market membership set in the Regulation to the financial instruments concerned by the trading activity, so that they must be admitted on a trading venue. AMAFI is of the view that, on this aspect but also on the ones related to time presence, one-to-one hedging, etc., ESMA has interpreted the level 1 text more extensively than originally meant by the legislator, with no benefit. Such interpretation excludes from the benefit of the exemption major market making activities performed on OTC products, which so far have not been singled out as raising particular issues.

This is an issue beyond the short selling regulation because there exists no other definition of market making at the EU level than ESMA's definition and it will be absolutely fundamental to a number of other EU regulatory initiatives that are likely to draw on it, like the structural reform of banking assigning some activities to separate entities or the enhanced cooperation on financial transaction tax between 11 European Member States. Although as regard this last initiative, no reference to market making is made at the moment, it is very likely that it will at a further stage, and AMAFI will anyhow strive to the best of its ability that it be so, as it is essential that the tax does not harm activities that are useful to the economy. It is therefore more than likely that ESMA's definition, and the exclusion of essential market making activities, will reverberate to areas beyond the short selling regulation.

15. In addition, it appears that despite the guidelines being published, competent authorities still differ on a common approach of this notion. Hence, although the definition of market making is key for the application of the Regulation and for a level-playing field in the EU, compliance with it is down to each competent authority's decision to "comply or explain" with the guidelines. AMAFI therefore is very concerned that the publication of the guidelines does not seem to follow on from a complete adherence of competent authorities on this definition, which could lead to major competition distortions within the EU.

D. Intervention powers and emergency measures

Q26: Do you have any others comments on the provisions of the Regulation concerning intervention powers and emergency measures or on how they have operated since 1 November 2012?

16. The implementation of emergency measures by some Member States since 1 November 2012 has shown that they are unmanageable by firms as currently organised and that they put them at risk of regulatory failing. This is because there is a need both for better communication of the measures and cooperation between competent authorities.

Communication is achieved by the national competent authority itself, on its website and own language (translation in English often occurs later on). Considering the urgency inherent to these measures and their lifespan that can be very short, the communication medium used should allow reaching market participants widely and timely, which is not the case when reliance is placed on market participants' checking the 27 competent authorities' websites. One solution could be to directly email contact persons in charge of short-selling reporting at firms, given that those persons are already identified by competent authorities. Another solution would be to issue the information via ESMA's website, in English.

As for the cooperation between competent authorities, markets being fragmented, the short sell ban imposed on the national trading venue is likely to be ineffective if not imposed on the other venues trading the financial instrument(s) concerned, generally located elsewhere in the EU. When a decision is made to ban the short selling of some financial instruments, agreement should be reached beforehand between competent authorities to communicate clearly and in a coordinated way on the scope of the ban in terms of trading venues.

