FORMAL REQUEST TO ESMA FOR TECHNICAL ADVICE ON THE EVALUATION OF THE REGULATION ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS ((EC)NO 236/2012)

With this formal mandate to ESMA, the Commission seeks ESMA's technical advice on the evaluation of the Regulation on Short Selling and certain aspects of Credit Default Swaps (the "**Regulation**")[1].

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudge the Commission's final policy decision.

This request for technical advice will be made available on DG Internal Market's website once it has been sent to ESMA.

The formal mandate focuses on technical issues which follow from the **Regulation**. The Commission is under the obligation to Report to the European Parliament and the Council by 30 June 2013 on the following issues:

(a) the appropriateness of the notification and disclosure thresholds for reporting of significant net short positions in shares to competent authorities (CA)'s, for publication of significant net short positions in shares, for reporting of significant net short positions in sovereign debt to CA's, and for reporting of significant net short positions in credit default swaps to CA's in times when restrictions on such positions have been lifted;

(b) the impact of the individual disclosure requirements of significant net short positions in shares, in particular with regard to the efficiency and volatility of financial markets;

(c) the appropriateness of direct, centralised reporting to ESMA;

(d) the operation of the restrictions and requirements, notably the notification and reporting requirements, the ban on naked short selling of shares and government bonds, the ban on naked CDS, and the provisions regarding buy-in procedures;

(e) the appropriateness of the restrictions on the uncovered sovereign credit default swaps and the appropriateness of any other restrictions or conditions on short selling or credit default swaps.

The Regulation requires the Commission to discuss these issues with the competent authorities and ESMA, before reporting to the European Parliament and the Council.

It should also be noted that the Regulation empowers CA's to temporarily limit short selling or otherwise restrict transactions in case of a significant fall in the price of a financial instrument. The Delegated Acts specified a threshold for most financial instruments but did not specify a threshold for those derivatives without a financial underlying – in particular commodity derivatives- and UCITS. The Commission wishes to assess the appropriateness of not setting a threshold for these derivatives and UCITS and requests that this issue be addressed in part (e).

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The European Parliament and the Council have been duly informed about this mandate.

1. Context.

1.1 Scope.

At the height of the financial crisis in September 2008, competent authorities in several Member States adopted emergency measures to restrict or ban short selling in some or all

[1] The text provisionally agreed by the Council and the European Parliament is available on the Council web site at this page: http://register.consilium.europa.eu/pdf/en/11/st16/st16338.en11.pdf

securities. More recently, several Member States have adopted emergency measures to restrict or ban short selling of shares, government bonds and through related derivatives.

The Regulation on short selling and certain aspects of credit default swaps (SSR)[2] lays down a common regulatory framework with regard to the requirements and powers relating to short selling and credit default swaps (CDS) and ensures greater coordination and consistency between Member States.

The Regulation aims to enhance transparency, reduce certain risks associated with short selling and uncovered CDS, and ensure a common regulatory approach across Member States. The Regulation contains four principle measures to address these objectives:

- Transparency: significant short positions in shares must be notified to regulators above a threshold of 0.2% and to the public if above a higher threshold of 0.5%. Significant short positions in EU sovereign debt need only be notified to the regulator. There are exemptions for market making activities and primary market operations.
- Settlement: Restrictions on naked short selling are proposed through a requirement for a "locate plus" rule for short sales. This rule requires that the third party issue a "locate" which confirms that it is reasonable for the investor to expect to be able to cover their short sale. There are exemptions for market making activities and primary market operations.
- Intervention Powers: The Regulation gives national regulators and the new European Securities and Markets Authority (ESMA) the power to adopt measures in exceptional situations to mitigate threats to financial stability.
- A ban on naked sovereign CDS is introduced. Only CDS positions for legitimate hedging are permitted but regulators may suspend the ban if their sovereign debt market's liquidity falls significantly. There are exemptions for market making activities and primary market operations.

The transparency provisions and exemptions apply to persons whether resident or established in the EU or outside.

1.2 Principles that ESMA should take into account.

On the working approach, ESMA is invited to take account of the following principles:

- It should take account of the principles set out in the de Larosière Report and the Lamfalussy Report and mentioned in the Stockholm Resolution of 23 March 2001.
- The proper functioning of the internal market and to improve the conditions of its functioning, in particular with regard to the financial markets, and the high level of consumer and investor protection which are the objectives of this Regulation.
- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objectives of the Regulation. It should be simple and avoid creating divergent practices by national competent authorities in the application of the Regulation.
- ESMA should respond efficiently by providing comprehensive advice on all subject matters covered by the mandate.

[2] Regulation (EU) No 236/2012

- While preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.

- In accordance with the ESMA Regulation, ESMA should not feel confined in its reflection to elements that it considers should be addressed, if it finds it appropriate, it may indicate guidelines and recommendations.

- ESMA will determine its own working methods, including the roles of ESMA staff or internal committees. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different works being carried out by ESMA.

- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants (practitioners, consumers and end-users) in an open and transparent manner. ESMA should provide advice which takes account of different opinions expressed by the market participants during their consultation.

- The technical advice carried out should contain sufficient and detailed explanations for the assessment done, and be presented in an easily understandable language respecting current legal terminology used in the field of securities markets and company law at European level.

- ESMA should provide sufficient factual data backing the analyses and gathered during its assessment. To meet the objectives of this mandate, it is important that the presentation of the advice produced by ESMA makes maximum use of the data gathered.

- ESMA should provide comprehensive technical analysis on the subject matters described below covered by the relevant Commission's request included in this mandate.

- ESMA should provide the Commission with an "articulated" text which means a clear and structured text, accompanied by sufficient and detailed explanations for the advice given, and which is presented in an easily understandable language respecting current terminology used in the field of securities markets in the Union.

- ESMA should address to the Commission any question they might have concerning the clarification on the text of the Regulation, which they should consider of relevance to the preparation of its technical advice.

2 Procedure.

The Commission would like to request the technical advice of ESMA in view of the review to be conducted pursuant to the legislative act and in particular regarding the questions referred to in section 3 of this formal mandate.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudge the Commission's final decision.

The Commission has duly informed the European Parliament and the Council about this mandate.

3. ESMA is invited to provide technical advice on the following issues:

ESMA is asked to consider the observable effects of the Regulation, if any, in order to answer the following questions, taking into account both the provisions relating to short selling as those pertaining to CDS:

i. Whether and to what extent the beneficial effects of short selling for volatility and price formation during normal times have been impacted by reporting and publication requirements or restrictions on uncovered short selling,

ii. to what extent any temporary restrictions imposed by competent authorities on short selling have had any positive effects in terms of reducing price falls, or any negative effects on volatility and price formation,

iii. to what extent the thresholds set for notification to CAs are appropriate for CAs' supervisory purposes and the thresholds for public disclosure are appropriate for the market's needs,

iv. whether the thresholds set to identify a significant drop in the price of financial instruments are appropriate for all instruments, and whether (and if so how) thresholds should be set for significant price falls in UCITS and commodity derivatives,

v. whether and to what extent the ban on naked sovereign CDS has had any effects in terms of market prices and of volatility of sovereign debt markets or investment by affecting the scope for hedging,

This assessment will require evaluation of statistics and, where possible, comparison of data <u>before</u> and <u>after</u> entry into application of the Regulation on 1st November 2012. More specifically, the statistical analysis would include:

i. An analysis of published short positions since the regime has entered into force;

ii. An analysis of volatility and price formation for shares and bonds, including spreads and news transmission, related to the size of published short positions;

iii. An analysis of the impact on securities lending behaviour provided that data are available;

iv. An analysis of the impact on settlement discipline;

v. An analysis of the impact of short selling bans adopted under the new regulation, if any;

vi. An analysis of the impact of the lifting of short selling restrictions adopted under the new regulation, if any.

ESMA would develop a baseline and appropriate benchmarks to try to measure the impacts mentioned above. It is acknowledged that there might be limitations to the exercise considering that it will be conducted soon after the Regulation enters into application and over a limited period of time and that relevant, accurate and reliable data may not be available in all instances (e.g. on securities lending).

In addition, ESMA would conduct a representative survey of market participants and competent authorities in order to answer the following questions:

i. whether reported information is sufficient for CAs to perform their functions, including monitoring and supervision of systemic risk, market stability and market abuse,

ii. whether published information is sufficient for market participants to better understand market dynamics,

iii. whether and to what extent the Regulation has affected non-financial actors, notably their need to hedge,

iv. whether there are possibilities for circumvention, notably through third countries,

v. whether the exemption for market makers allows for liquidity provision without undue circumvention,

vi. whether the thresholds set to identify a significant drop in the price of financial instruments are appropriate for all instruments, and whether (and if so how) thresholds should be set for significant price falls in UCITS and commodity derivatives,

vii. whether reporting mechanisms are operating efficiently.

4. Indicative timetable

The Commission is under the obligation to Report to the European Parliament and the Council by 30 June 2013.

The deadline set to ESMA to deliver the technical advice is **31 May 2013**.