



ADVICE TO ESMA

SMSG advice to ESMA on its Consultation Paper on the review of certain aspects of the Short Selling Regulation

I. Executive summary

The SMSG discussed the need for regulatory coordination and the need for a fundamental reflection on the use of short selling bans in its Own Initiative Report II on Covid-19 related Issues of 29 June 2020, and also discussed short selling in its own initiative overview report on Wirecard.

The SMSG has acknowledged the important role of short selling in price discovery, market efficiency and liquidity provision, even if there are different views on whether short selling bans in the Covid-crisis were counterproductive or useful. There is broad support for common interpretations of applicable rules, based on which NCAs may issue short selling bans, and a common interpretation of what constitutes short selling.

Against this background, the SMSG welcomes the ESMA Paper on the Review of Certain Aspects of the Short Selling Regulation (“the Consultation”) which will be followed by a report to the Commission on suggested improvements to the SSR framework.

The SMSG generally supports ESMA’s proposals in the Consultation to amend SSR provisions where and to the extent needed to increase legal certainty and make operational improvements and clarifications. The SMSG also agrees with the ESMA proposals *inter alia* to include subscription rights in NSPs and to introduce a centralised notification and publication system for NSPs.

Amongst the positions, comments and proposals put forward by the SMSG in this Consultation response, the following are highlighted:

The SMSG considers that when issuing SSR opinions, ESMA should be transparent about the extent to which it relies on information from the Relevant Competent Authority (“RCA”) and should be obliged to consider as many relevant sources and make as much analysis as possible in the time it has at its disposal.

The SMSG also proposes that ESMA should be obliged to conduct an ex-post analysis of short selling bans imposed in the future, on which ESMA issues an opinion, to inform market participants and increase knowledge about the consequences of short selling bans.

The SMSG notes that where indices, baskets, and ETFs are used for taking positions on broader market movements and are used to hedge market-wide risks, such instruments are less likely to be used to take an NSP in a single share, making it reasonable to exclude such instruments from the scope of long-term bans.

While there are different views in the SMSG on whether a percentage-based weighting approach should or could be introduced, there is consensus that a threshold decision should be based on a proper analysis and

simulations to avoid unintended consequences *inter alia* by making it more difficult or impossible for market participants to carry out normal market hedging transactions.

The SMSG stresses the importance of not undermining the market-making exemption set at Level 1 and specified by the competent authority under article 20.3 and calls on the Commission to endorse the aspects of the Technical Advice submitted by ESMA in December 2017 relating to OTC market making activities.

The SMSG would support a reinforcement of third-party commitments so that commitments are based on clear confirmations, while also stressing the importance of not subjecting lenders and borrowers of shares in non-NSP situations to further administrative burdens, as this would hamper liquidity in markets.

I. Background

1. The SMSG discussed the need for regulatory coordination in regard of short selling in its Own Initiative Report II on Covid-19 related Issues, dated 29 June 2020 (2020 ESMA22-106-2738) (“the SMSG Report”). The SMSG noted in the SMSG Report that the Short Selling Regulation (“SSR”) enables national competent authorities (“NCAs”) to introduce restrictions aimed at tackling specific adverse circumstances that constitute a serious threat to market confidence. The assessment of the situation, the initiative and the specification of the measure are taken at national level and ESMA is asked to provide an opinion on whether the national measure is necessary. To this end, ESMA considers the measure, its appropriateness, proportionality, and duration.
2. In the SMSG Report, the SMSG acknowledged the important role of short selling in price discovery, market efficiency and liquidity provision. At the same time, there were different views in the SMSG as to whether short selling bans in the Covid-crisis were counterproductive or useful. One view in the SMSG Report was that especially in adverse circumstances and highly volatile markets, short selling activity is very important for price discovery, liquidity provision and market efficiency. Another view is that short selling bans in crisis situations provide protections to issuers and investors.
3. Further to this Report, the SMSG addressed the short selling regime again in its own initiative overview report on the Wirecard case (2021 ESMA22-106-3194). On this occasion the SMSG highlighted the limitations of the short selling regime at national and EU levels, and the need for a fundamental reflection on the use of short selling bans. The SMSG advised to make a distinction between a systemic short selling ban due to specific circumstances and a short selling ban applied to a specific share, noting that in effect the burden of proof may be higher for the imposition of a ban on individual shares than for sectoral or market-wide bans. The SMSG recommended that ESMA would use its supervisory convergence tools to clarify the circumstances under which a prohibition or a restriction can be enacted. In addition, it was stressed that ESMA’s opinion in regard of any short selling restriction proposed by an NCA should not be a mere consistency check.
4. While members of the SMSG may thus hold different views on some aspects of short selling, there is broad support for having common interpretations of the applicable rules, based on which NCAs may issue short selling bans, and a common interpretation of what constitutes short selling.
5. Finally, the SMSG considers that the exemptions granted to market-making activities in the Level 1 text are integral to price discovery, liquidity provision and market efficiency.
6. Against this background, the SMSG welcomes this ESMA consultation (“the Consultation”), which will be followed by a report to the Commission on suggested improvements to the SSR framework.

II. Question 1: Does ESMA’s analysis confirm the observation that you made in your perimeter of competency? Please provide data to support your views.

7. ESMA concludes in its analysis *inter alia* that the European long-term bans of 2020 had mixed effects, that restrictions on acquiring and increasing Net Short Positions (“NSPs”) could have contributed to

preventing increasing NSPs from exacerbating disorderly downward price spirals, impacts that were particularly relevant in stressed market conditions after the COVID-19 outbreak.

8. Against this background, ESMA considers that the current framework supports Relevant Competent Authorities' ("RCAs") capacity to address concerns on financial stability and it is in favour of keeping it that way. ESMA also proposes some "operational improvements" as further described in the Consultation.
9. As noted in the introductory comments, SMSG members have different views on some aspects of short selling, but generally agree that some operational improvements and clarifications could, as further discussed below, be beneficial.

III. Question 2: What are your views on the proposed clarifications?

10. ESMA proposes certain amendments to the SSR, with the aim to clarify certain rules to increase legal certainty.
11. The first proposed clarification, amending Article 2(1)(j) SSR, means that a reference to Delegated Regulation 1287/2006 supplementing MiFID I is replaced with a reference to RTS 22. ESMA thereby refers to certain situations, where the outcome could be different, depending on the interpretation of the rule.
12. A second proposed clarification, to the same SSR article, aims to specify the RCA definition in the context of emergency measures. ESMA proposes to make it explicit, thereby providing additional legal certainty, that the RCA competent for the "target" financial instrument is also competent in relation to all those instruments (subject to potential exclusions or limitations, see further below) conferring a financial advantage in the event of a decrease in the price or value of the "target" instrument.
13. The SMSG notes that unclear rules and a lack of legal certainty can lead to process delays as well as consequences that cannot always be foreseen. Against this background, to increase legal certainty and provide clarity, the SMSG would support the clarifications proposed by ESMA, subject to the exclusion from the approach of diversified indices, baskets, and ETFs, as set out under Question 4.

IV. Question 3: Do you agree with the proposed clarification?

14. ESMA proposes a clarification to Article 20(2) of SSR, to the effect that RCAs may adopt either one or both measures set out in point (a) and (b) of said Article. ESMA points out that the text as presently drafted could be read in such a way, that a choice would have to be made between the alternatives.
15. The SMSG considers that RCAs should be provided with the flexibility offered by the reading that "both" measures could be used, and supports the clarification proposed by ESMA.

V. Clarification of ESMA's reliance on information provided by the RCA

16. ESMA proposes an amendment to relevant SSR provisions, providing that the ESA's assessment and the relevant ESMA opinion will mainly rely on the factual events and representations outlined by the RCA in its notification. ESMA will consider further sources only when available and where its assessment is compatible with the short deadline.
17. While there is no explicit question on this proposal, the SMSG generally supports an amendment in line with the ESMA proposal. However, the SMSG considers that ESMA should not only be transparent about the extent to which it relies on information from the RCA, but also be obliged to consider as many relevant sources as possible and make as much analysis as possible in the available time.
18. The SMSG would further see value in, and would propose an amendment to the effect that ESMA should conduct an ex-post analysis of short selling bans that are imposed in the future on which ESMA gives an opinion. By doing this, and by making such analysis publicly available, market participants will be better informed and can make a proper analysis of the consequences of short selling bans.

VI. Question 4: What are your views regarding the exclusion or, alternatively, a percentage-based weighting approach, for indices, baskets, and ETFs in the context of long-term bans?

19. ESMA is considering that indices, baskets, and ETFs be excluded from the scope of long-term bans. As an alternative, a percentage-based weighting approach is considered, where the amounts of banned instruments as a percentage of the overall components are taken into account.
20. ESMA further considers whether it should be clarified that it is prohibited to trade in indices, baskets and ETFs, in a manner that clearly demonstrates an intention to circumvent the ban.
21. The SMSG preliminary observes that indices, baskets, and ETFs are largely used for taking positions on broader market movements and may be used to hedge market-wide risks. Such instruments are less likely to be used to take an NSP in a single share. Consequently, the SMSG believes that the exclusion of such instruments from the scope of long-term bans should be considered as a first best scenario to avoid a disproportionate cost with respect to a limited (if existent) benefit. An appropriate cost-benefit analysis should be performed prior to considering the percentage weighting approach.
22. The SMSG also considers that the exclusion of such instruments from the scope of long-term bans should not allow behaviours and trades intended to circumvent the SSR. In this respect a principle-based approach, that would limit the costs associated with a complex set of rules, should be implemented and enforced.
23. As a second-best scenario – in case a cost-benefit analysis shows the need to include such instruments in the scope of long-term bans – the SMSG considers that the exclusion should at least be granted to indices, baskets, and ETFs providing for sufficient diversification as – e.g. – identified by the EU rules on UCITS or equivalent. In any case, it is also important to ascertain that the SSR is not circumvented.
24. To avoid situations where narrow indices or undiversified baskets or ETFs theoretically could be used to circumvent the SSR, a percentage-based weighting approach could be used.
25. In case a threshold is set, such threshold should be decided based on a proper analysis and simulations to avoid unintended consequences, e.g. by making it more difficult or impossible for market participants to carry out normal market hedging transactions.
26. Furthermore, this form of indirect restriction should not undermine the market-making exemption set at Level 1 and specified by the competent authority under article 20.3. We also call on the Commission to endorse the aspects of the Technical Advice submitted by ESMA in December 2017 which relate to OTC market making activities.
27. In case ESMA excludes indices, baskets and ETFs governed by EU rules or equivalent, the SMSG would see the need to accompany such an exclusion with an explicit principle, clarifying that it is at all times prohibited to trade in indices, baskets as well as ETFs in a manner that clearly demonstrates that it is intended to circumvent the ban.
28. The SMSG would in such case also welcome more information about which indices, baskets and ETFs may be affected, and what the potential effects would be. The SMSG would also favour more clarity and consistency across the EU.

VII. Question 5: Do you agree with the proposed alignment of the conditions to adopt measures under Article 20 and Article 28 of SSR?

29. The SMSG can support the alignment of the conditions to adopt measures under Article 20 and Article 28 of the SSR. In connection herewith, we refer to the comments above (question 5) on the value of making an ex-post analysis of future short-selling bans where ESMA issues an opinion.

VIII. Question 6: Do you agree with the proposed amendments to Article 24 of Delegated Regulation 918/2012?

30. The SMSG considers it important that ESMA has the authority to act where this is justified, also where volatility is caused e.g. by a pandemic or other events with a similar effect or when an entity is involved other than financial institutions and entities that are now listed. It could in this context be noted that a recent example involved a FinTech company.

31. However, while ESMA should have the right “tools” and a proper mandate at its disposal, it should be carefully considered how such tools and mandates are put to use.

IX. Question 7: Do you agree with the proposed amendments to the SSR and, more specifically, the mediation procedure under Article 23 of SSR?

32. The SMSG would, based on the analysis provided by ESMA, support the proposed amendments to the SSR including the proposed changes related to the mediation procedure.

33. However, considering that the proposed changes would in effect leave it up to the most relevant national authority to take decisions on short-selling bans, it is important that a process is available to discuss and analyse the effects of such bans with concerned NCAs.

X. Question 8: What are your views on ESMA’s proposal to include subscription rights in the calculation of NSPs in shares?

34. SMSG would support the inclusion of subscription rights in the calculation of NSPs in shares. The SMSG notes the importance of transparency and avoiding unintended consequences, such as sending misleading signals regarding market positions.

XI. Question 9: Do you agree with this proposal to reinforce the third-party’s commitment? If not, please elaborate. If yes, would you either (A) keep the three types of locate arrangements, but increase the level of commitment of the third party to a firm commitment for all types of arrangements, or (B) simplify the regime to keep only one type of firm locate arrangement?

35. The SMSG notes that the location rules today include relatively “weak” options, such as a promise of a third party that certain shares are easy to procure. Against this background, the SMSG would support a reinforcement of the third-party commitments, with the aim to reduce NSPs, so that commitments are based on clear confirmations. However, it is also important not to subject lenders and borrowers of shares in non-NSP situations to further administrative burdens, as this would hamper liquidity in markets.

36. As further discussed below (question 11) more focus should also be put on enforcing the rules that are already in place, including sanctions for parties taking NSPs without having or even intending to get commitments from third parties. The SMSG also underlines the importance of supervisory convergence in this area, to create a level playing field.

37. It could be noted that CSDR, incl. rules that are of relevance to this area, is presently being reviewed.

XII. Question 10: Do you agree with this introducing a five-year-long record-keeping obligation for locate arrangements? If not, please justify your answer.

38. The SMSG would support the introduction of a five-year-long record keeping obligation for locate arrangements, where relevant and necessary.

XIII. Question 11: Do you agree with reinforcing and harmonising sanctions for “naked short selling” along the proposed lines? If not, please justify your answer.

39. The SMSG takes note of the fact that questions relating to sanctions are primarily dealt with at level 1, but nevertheless considers that it would be valuable to have stricter and harmonised sanctions for “naked short selling” in the EU.

40. While the SMSG is not in a position to determine exactly what those levels should be, it notes that levels of sanctions presently differ very much between markets in the EU. At the same time, it is noted that markets in the EU have different characteristics.

XIV. Question 12: Do you consider that shares with only 40% of their turnover traded in a EU trading venue should remain subject to the full set of SSR obligations?

41. The SMSG understands the reasoning behind the proposal but is not in a position to agree on a specific threshold. The SMSG also notes potential difficulties with having the SSR rules apply to shares primarily traded outside the EU.

42. Against this background, the SMSG advises EMSA to underpin the proposal with more data, e.g. regarding stocks that would historically have been affected by a 40% threshold.

XV. Question 13: Do you consider that NCAs should take any other qualitative but specific parameter into account in the identification of the shares subject to the full set of SSR obligations even if they are more heavily traded in a third-country venue? If yes, please elaborate.

43. The SMSG considers that including additional parameters into the equation would make the rules more complex and does not support this proposal.

XVI. Question 14: Would you modify the threshold for the public disclosure of significant NSPs in shares? If yes, at which level would you set it out? Please justify your answer, if possible, with quantitative data.

44. SMSG notes that apart from “naked short selling”, the main problem for securities markets is stock loans being called to such an extent that it creates a short squeeze. While transparency is often good, too much public disclosure may increase the risk of speculation.

45. Against this background, the SMSG concurs with ESMA that the present threshold seems to provide a “good compromise” between transparency to the market and market efficiency, as long as a compulsory publication of anonymised aggregated NSPs per issuer integrating all individual positions reaching or exceeding the notification and the publication thresholds, are published on a weekly basis, as suggested by ESMA in section 15.

XVII. Question 15: Would you agree with the publication of anonymised aggregated NSPs by issuer on a regular basis? If yes, which would be the adequate periodicity for that publication?

46. The SMSG would, to increase transparency without harming market efficiency, support the introduction of a system where more information is published, on an anonymised basis, about aggregated NSPs.

47. As regards periodicity, the SMSG would find it valuable if such information was published on a regular basis, to begin with, during an initial trial period, on a bi-weekly basis.

XVIII. Question 16: Have you detected problems in the identification of the issued share capital to fulfil the SSR notification/publication obligations? If yes, please describe and indicate how would you solve those issues.

48. The SMSG has not detected any major problems in this regard, subject to minor delays that may occur for technical reasons in connection with new share issues, buy-backs etc.

49. The SMSG finds that stock exchanges normally provide information regarding issued share capital of companies listed on such exchanges.

XIX. Question 17: Do you agree with the establishment of a centralised notification and publication system for natural and legal persons to communicate their NSPs? In your view, which would be the benefits or shortcomings this system would bring? Please explain.

50. The SMSG takes note of the fact that several notification and publication systems are in use across the EU and considers that a centralised notification and publication system for natural and legal persons to communicate their NSPs would be valuable.

51. However, it is important that the introduction of any such system be preceded by consultations with market participants, and that robust standards and templates are agreed and used in all markets and by all relevant market participants, in order to ascertain that there are no unintended negative side effects.

52. It is also important that NCAs retain a right and possibility to access data that is of relevance to their supervision of national markets.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 19th November 2021

[signed]

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[signed]

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