13 February 2012

AFME, ICMA, ISLA and ISDA joint input for ESMA Consultation Paper on draft technical standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps

On behalf of our members, the Association for Financial Markets in Europe ("AFME"), the International Capital Markets Association ("ICMA"), the International Securities Lending Association ("ISLA") and the International Swaps and Derivatives Association ("ISDA") appreciate the opportunity to contribute to the ESMA Consultation Paper on draft technical standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (SSR)**.** We hope to continue further dialogue with the regulatory community and policy makers and welcome the opportunity to discuss in depth the responses provided in this paper at your convenience.

AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website www.afme.eu.

The International Capital Market Association (ICMA) is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. Further information is available at www.icmagroup.org

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has more than 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America. For more information please visit the ISLA website www.isla.co.uk

Since 1985, the International Swaps and Derivatives Association (ISDA) has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

AFME, ICMA, ISLA, ISDA, henceforth "We" are pleased to provide the following input.

Executive Summary

We appreciate the opportunity to contribute to the ESMA Consultation Paper on draft technical standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps**.** We hope our comments will be helpful in developing proportionate rules to deal with the issues of concern.

Our main feedback is as follows:

- The use of the Mifid liquid shares definition in Article 6 is inappropriate and would cause significant costs to the market place and ultimately to long term investors who lend securities. It would also materially worsen liquidity in shares that are less liquid. Our analysis shows that there are significant differences between what is liquid in the cash market and what is liquid in the securities lending market (the most relevant market for this purpose). We have suggested alternative approaches which would lessen the negative impacts of the proposal.

- We do not believe it is appropriate or necessary for the Implementing Technical Standards to provide for exhaustive lists of Agreements, Arrangements etc. or of Third Parties. The lists provided in the draft in fact do not include certain agreements or entities that are very commonly used for covering of short sales and we have made suggestions as to what should be included. Importantly we do not believe that the definition of Third Party should preclude the use of a specialist internal repo or securities lending desk. Whilst we understand that there may be certain legal issues, requiring that a third party is a separate legal entity only serves to increase costs of business and will have a detrimental effect on liquidity.

- We feel that the limited timeframe ESMA has had to prepare the technical requirements, and the three week consultation period available to market participants, has not provided sufficient time to thoroughly consider the impact the ESMA proposals will have on the market.

- The proposed interpretation of the grandfathering rule could result in retrospective effects of the ban on uncovered sovereign CDS, which could introduce legal uncertainty, increase prices of the sovereign CDS protection or significantly reduce its availability and consequently increase funding costs for the sovereign and corporate debt markets.

We and our respective members again thank you for the opportunity to participate to this consultation paper. We have aimed to provide as much detail and constructive feedback to the questions posed in the document as possible. We remain fully at your disposal for further engagement and correspondence.

Yours faithfully

AFME	**ICMA**	**ISDA**	**ISLA**
Sander Schol	**John Serocold**	**Julia Rodkiewicz**	**Kevin McNulty**

General Remarks not relating to a specific question

Timing

We feel that the limited timeframe ESMA has had to prepare the technical requirements, and the three week consultation period available to market participants, has not provided sufficient time to thoroughly consider the impact the ESMA proposals will have on the market. We believe more time is required to enable all parties to analyse in detail how these requirements will impact the operation, efficiency, and liquidity of the market. This is also true for the analysis of the costs involved; three weeks is a very short time to allow firms to provide detailed and realistic estimates of the cost impact of the proposals, let alone for associations to develop market-wide estimates.

Furthermore, we are concerned that ESMA may not have had sufficient time to draft standards on all aspects of the regulation. For example, there is no guidance as to what the penalties are for non compliance, and hence these appear to be left to individual Member States to decide. This may produce multiple approaches across the Union which contradicts the regulation's intention of harmonisation. We remain concerned that, notwithstanding the direct application of the Regulation and the ESMA technical standards, individual Member States and relevant competent authorities will have to interpret a number of other aspects of the legislation themselves which will lead to differences and disparity across the Union.

We understand that the process is significantly compressed compared to normal ESMA practice and that our concerns are shared by ESMA itself, as expressed in its letter to the European Parliament of January 17 last[1].

[1] http://www.esma.europa.eu/system/files/2012-smsg-6.pdf

For further information on our general concerns in relation to the shortness of consultation periods, we refer to the joint associations' letter of 17 January 2012 to Commissioner Barnier and others, available at:
http://www.icmagroup.org/ICMAGroup/files/50/501ee614-91c0-4b9b-b293-cbae53045020.PDF

Grandfathering of CDS transactions – negative consequences of retrospective interpretation

We understand that ESMA and the European Commission are contemplating the following interpretation of the CDS contracts grandfathering rule:
- those CDS transactions entered into before the date of entry into force (probably mid March)of the SSR will be grandfathered from the ban on uncovered sovereign CDS; and
- those CDS transactions entered into between the date of the entry into force and its date of application (1 November 2012) can remain 'uncovered', but only until that application date, after which they will need to be covered or unwound.

The proposed interpretation of the grandfathering rule could result in retrospective effects of the ban on uncovered sovereign CDS, which is, though, applicable only from 1 November 2012. Such effects could introduce legal uncertainty, increase prices of the sovereign CDS protection or significantly reduce its availability and consequently increase funding costs for the sovereign and corporate debt markets and reduce their liquidity. It would have a significant negative impact on the ability of both corporates and financial institutions to manage country-specific risk, whilst also increasing systemic risk and hurting the real economy, which we believe would not be a desirable outcome, especially given the current market conditions and sovereign debt crisis. We also need to consider further amplification of these legal and market effects due to a large scale unwind of sovereign CDS in the run up to 1 November 2012.

A solution could be to clarify that Art 46.2 (grandfathering) provision does not affect the treatment of CDS transactions which were concluded on or after the entry into force of the

SSR but prior to the date of application of the SSR (1 November 2012), and that only CDS transactions concluded on or after the date of application of the SSR would be subject to the provisions of Article 14 of the SSR. Moreover, the level 2 legislation, including specifications of the cases when a CDS can be considered as covered should be finalised by the time the regulation enters into force. Another solution could be to ensure that the date of entry into force is delayed until technical measures are finalised. Alternatively a market participant's own documented interpretations of the rules should be recognised and sufficient for the trades entered into before the rules are finalised. Please see **Annex I** for a detailed analysis of the potential negative consequences of retrospective interpretations of the grandfathering provisions and entry into force of rules that are not clear.

Interaction with MAR and MAD

An additional point that we would like to highlight to ESMA is a potential issue that will arise from the interaction between this legislation and the revised Market Abuse Regulation (MAR) and associated Market Abuse Directive (MAD).

Under Articles 12(1)(c) and 13(1)(c) clients are required to obtain either a locate or confirmation from a third party that there is a reasonable expectation of settlement, prior to entering into a short sale. Where a client requests such a locate or confirmation of reasonable expectation of settlement from an investment firm in advance of trading, this implicitly discloses to the investment firm the client's intention to trade. If the investment firm then trades for its own account or for other clients then this would amount to market abuse under the proposed MAR legislation, which as currently drafted provides no safe-harbour or defence for such activity. This issue is of particular relevance where the investment firm is required to buy in securities in order to provide the locate.

In order to avoid the potential for market abuse as defined under MAR, investment firms would have only two options available to them. The first would be to establish internal information barriers between trading desks and the desk responsible for providing the locate. This however would not be practical as the ability to provide a locate or confirmation of reasonable expectation of settlement, requires specific knowledge of the prevailing market that could only be obtained from a desk actively trading in the market. Also, it could not be guaranteed that clients would always make a locate request to the desk subject to the information barrier.

The alternative options to ensure that an investment firm was not committing market abuse in this instance would be to restrict trading of the requested instrument by the investment firm until they had confirmed that the client had completed their transactions in the market (of which there is no guarantee this information would ever be received). This would obviously be an impractical and impossible requirement on the investment firm as it would prevent them from performing their normal course of business, and would also severely reduce liquidity in securities and sovereign debt as a result of being required to stop trading.

While we recognise that to address this issue is not something that can be achieved by ESMA through its work on this specific regulation, we would propose that that subsequent drafts of MAR and MAD should include appropriate provisions, similar to those in original MAD, that provide for an express defence to cover this issue.

Buy-ins

We seek confirmation from ESMA that this article applies to short sales only, and not to all failing sales via a Central Counterparty (CCP). We expect further guidance on buy-ins, settlement matching and settlement fails in the forthcoming CSD legislation.

Article 15 does not require a Delegated Act, but the absence of any further guidance on how the rules are to be implemented, or on phasing, could lead to divergent application across Member State CCPs. There is scope for a wide variety of fees, charges and buy-in notification practices to be applied which would go against the aim of harmonisation.

In Article 15.1.(a) we should be grateful for clarification about the settlement cycle related to the buy in process. It would be helpful to understand if this is based on a T+2 or T+3 settlement cycle, and, if a buy-in pre-advice will be issued by the CCP in question. Pre-advices are standard practice at many European CCPs.

Whilst AFME strongly supports fair measures that incentivise good settlement behaviour, we believe that the aggrieved party should receive the appropriate compensation rather than monies being treated as a source of revenue by an infrastructure. Compensation is available if a trade cannot be bought-in (15.1.b), but no compensation is offered to the aggrieved party if a buy in is executed. Can ESMA confirm that such a procedure will be included in further guidance? We would also appreciate guidance how the amount described in (b) will be calculated.

We believe that the proposal in section 15.2 may be appropriate in the context of short selling and seek clarity from ESMA that other CCP cleared transactions will not be affected.

Revocation of existing short selling rules

We note that Article 46 of the Regulation provides for short selling rules effected in Member States prior to 15 September 2010 to remain in force until 1 July 2013 following implementation of the Regulation and therefore to run concurrently with the Regulation. We also note that Member States are required to notify these 'measures' to the Commission in order for them to continue. We therefore seek clarification from ESMA as to (i) how the Regulation and these measures will apply where there is inconsistency between them, and (ii) whether ESMA (or the Commission as appropriate) will publish a list of those Member States that have provided prior notification including details of the rules that will run in parallel to the Regulation.

Feedback per question

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 disagree with the approach of providing an exhaustive list. We consider that this approach is unnecessarily inflexible and risks needlessly prohibiting firms from putting appropriate arrangements in place simply because that specific arrangement is not on the list, or because it is not clear whether a particular arrangement is one of those listed. In particular, given the timing for consultation on these guidelines, we consider that there is a high risk that the "exhaustive" list would be incomplete.

We agree that ESMA should provide a list, and that in the interests of clarity that list should be as complete as possible. However, we do not agree that it should be an exhaustive list. We do not consider that ESMA has an obligation to create an exhaustive list, nor do we consider that this would be desirable.

We consider that ESMA would fulfil its obligation to provide "implementing technical standards to determine the types of agreements, arrangements and measures that adequately ensure that shares or sovereign debt instruments will be available for settlement" where it provides a list of the types of agreement that it considers would be adequate. In addition, in order to ensure compatibility with the Regulation (which permits a person to rely on any agreement, arrangement or measure which provides an absolutely enforceable claim to be transferred ownership of relevant securities so that settlement can be effected when due) the implementing standards should also include a general provision, recognising that there may be other types of agreement, arrangement or measure which meet the requirements of Article 12(1)(b) or 13(1)(b) of the Regulation and which would be adequate.

We also have the following comments on the draft Article 5 of the implementing technical standards:

(a) Article 5(1)(f) should read "specifying a delivery or execution date that ensures settlement can be effected when due". This would reflect the wording used in Article

5(1)(d), and would also make more sense (as the execution date of an agreement is less relevant to settlement than the delivery date).

(b) It is difficult to see how a third party could comply with Article 5(2) in all circumstances. For example, if the claim that the investor has is a claim for delivery of securities that they have purchased, it is not clear how a third party would "provide this claim on a durable medium". It may make more sense for the third party to provide the key terms of any agreement, contract or claim to the investor in a durable medium by way of confirmation.

(c) Article 5(3) appears to provide for retroactive effect, stating that a person who complied with all their obligations under the Regulation on the date that they entered into a short sale might (through no action of theirs, and possibly without their awareness) breach the Regulation if the agreement they had entered into can no longer be fulfilled. It is not clear what this provision is intended to achieve. It is likely to create legal uncertainty regarding whether or not a person has complied with their obligations under the Regulation. If this provision is retained, it should be revised so that a person would only be deemed not to comply if the relevant agreement has been revoked or can no longer be fulfilled at the time that the person enters into a short sale.

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

Notwithstanding our comments to Question 1, we suggest that the list of agreements referred in paragraph 11/Article 5 should also include;

- Prime Brokerage Agreements (or any written confirmations or other similar agreements containing substantially equivalent provisions thereto),
- Securities Lending Agreements and

- Agreements relating to conversion rights; where an investor has the right to convert an asset (for example a bond) into shares of the relevant issuer, provided that the investor is entitled to receive the shares on or before settlement of the short sale.

Furthermore, we would suggest adding the term 'Arrangements' to Article 5(f) as follows: "Other Claims, Agreements or <u>Arrangements</u> leading to physical exchanges…..".

More specifically, we do not agree that you can only use the redelivery leg of a repo to settle a short sale. In line with current market practice, firms expect to enter into a repo prior to <u>settlement</u> (rather than just entry into) of the short sale. They also expect to be able to rely on the <u>Purchase Date</u> leg of the repo to meet their settlement obligations under the sale (rather than the Repurchase Date leg). To do otherwise would mean that firms could only rely on a repo to hedge their delivery obligations under a short sale if the firm has already repo'd out the securities that are the subject of the sale. If that is the interpretation, we see a risk that liquidity will be disrupted as trading practices change.

Furthermore, Paragraph 13 appears to require some re-drafting specifically with reference to the last sentence. The phrase: "the date and time on which they entered into" is unclear. Reading this paragraph in conjunction with Article 5 (2) of the Draft Implementing Standards (page 51 of the Consultation Paper), that the intended wording is "the date and time on which they **were** entered into…"

Q3: Do you consider that these criteria will entail additional costs as compared to current practices on the market? If so, could you specify the drivers for those additional costs and any indication of their amount?

Provided that the list is non-exhaustive and contains the appropriate additions as suggested in our answer to question 2, the costs should be limited.

As a separate point, we consider that Article 5(3) of the implementing technical standards regulation, as currently drafted, is significantly problematic. An assessment of whether a seller of securities has sufficient cover to comply with Articles 12 and 13 of the Short Selling Regulations should be made by reference to the type of agreement, commitment, or confirmation that the seller has received at the time of entering into the sale. As with all transactions and contractual commitments, it is possible that the lender/repo counterparty/seller or other provider of securities for settlement of the short sale may default in its obligation to provide the securities. The fact that this may later happen should not have the effect of nullifying the original commitment or of causing a breach by the seller of the regulations. The criteria suggested by ESMA to determine the type of agreement/commitment and the type of third party should ensure that only bona fide agreements/commitments are relied on by sellers.

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?

Whilst we believe that the parties listed are relevant for the purposes of the Technical Standard we do not agree with the approach of providing an exhaustive list for the same reasons as articulated in our response to Question 1.

In addition we would respectfully question whether ESMA is required or empowered to define or limit what is a "Third Party", as this term is not defined within SSR and there appears to be no reference to this in Article 12.2 (which provides for the development of implementing technical standards).

Notwithstanding the above comments, to the extent that ESMA feel inclined to list eligible types of Third Parties then as a minimum the following should be added as these are all commonly used sources of supply.

A bank
An investment fund (including sovereign wealth funds)
A bank or investment firm lending on behalf of its clients

An International Clearing and Settlement Depository (ICSD)

We note that Article 8(g) includes "Any other person subject to authorisation…in accordance with EU law and who is an active participant… and can provide data on its ability to deliver…". In many cases, common sources of securities include institutional investment funds (such as pension, mutual and sovereign wealth funds), which may not be subject to authorisation under EU law (though the manager of the fund may well be authorised). As well as third country entities which are regulated in other major jurisdictions such as the US, Canada, Japan, Switzerland or Australia. We would request confirmation from ESMA that such entities would be included under Article 8(g) and that the relevant authorities in such countries would be deemed equivalent for the purposes of the test in Article 8(g).

Articles 8 (a) and (g) contain very specific data requirements which are impractical. Whilst we understand ESMA's need for the Third Parties dealt with under these articles to be able to evidence their credentials to provide cover for short sales, it is not reasonable for the Third Party to know exactly how many short sales it covered were settled on the intended settlement date ("ISD"). The responsibility for ensuring settlement on the ISD belongs to the short seller and the details of the short sale (including the ISD may not be known to the Third Party. We would suggest that Article 8(a) and (g) would each end as follows;-

"8 (a) and (g) ………and can provide, on request, evidence of such participation."

Q5: Are there further criteria which should be added?

See our answer to question 4.

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.

We do not consider that the reference to "third party" in Article 12(1)(c) and 13(1)(c) of the Short Selling Regulations should be construed to require that only a separate legal entity could constitute a third party for that purpose. There are a number of drawbacks with this approach:

- Many financial services firms have a number of trading desks, together with a central repo (or securities lending) desk that provides repo and lending services to internal and external clients. As drafted, it fails to take into account that a central repo desk (rather than the desk that actually entered into the short position) will of necessity be entering into a repo with a third party when required in order to provide the security promised to the internal desk.
- In the specific case of sovereign debt, some debt management agencies provide repo-lender-of-last-resort facilities to their primary dealers in order to facilitate liquidity, smooth market operations and avoid chains of settlement fails (as recognised in ESMA's consultation paper). However these are only available to the legal entity with the primary dealership contract. A third-party repo desk would be unable to avail itself of this facility. (The PD desk would be able to go to the facility directly, but this would necessitate a parallel process to their ordinary repo arrangements.)

In terms of the costs that would be entailed by the proposed third party requirement, they can be classified as the direct costs of implementing standalone desks, and the indirect costs of increased market inefficiencies. Of course the latter is likely to be by far the most important factor. Taking a purposive interpretation of the Short Selling Regulations, the overall intention is clearly to reduce the risk and instances of settlement failure. To require that sellers of securities source those securities from external counterparties when they could have sourced them via specialist internal trading desks will surely increase the potential risks of settlement fails, and the related counterparty and credit risks that come with any external trading relationship.

In this context it is also important to note that Article 13 para 5 of the level 1 text instructs ESMA to "take into account the need to preserve liquidity…of sovereign bond and sovereign bond repo markets," which is inconsistent with disrupting existing market arrangements and restricting the ability of major market participants to trade internally, hence fragmenting liquidity. The combination of reduced liquidity and increased risk of settlement fails is likely to impose significant friction on the market.

We also understand that the practice of covering shorts with an internal repo desk is accepted on the US markets: its prohibition across EU would lead to another competitive disadvantage for non US banks.

In addition to the loss of market efficiency, the increase in settlement risk, and the competitive disadvantage, the direct costs of setting up arms-length repo facilities under ESMA's current interpretation of the regulation would require staffing costs (for at least 3 people), IT infrastructure, legal costs to set up new agreements, costs of ongoing support and infrastructure in addition to the cost of restructuring and rebuilding the current SBL desks within the relevant entity.

It would require a considerable amount of study to estimate the direct and indirect costs of this third-party requirement, which is not feasible within the three week consultation period.

An example of how the French market operates today which is of relevance to this question can be found in **Annex 2**.

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?

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?

Q9 In relation to the approach suggested for liquid shares, do you consider it appropriate to use the MiFID definition of liquid shares? Do you think ESMA should consider different approaches to determine the reasonable expectation test for liquid and illiquid shares? If not, can you provide indications as to the criteria to consider to define liquid shares or to take into account the liquidity of the shares in these circumstances? Is securities lending activity an additional factor to consider when determining liquidity of a share?

In response to questions 7, 8 and 9:

Firstly, the proposed drafting creates some confusion as to the types of measures that are required and in which circumstances. Subject to our comments below, we would suggest that a table setting out the various scenarios contemplated, and the level of cover required in each case, be included either in the regulations or in ESMA's commentary. The following table sets out our understanding of ESMA's draft guidance:

	Locate	**Confirmation easy to borrow/ purchase**	**Icing required**
Liquid Intra day	Yes	Yes	No
Liquid Intra day	Yes	No	Yes
Liquid > 1 day	Yes	Yes	No
Liquid > 1 day	Yes	No	Yes
Illiquid Intra day	Yes	Yes	No
Illiquid Intra day	Yes	No	Yes
Illiquid > 1 day	Yes	Yes or No	Yes

Secondly, as an overall point we do not consider that the prescribed criteria regarding intra-day trading is workable in this context. An investor will not always know at the time it intends to sell a security whether it also intends to purchase that security on the same day. An investor may buy back shares it has sold within the same trading day, having originally intended to purchase at a later date, and vice versa. It is essential that such trading flexibility be maintained, and we have significant concerns that the proposal in the ESMA guidance may cause unnecessary restrictions on trading activity in that regard. Also, to require that this intention be communicated to the locate provider, and that this information determine the level of cover required, seems operationally and practically difficult, and involves the unnecessary sharing of proprietary information. As such, we would suggest that the criteria relating to the intra-day trading activity be removed. This would leave the table as:

	Locate	**Confirmation easy to borrow/ purchase**	**Icing required**
Liquid	Yes	Yes	No
Liquid	Yes	No	Yes
Illiquid	Yes	Yes or No	Yes

We do not believe that the Mifid definition of "liquid shares" is appropriate for use in the context of the Short Selling Regulation, and risks providing market participants with an inaccurate picture of the availability of the shares. In delivering the requirements in Article 12 of the Short Selling Regulation the key factor is the availability of the shares for borrowing. However, Mifid liquidity relates to the execution (cash) market and the relationship between these two is not strong. Under the MIFID definition only a small number of securities are categorised as liquid (785 out of 6160). But in practice a far greater number of shares than this are readily available to short sellers needing to achieve settlement. Conversely, at certain times and under particular market conditions, a stock that is "liquid" according to the Mifid definition might in fact be unavailable to short sellers.

In addition, any attempt to define what amounts to liquid or illiquid needs to be sufficiently flexible as to take into account the dynamic nature of the securities lending market. A static list of securities will quickly become inaccurate and misleading as changes in the demand for and supply of securities impacts the liquidity in those securities.

Whilst we have not had sufficient time to undertake detailed analysis, we have reviewed the Mifid list of liquid shares against what we believe to be a reasonable measure of liquidity in availability to borrow.

In calculating this liquidity we have compared borrowing availability, as published by an independent third party source, to the 30 day average daily traded volume (ADTV) of each share in the Mifid list. We have assumed that where availability exceeds 50% of the ADTV shares should be considered liquid for short selling purposes. We believe this to be a conservative approach to identifying liquid shares as short selling activity would rarely represent as much as 50% of the daily turnover. On this basis it can be seen that some shares defined as liquid under the Mifid list are actually deemed illiquid in the borrowing market and vice versa. Examples of this are:

Sanofi - FR0000120578. This is defined by Mifid as an illiquid share. The analysis shows that there are 222,434,976 shares available to cover a 50% ADTV of 1,603,324, illustrating sufficient liquidity to cover all short selling activity for the next 137 days, even with the conservatively high 50% assumption

Yell Group - GB0031718066. This is defined by Mifid as a liquid share. The analysis shows that in the borrowing market there is no availability in this share and so should be recognised as a very illiquid share for SSR.

In total our analysis illustrates that availability of shares for borrowing, and hence liquidity for the purpose of settling an investor's sale is quite different to the Mifid list. Based on these more appropriate criteria the following comparison can be made.

	Liquid	Illiquid
Mifid	785	5375
SBL methodology	2183	3977

753 of Mifid's liquid list are also liquid using the SBL methodology

Full analysis of the Mifid list can be found at the following link:

http://www.isla.co.uk/images/PDF/PublicationsMIFID analysis.pdf

For the reasons outlined above, the reference to liquidity of shares being determined in accordance with the Mifid definition will provide a misleading outcome. Recognising that the Mifid definition of liquid shares is not appropriate and ESMA has requested alternative approaches we would like to propose two options for assessing liquidity for SSR.

Option 1

Determining the liquidity of shares for the purpose of settling investor sales is best established by the Third Party providing the locate based on market expertise and from its own individual share availability/supply. Therefore, an investor would need confirmation from the third party that the shares are easy to borrow or purchase for the investor to deem the share as liquid. If such confirmation could not be obtained, the investor would have to deem the shares illiquid and would then need to make arrangements with that or another Third Party to have the shares put on hold (ice), to ensure they are available for settlement.

This should reduce risks of settlement fails, as the Third Party would need to confirm to the investor that it sees sufficient supply available to it, that the share is nevertheless easy to borrow. This would allow the investor to comply with its obligation under the Short Selling Regulation that the investor must have a reasonable expectation of settlement. This reasonable expectation would arise if the investor has obtained confirmation from a third party that the shares are easy to borrow. If no such confirmation were obtained, the investor would need to make arrangements with the third party to have the shares put on hold

In determining the liquidity of shares available to third parties providing such confirmations, consideration will be given to the size of the locate requested, an assessment of the likelihood that such a request will give rise to a short sale and the internal and external sources of liquidity available to such parties. Internal sources may include proprietary portfolios or approved client inventory which has been made available. External inventory will include ‘exclusive’ securities; where a lender has committed to lend a portfolio of securities to the Third Party on an exclusive basis and, indicative non-exclusive securities which may also be available to other borrowers. These factors enable an assessment of the availability of shares to the investor for the purpose of settling a sale, and ESMA could state in its guidance that these factors should be considered by third parties when confirming that a share is easy to borrow.

Option 2

ESMA could develop a market list of liquid shares that is based upon more appropriate factors such as available supply. Data for this purpose is available from independent data vendors, and would not need to be sourced from market participants directly.

Recognising that ESMA may prefer to maintain a market list of liquid shares for the purposes of SSR, we would be happy to work with ESMA in establishing objective criteria similar to that used in the analysis detailed above for the creation of an appropriate list. Aside from defining the appropriate criteria, there are a number of issues of practicalities with this option that would need to be worked on, such as where data would be sourced from, as well as how this list would be published and maintained. However, we are confident that in conjunction with the market, and with appropriate time to develop the criteria, this could be achieved.

In addition, we propose that the objective criteria for liquidity, once defined, may be applied to a Third Parties' own specific available supply to calculate their own list of liquid securities. This will recognise that each third party may have a different availability or supply source as previously described in option1.

Securities would be deemed liquid for the purposes of SSR, when the share is liquid according to either the market list, or liquid according to the application of the criteria to the third parties own availability supply.

We believe that either of these options will achieve the purpose of defining the liquidity of a share for the purposes of settling an investor sale. Alternatively ESMA may consider implementing a hybrid of option 1 and 2, in which case we would be happy to work with ESMA to this end.

Q10: Do you agree with the approach proposed by ESMA on the location confirmation and reasonable expectation arrangement in relation to sovereign debt and that the reasonable expectation test should only apply in the case of intraday short selling of sovereign debt?

We do not agree with the interpretation of Articles 12(1)(c) and 13(1)(c) of the Regulation whereby it is the third party, rather than the investor, who needs to have the reasonable expectation that settlement can be effected when due. We were concerned that the November compromise proposal text left this issue unclear, and we are more concerned that both the jurist-linguist text and the ESMA technical standards also endorse this interpretation.

This interpretation clearly narrows the types of arrangements which may exist in relation to short sales of shares or sovereign debt. In particular, it is very impractical for the responsibility to be on the third party with regards to the location confirmation and reasonable expectation arrangement. The third party will not necessarily have access to all of the information relevant for settlement (including any last minute changes thereto), which would make this responsibility hard to fulfil.

It is also unclear why the third party should be required to take measures with third parties, when it may be able to produce the shares or sovereign debt in time for settlement itself. This obligation does not appear to add any benefit or protections, but rather has the potential to create the opposite effect. By requiring persons entering into a short sale to source securities or sovereign debt for settlement through a chain of third parties, this obligation could have the effect of increasing the likelihood of settlement failure, as there are more parties involved in the transaction.

We consider that the correct interpretation of Articles 12(1)(c) and 13(1)(c) would be as follows:

Article 12(1)

(c) the natural or legal person has an arrangement with a third party under which that third party has confirmed that the share has been located and the natural or legal person has taken measures vis-a-vis third parties necessary for the natural or legal person to have a reasonable expectation that settlement can be effected when due.

Article 13(1)

(c) the natural or legal person has an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or the natural or legal person otherwise has a reasonable expectation that settlement can be effected when due.

This interpretation is supported by paragraph 20 of ESMA's consultation paper.

Regarding the implementing technical standards on Article 13(1)(c), we consider that the implementing technical standards go beyond simply implementing the level 1 text, and actually seek to revise the level 1 text. For example, Article 7(b) of the implementing technical standards refers to “same day” arrangements, when the level 1 text does not limit the “reasonable expectation” test in this way. In addition, although Article 13(1)(c) of the Regulation makes it clear that having a "reasonable expectation" is an *alternative* to the requirement for a third party to confirm that the security has been located, Articles 7(a) and (b) of the implementing technical standards provide that a person would only have a "reasonable expectation" if they have confirmation that the securities have been located. This seems to be an attempt to narrow the scope of the level 1 text, in the face of the agreement reached on the level 1 text.

In addition, the level 1 text clearly requires ESMA to take into account the need to preserve liquidity of markets, especially sovereign bond markets and repo markets. By limiting market participants to relying on locate arrangements, we consider that ESMA has not taken into account the need to preserve liquidity of these markets. The implementing technical standards clearly ignore other effective measures which would provide a reasonable expectation that settlement can be effected when due: for example, a right to redelivery of securities under a repo agreement. This flexibility is particularly important if ESMA intends to adopt the approach of prescribing an exhaustive list of types of agreements which would satisfy Article 13(1)(b).

We would also like it to be made clear that the tri-party repo arrangements operated by the International CSDs (Euroclear bank and Clearstream Banking Luxembourg) would be qualifying arrangements under Article 13.

We also understand that the practice of covering shorts with an internal repo desk is accepted on the US markets: its prohibition across EU would lead to another competitive disadvantage for non US banks.

In addition to the loss of market efficiency, the increase in settlement risk, and the competitive disadvantage, the direct costs of setting up arms-length repo facilities under ESMA's current interpretation of the regulation would require staffing costs, IT infrastructure, legal costs to set up new agreements, costs of ongoing support and infrastructure in addition to the cost of restructuring and rebuilding the current SBL desks within the relevant entity.

It would require considerable amount of study to estimate the direct and indirect costs of this third-party requirement, which is not feasible within the three week consultation period.

An example of how the French market operates today which is of relevance to this question can be found in Annex 2.

Q11: Do you agree that there should be one standard format for notifying relevant competent authority for each type of instrument?

Yes. We support the principle of a common set of standards for the reporting of short positions to competent authorities ("CAs"). However, we would suggest that the regulators should allow service providers to offer a single reporting front end for the input and routing of this information to the relevant regulator. That reporting front end would also provide an audit trail enabling a firm to evidence the submission of a report and the confirmation of receipt of the report by the regulator.

It is not clear from the wording under III.II how the forms should be submitted to CAs and we would suggest that the use of fax for this type of activity is not commensurate with the importance of the information being disclosed.

Q12: Do you agree that there should be one standard form for public disclosure of information on significant net short position in shares?

Yes

Q13: Do you agree with the proposed way to identify natural and legal persons, including the contact information details?

To identify legal entities submitting reports, we support the proposal to use LEI codes, when these become available. Sufficient time should be given to market participants to allow a gradual implementation.

We fully support the Financial Stability Board's (FSB) process to develop a recommendation on a global LEI standard to be delivered to the G20 at their June 2012 summit and are actively involved in the process through the Industry Advisory Panel. Consistent with its G20 mandate, we are confident the FSB process will deliver the necessary recommendations, including corporate governance, in a timely manner to move the LEI solution forward in line with the public interest.

We fully recognise and support that the FSB has yet has to make any recommendations on a global LEI standard and its implementation. Respectfully, we would like to draw your attention to the efforts of the Trade Associations that have made the following recommendations for the LEI Solution Providers:

- **Standards body –** The International Organization for Standardization, i.e., ISO's new standard, ISO 17442, is recommended for use as the new, authoritative legal entity identification standard.

- **Core Issuing and Facilities Manager –** The Depository Trust & Clearing Corporation (DTCC) and the Society for Worldwide Interbank Financial Telecommunications (SWIFT), along with DTCC's wholly-owned subsidiary AVOX Limited, are recommended as key partners to operate the core LEI utility as the central point for data collection, data maintenance, LEI assignment, and quality assurance.

- **Federated Registration –** ANNA, through its network of local national numbering agencies (NNAs), is recommended as a key partner in the solution for registering, validating and maintaining LEIs for issuers, obligors, and other relevant parties in their home markets. The NNAs are envisioned to serve as the "face" of the LEI Utility to those markets.

The ISO standard is 20 characters. Therefore, may we suggest that any designated reporting field allows for this, to accommodate the ISO LEI should FSB and ESMA decide that the Trade Associations' work has value.

If further information is required, the following link provides all public information made available by the Trade Associations (http://www.sifma.org/issues/operations-and-technology/legal-entity-identifier/overview/)

In relation to paragraph 44, it is not clear how ESMA will authenticate the name of the natural person. The name by which the person is known to the intermediary should be sufficient.

Q14: Do you agree with the proposed way to notify and disclose the size of the relevant position?

We believe it is practically impossible to fully answer this question at this stage, as the methods of calculation of uncovered positions in CDS and net short positions in securities (taking into account derivatives and other relevant instruments) have not been specified yet. We would welcome an opportunity to come back to this question when the second consultation, on delegated acts, is published.

Paragraph 50-52: For the purposes of reporting share holdings as a percentage of issued share capital, it is necessary to have the issued share capital value per instrument. Given ESMA's comments that they have seen significant mis-calculation based on the total issued share capital figure, it would be most helpful if ESMA could publish and keep current a list of the total issued share capital for each in scope equity. This would, in a stroke, avoid any such errors.

Further, for the avoidance of errors in reporting, we would propose that ESMA publish the relevant Competent Authority to whom net position reporting should be submitted for each in scope equity. ESMA currently publish a daily file containing all EEA traded shares for the purposes of MiFID reporting. This file contains an authority per instrument and is in a standardised format which firms can readily use for reporting. We would propose that ESMA specify that this file (or a new file to be published for this purpose but using the same reporting format) should be the source for firms to identify (1) the population of shares to which the proposed regulations apply, (2) the relevant competent authority to whom net position reporting is submitted per instrument and (3) the total issued share capital for such share instrument.

We would also propose that ESMA publish a daily file that contains all relevant instruments to which the specific articles of the regulation apply, or as a minimum a list of the specific issuers. This is important for ensuring accuracy and completeness in reporting, especially given the inclusion of SPVs, national ministries and agencies and federal states as eligible issuers. This list should also contain the competent authority to which they are reportable.

Paragraph 53 & 54 specify that short positions in Sovereign debt & CDS should be "expressed in the same currency of the outstanding issued debt". The list of fields on page 41 however, specifies that reporting should be done in Euro equivalent. Sovereign issuers will have issuance in multiple currencies. Additionally, sovereign CDS are predominantly traded in USD notionals. We assume this is a drafting error and it is not anticipated that we submit a net position per currency per issuer. To the extent that an FX conversion will be required to report the required data in Euro equivalent, some guidance on how to apply FX would be welcome.

It would also be useful to clarify whether it would be necessary to notify regulators (and the public) of changes in net positions that cross trigger thresholds when the change is purely due to movements in FX rates (i.e. technical in nature).

Q15: Do you have any comments on the proposed way to identify the issuer in relation to which the relevant net short position is held, including how to use the ISIN code in this matter?

We would suggest using the ISIN associated with the main class of Ordinary shares. To require use of the ISIN relating to the class of shares first admitted to trading may require onerous checks on a per share basis to identify which is the appropriate ISIN / share class. Considerable resources would be required in order to ensure the correct ISIN was being reported for each issuer admitted to trading on an EU exchange and MTF. This would result in increased headcount requirements and infrastructure changes, which would be very costly. Further to the response on Q14, if a daily file was published by ESMA containing all reportable instruments, the relevant ISIN could be clearly identified for correct and consistent application by all reporting parties.

For sovereign debt, which includes other government entities within the member state, the name of the issuer should be sufficient.

Q16: Do you agree with the ISO 8601 2004 standard use to notify and publicly disclose the date on which relevant position was created, changed or ceased to be held?

Yes

Q17: Do you agree that the additional information as described above should be provided?

We foresee potential for confusion in relation to the requirement to include the date of the previous notification. This can be seen in the following example:

- 4 January 2012: notification
- 5 January 2012: notification
- 9 January 2012: cancellation of notification on 5 January

Should the next notification include the date of 5 January or not?

Q18: Do you agree that information on the central website should be provided at least in a machine-readable format?

Yes, we agree that the information relating to public disclosure of short positions should be provided in machine-readable format to allow vendors to upload and consolidate this data in way that would be useful to consumers of this data.

But it should also be readable by the human eye without further processing, in the same way as notifications under the Major Shareholdings Directive.

Q19: Do you agree that information on the central websites should at least include data as provided in Annex 1 of the draft implementing standard presented in appendix to this consultation paper?

Yes, we agree that the central websites operated by competent authorities should at least include the 6 fields of data set out in Table 2 of Annex 1 of the consultation paper.

Q20: Do you foresee any other situation that might merit an update of the list of exempted shares within the two-year effectiveness period?

We believe that the occurrence of a merger or acquisition should warrant an update of the list within the two-year effectiveness period.

Annex I

Potential negative consequences of retrospective interpretation of CDS grandfathering provision – detailed analysis.

Legal uncertainty

If the grandfathering provision is interpreted retrospectively and Level 2 technical measures (technical standards and delegated acts) are finalised after the date of entry into force of the SSR, market participants will be unable to determine whether they have entered into an uncovered sovereign CDS during the period from the date of entry into force of the SSR up until the date of finalisation of the Level 2 legislation.

Market participants that thought that their sovereign CDS was covered but subsequently find that their sovereign CDS is uncovered, because their interpretation of **definition of uncovered CDS** is different from the Level 2 legislation, they may be subject to legal restrictions in altering the "coverage" or unwinding.

Altering the "coverage" or unwinding sovereign CDS may impose significant cost implications on market participants. The example below illustrates this point.

Retrospective interpretation of the grandfathering rule - an example of impact
A market participant has counterparty exposure to the sovereign based on a rates swap. This person hedges its risk through purchasing CDS on the sovereign. This is based on how the participant determined its potential exposure and this is done prior to the date of the entry into force of the SSR. Then ESMA suggests technical measures that could indicate that the person was overly conservative on amount of CDS protection purchased. The participant will not know this until he/she already purchased and paid for the protection.

Come November 2012, if the participant is supposed to recalculate the position based on the ESMA technical measures, he/she will need to suddenly increase its risk exposure to the sovereign (this seems counterintuitive) or need to terminate the "excess" protection, which he/she have already paid for.

These uncertainties and costs could lead to a reduction in the range of market participants willing to write or buy sovereign CDS contracts, reducing liquidity and raising the cost of risk management (including hedging of direct exposure to sovereign bonds), up to a complete chill of the CDS markets for several months.

Reduced liquidity

Any measure to curb activity in the sovereign CDS market will affect liquidity in that market, making it more costly for firms to hedge the risk arising from a given country. In addition, this is likely to result in a spillover effect, whereby markets in the underlying sovereign debt will also be affected, making it more costly to invest in those markets. It is also worth noting that the sovereign debt market is often a reference market for other asset classes. Therefore that reduced liquidity in the sovereign debt market (impacted by the reduced liquidity in the sovereign CDS market) will in turn impact liquidity in, for instance, corporate bond market because much activity there is priced by reference to the sovereign debt market.

Increased funding costs

The ultimate consequence of legal uncertainty and reduced liquidity would be higher issuing costs for European companies and Member States, in particular smaller ones whose debt is already less liquid: if CDS protection ends up becoming more costly or uncertain, then Member States will have to compensate investors for the increased risk, leading to higher funding costs.

Annex 2

Further information regarding Question 6.

The associations would like to draw ESMA's attention to the fact that the concept of "reasonable expectations that settlement can be effected when it is due" has precedents in Europe, one of them having inspired the EU Short Selling Regulation, namely the law applicable in France on short sales of equities [reference to loi bancaire et financière].

The Autorité des Marchés Financiers has a large experience in following the practice of financial institutions entering short sales in France. In that regard, it is worth explaining how the "reasonable expectations" principle may be applied in France, as it could give ESMA examples of good practices that can be followed in Europe.

An Example of an application of soft locate rule based on the "reasonable expectations" principle

The way that that financial institutions active in France take the "soft locate rule" from the French law into account in its daily practices is as follows:

- Internal Securities Lending Desk (SLD) constantly monitors the repo market, using both internal systems , contacts in the markets (brokers, banks that send out their inventory available for repo) and external data service providers (like DATA Explorer) to assess the liquidity in the stocks that are traded within the bank.
- The moment that the SLD expects that a share will become difficult to borrow, the SLD will pro-actively alert the trading desk, send **immediate notification** (usually by email) that this specific share will be very difficult to be found in the market to cover the short position.
- They will request that the traders contact them first before going short in this specific share, to make sure that the SLD has the possibility to find the share and can actually borrow it the moment the share is sold.

This shows that indeed that:

a) under a "reasonable assurance" regime, financial institutions need to have proper internal systems in place under the supervision of market authorities, **including appropriate reporting to the Autorité des Marchés Financiers**;

b) this is a pro-active approach and a thorough monitoring and follow-up from the side of the Securities Lending Desk as far as the covering of short positions is concerned,

As a result, the notion "reasonable assurance" implies indeed specific actions that will guarantee correct settlement in an efficient way, without having a contrarian effect on liquidity.

Important to know also is that the SLD usually monitors all short positions in the institution and automatically covers these, not on an intra-day basis, but on trading day + 1, to ensure correct settlement.

They will **do this independently**: they do not ask consent of the trading desk.

Based on the French implementation of the "reasonable expectations" rule, we think that as long as internal securities lending desks are managed independently from other trading desks to perform their duties and the internal system provides the appropriate reporting to the market supervisor, this system should be recognised by ESMA as equivalent to a third party entity.