Consultation response: ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps[1]

1. Introduction

The HFSB welcomes the opportunity to respond to the Consultation paper on ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community.

The HFSB has in the past responded to consultations on issues in relation to short selling, including the European Commission consultation on short selling (2010), the CESR proposal for a Pan-European Short Selling Disclosure Regime (09/2009), the FSA Consultation (DP 09/01) on Short Selling (05/2009), the IOSCO Consultation on Regulation of Short Selling (05/2009) and the Committee of European Securities Regulators (CESR) call for evidence on regulation on short selling (01/2009).

The HFSB is pleased to continue to inform the regulatory process in the context of short selling disclosure, but it is quite unfortunate that ESMA deviates from normal practice, and does not engage in a call for evidence format (to gather comments to help shape the legal proposal). A cost benefit analysis should complement the regulatory proposals in this context.

2. Overview

The HFSB has in the past actively engaged in the discussions on regulation of short selling and submitted numerous responses to official consultations in this context, including IOSCO, CESR, FSA and the European Commission (http://www.hfsb.org/?page=11647).

[1] ESMA Consultation Paper: http://www.esma.europa.eu/node/56557 , European Parliament legislative resolution: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2011-0486&language=EN#BKMD-12

The HFSB acknowledges that when regulators and politicians are coping with an emergency brought on by fears of a meltdown of the banking system (i.e. run on the banks caused by plummeting bank stocks), extreme measures may be warranted. In such instances, however, it is important that regulators and politicians assess the adequacy of specific measures to resolve a given problem.

Indeed, regulatory intervention interfering with the market and price formation process can have a more devastating impact, since it can give rise to concerns by investors about the efficiency of the price formation process, thereby triggering further sell offs of those who would otherwise hold on to their assets.

The HFSB has also highlighted in past consultations[2] that regulatory interference (e.g. in relation to short selling) can also implicitly tell the markets that the practice of short selling results in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, in the context of the recent crisis, we believe that, on the contrary, the price discovery process did work , and that the short selling ban may have distorted the price discovery process, and that the ban has ultimately undermined confidence in the markets.

Therefore, it is of utmost importance that the regulatory toolkit to be developed in relation to short selling is anchored in a) a rigorous process for identifying and classifying disorderly markets, and b) a carefully calibrated spectrum of tools/mitigants that can be employed to counter disorderly markets (as part of this, restrictions on short selling might be only one of the available tools). We believe that in many instances short selling will not be the cause of disorderly markets.

In this context, the HFSB has stressed **the need for a regulatory disclosure of short positions exceeding certain thresholds (as detailed in the current consultation)**, but also highlighted that **there is no justification for a public disclosure regime of short positions from a financial stability and market integrity/efficiency perspective**, and that in the context of equities, a symmetric disclosure regime where the short disclosures mirror the long disclosure requirements (e.g. 3% threshold).

3. Consultation responses

The following sections provide responses to select questions raised in the ESMA Consultation Paper. Section numbers and page references refer to the ESMA Consultation document.

Q1: Do you agree with the proposal concerning Article 2(1)(r) of the Regulation?

The HFSB agrees with the approach to ownership of a financial instrument.

Q6: Do you agree with the above proposal? If not, please give reasons.

We have one general and two specific observations on the proposal:

[2] See for example the HFSB response to FSA's Consultation (DP 09/01) on Short Selling (05/2009) (http://www.hfsb.org/?page=11647)

More generally, the total public and private debt could be used to determine the basis for calculating the threshold (based on the relevant percentages), rather than just the sovereign debt exposure.

> *Rationale: Sovereign CDS are often used to hedge the country risk component in the context of private (e.g. corporate) debt and equity investments. The rationale for this is given in ESMA's own assessment in the consultation paper (non exhaustive list of qualitative events that might pose a serious threat to the financial stability) :* [3] *Serious instability and uncertainty concerning EU member states could indeed threaten the orderly functioning of entire markets, which explains the rationale for investors to manage this risk actively and use sovereign CDS to hedge the country risk component in relation to their total exposures (also see response to question 20).*

More specifically: in order to improve consistency and certainty as to what constitutes sovereign debt, the HFSB would welcome publication of a definitive list of sovereign issuers.

Box 3 2) refers to a non-exhaustive list of instruments. Convertible bonds are not explicitly mentioned. As highlighted in the previous HFSB consultation responses (e.g. see …), short positions often arise in the context of the risk management of convertible bond portfolios, and, as indicated in the example above, many other instruments.

Q7: Do you agree with setting a quantitative threshold for high correlation? If so, what would be the best correlation co-efficient to use for this purpose?

The HFSB has practical and conceptual concerns in relation to the quantitative threshold approach:

The concept of correlation introduced by ESMA is difficult to implement in practice given the requirement to test correlations on an ongoing basis between a large number of instruments. There can be many factors affecting the daily price fluctuations of a particular instrument in comparison to a reference asset, for example due to specific non-vanilla investment terms, non-matching terms to maturity, or different levels of market liquidity. This can result in a low correlation measures, in some instances far below the threshold set by ESMA, although the two assets exhibit exactly the same long term trend and might even behave in a similar way in times of distress or sovereign default (tail risk). It is also important to highlight that correlation is a backward looking measure.

In this context, the HFSB would like to highlight the EDHEC Risk-Institute Discussion Paper "Correlation vs. Trend: A Common misinterpretation"[4], which illustrates many common misconceptions around correlation and highlights that Pearson's correlation coefficient says nothing about the trend of asset prices.

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[3] Section VII, p. 64 of the consultation paper (criteria and factors … in determining … adverse events…)

[4] http://www.edhec-risk.com/edhec_publications/all_publications/RISKReview.2011-09-07.3757/attachments/EDHEC_Working_Paper_Correlation_vs_Trends_F.pdf

Therefore, it would be more appropriate to choose a qualitative approach to assessing whether correlation exists. If indeed the "correlation threshold" approach is chosen, a much lower threshold should be adopted. Also, it is advisable to allow for a longer" temporary buffer period" (e.g. 6-12 months) for temporary fluctuations. Correlation could be used as a sufficient condition for eligibility, but should not be a necessary condition.

Q8: Do you think it is practicable to measure correlation for sovereign debt with a liquid market price and a long price history on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out? Do you consider that a 24 month reference period is the most appropriate one?

See previous answer on the suitability of correlation.

Q9: Do you think it is practicable to measure correlation for assets with no liquid market price or with no sufficiently long price history by using a proxy? What could be a good proxy? What criteria do you think are necessary?

See response to question 7 on the suitability of correlation.

Q10: Do you consider that this Delegated Act needs to provide further specifications on the calculation of whether the high correlation test is met? Do you have any suggestions on what they may contain (e.g. use of a maturity bucket)?

See response to question 7 on the suitability of correlation.

Q11: Do you think that there is a need for a buffer period addressing the issue of temporary fluctuations in the correlation of the sovereign debt (e.g. period of 3 months during which the correlation is less than the standard level (e.g. 90% or 80%) but at least met a prescribed lower threshold (e.g. 75% or 70%)?

See response to question 7 on the suitability of correlation.

Q12: Do you think it is appropriate the "delta adjusted method" for the calculation of short position for shares?

The delta adjusted method is appropriate.

Q13: Is there any comment you would like to make in relation to the calculation of the position in shares set out in Box 4?

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Q14: Is there any additional method of calculation for shares that you would suggest ESMA to consider?

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Q15 Which in your view is the most appropriate method for the calculation of short position for debt instruments of a sovereign issuer? Are there methods other than the nominal or sensitivity adjusted ones outlined above which you think ESMA should consider?

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Q16: Is there any comment you would like to make in relation to the calculation of the position in sovereign debt of a sovereign issuer set out in Box 4?

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Q17: Do you agree with the approaches described above to cater for specific situations when different entities in a group have long or short positions or for fund management activities related to separate funds? If not, can you state your reasons and provide alternative method(s) of calculation? / Q18: Which do you consider the better definition of a group for the purpose of this Regulation?

The described approach to single out short positions on a "per decision maker" level seems fairly complex and unnecessary in light of the overarching objective of assessing exposure on a legal entity level.

Q19: Are there other situations that should be taken into account?

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Q20: Do you agree with the general conditions proposed for determining when a sovereign CDS position can be considered covered? Are there any modifications you would propose? / Q21: Do you have any comments or alternative suggestions on the proposed test for correlation? Do you have any estimates of the costs which applying the qualitative test envisaged by ESMA would entail for market participants or the costs which would be associated with the imposition of a quantitative test?/ Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

As indicated in response to question 7, the concept of correlation has significant weaknesses. While there might indeed be assets/hedges exhibiting the correlation characteristics, there can be many situations where the correlations test will not work, despite hedges working perfectly well during distress/default. Therefore, high correlation can serve as a sufficient condition to establish a hedge, but it should not be applied as a necessary condition. Therefore, the application of "correlation" should not be treated in a narrow sense of Pearson's correlation coefficient, but more broadly allow for the application of qualitative criteria to determine eligibility of netting.

Illustration:

It is important to highlight that CDS are commonly used to hedge the country risk component in corporate risk. For example, an investor (e.g. a dedicated corporate bond fund) wants to build up exposure to the corporate credit risk of an issuer (who might heavily depend on business with the local government), but wants to limit the country specific risk. The trade will involve buying corporate bonds, and buying CDS protection on the respective sovereign. If the sovereign CDS cannot be netted with the long position in corporate debt, the investor might have to publicly disclose their country allocations via the public disclosure regime on short positions. This might be a concern from the investor's position and might result in lower allocations.

The public disclosure regime along with the calculation methodology (i.e. non-eligibility of corporate debt to offset short positions/sovereign CDS) will therefore have a detrimental impact on capital flows towards the corporate sectors. This is particularly relevant in the context of corporate bond investment in emerging economies, for example in Eastern Europe, or more generally in countries where government debt levels are generally lower (than, for example, in Western Europe) and markets not yet as developed.

The assessment above also makes a case for inclusion of total private and public debt in order to determine a basis for calculating the absolute disclosure thresholds (in the context of Question 6).

Q23: Are any changes required to the proposals for determining whether a sovereign CDS position is proportionate?

The following example illustrates that the size of a hedge can depend on multiple factors, and from a risk management perspective, an investor might want to calibrate the size of a hedge in such a manner that it covers a potential loss when a default occurs (i.e. compensating for the "loss given default", or LGD).

A sovereign CDS usually references a specific set of sovereign debt instruments (i.e. bonds), thereby providing protection by compensating for the LGD. However, not every single existing debt instrument in the context of a sovereign borrower might be referenced in the terms of the CDS, and the specific bonds or loans held by the investor might exhibit a different LGD.

Example: In the event of a sovereign default, an investor with a static hedging strategy expects that regular bond investors will recover 80% of their investments (=> LGD = 20%) in the debt restructuring. Those investors with CDS protection will receive compensation through the CDS to make up for the 20% LGD (either in cash or by delivering the bonds against the face value). However, the investor has made loans to a specific governmental entity (e.g. a local public development bank) and expects to recover only 20% of the investment in the event of default. The expected LGD is 80%. In order to statically hedge this expected LGD, the investor will have to buy CDS protection for four times the face value of his loan exposure.

The example illustrates that considerable leeway is needed in determining the "appropriateness" of CDS positions.

Q24: Do you think that a position that had become partially uncovered due to fluctuations in the value of the assets or liabilities being hedged and/or the CDS used as the hedge should be allowed only for a certain period of time? If so, what would be an appropriate time limit?

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Q25: Do you agree that sovereign CDS positions which are obtained involuntarily as a result of the operations of a CCP clearing sovereign CDS should not fall to be considered as entering into a CDS transaction for the purposes of the Regulation?

Yes.

Q26: Do you consider there are any other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position which should be included in the indicative list?

As indicated above, the risk of sovereign default affects many areas of business and financial products, including corporate bonds, interest rate swaps etc. It is difficult to provide a complete list, and it ultimately depends on an individual investor's perspective as to how this risk can materialise in many different contexts, even across borders.

Q27: Do you agree that the net CDS position is the correct one to use in the calculations?

Yes. Also see responses to Question 20 and Question 26 above.

Q28: Do you consider that there should be different methods for calculating the value of the positions to be hedged by the sovereign CDS according to whether a static or dynamic hedging strategy is used?

See the response to Question 23 which illustrates the complexities arising when structuring hedged portfolios and managing risk.

Q29: Are there refinements which can be made to the proposed methodology? Are there any standard calculation formulae which can be used when applying risk adjustments which we should include in the draft advice?

See the response to Question 23 providing one illustrative approach. There are indeed many more risk management techniques which can be applied in the structuring of hedged portfolios.

Q30: Do you agree with the proposed method of treating indirect exposures?

Yes, indirect exposures should be considered.

Q31: Do you agree that the relevant notification threshold should be based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer?

The HFSB agrees. ESMA should also specify the denominator for the calculation. As indicated in the answer to Q6 a definitive list of sovereign issuers should be published by ESMA.

Q32: Do you agree with the proposal to convert these percentages into monetary amounts which would be updated quarterly to reflect changes in the issued sovereign debt? If not, what other arrangement would you suggest?

The HFSB agrees.

Q33: Do you agree with ESMA's proposal to group sovereign issuers into categories for the purposes of setting the notification thresholds or would you prefer an alternative approach (e.g. a single threshold for all sovereign issuers or setting individual thresholds for each sovereign issuer)? Please state your reasons.

Taking into account the characteristics (e.g. liquidity) of the respective markets, a diversified approach seems more appropriate. Considering that the absolute amounts are relevant for each individual sovereign issuer (the "denominator for the calculation", as indicated in the answer to question 31) and which will in many ways differ between sovereign issuers, having individual percentage thresholds for each sovereign does not add to complexity.

Q34: If you support grouping sovereign issuers into categories, do you agree with ESMA's proposal to set the three categories of notification thresholds suggested above? If not, what other grouping would you suggest and why?

As per above, the grouping does not reduce complexity, and therefore, a more differentiated approach can be taken.

Q35: Do you consider the proposed initial amounts and the incremental levels as reasonable and optimal? If not, what amounts and incremental levels do you consider as more appropriate and why?

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Q36: If given the thresholds ESMA has proposed above are implemented, how many notifications do you expect to make in a month to each relevant competent authority?

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Q37: What level of net short position do you regard as significant for the particular sovereign debt markets?

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Q38: Do you agree with the general proposal suggested by ESMA for setting the parameters and methods for calculating the threshold of liquidity of the issued sovereign debt for suspending restrictions on short sales? If not, please state your reason and explain what could be an appropriate alternative.

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Q39: In particular, do you agree that a measure in percentiles of the monthly volume traded in the last twelve months is suitable to define a threshold that represents a significant decline relative to the average level of liquidity for the sovereign debt concerned?

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Q40: In light of your response to the question above, do you think that a threshold of a) the 5th percentile, b) 2nd percentile or c) 1st percentile would best represent a significant decline relative to the average level of liquidity for sovereign debt? Please explain why providing data if possible.

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Q41: Do you agree that three categories are necessary? If not please state you reasons.

In general, a differentiated approach makes sense. It is also important that the thresholds are set such that they are exceeded only in very exceptional circumstances, and should therefore be relaxed.

> *Rationale: Capital markets provide a mechanism for balancing supply and demand and price formation. A large drop in market price of an instrument can be perfectly justifiable, and reflects the views and expectations of market participants about the future (e.g. change in outlook for a company, a sector, the economy etc.). It is desirable that these price corrections happen as fast as possible, in order for prices to reach a sustainable level where investors are again prepared to buy.*
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> *The more frequently regulators intervene in markets and thus implicitly interfere in price formation, the less attractive the market becomes for all investors: long only/retail investors, index investors, and hedge funds.*
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> *The negative impact on hedge funds and other investors with sophisticated approaches to risk management is quite obvious: short selling is an important instrument in structuring sophisticated portfolios, by combining long and short positions to immunise the overall portfolio against broader market fluctuations. Short selling is also an important risk management instrument for convertible bond investors, and restrictions on the ability to*

manage risk will prevent these investors to hold on to these investments.[5] If these investors expect regulatory intervention to happen frequently and in particular in times when short selling as a risk management instrument is particularly needed, they will withdraw from the market.

This has major negative consequences for other market participants, including retail, long only and index investors. Not only will the withdrawal of active and sophisticated players reduce liquidity and result in higher trading cost for all [6], more importantly, it will reduce overall confidence in the price formation in the market place. Sophisticated players, who invest heavily in market research/information acquisition and have the ability to sell short, act as market detectives spotting overvaluations, thereby helping smooth bubbles. Reduced activity of such players is a warning signal to retail and index investors, since it increases the risk of overpaying and will reduce their activity as well, accentuating the market contraction during major crises.

In summary, it should not come as a surprise that short selling restrictions (or the threat thereof) will deter most investors from entering a market, due to the limited ability to manage risk and the concerns about the quality of price formation.

Regulators should be aware of the above mentioned consequences of market intervention (or the threat of intervention) and should therefore set the relevant thresholds in a manner to minimise the trigger frequency.

Q42: For the more illiquid shares, do you agree that EUR 0.50 is the correct cut off point to use? If not please state you reasons.

See response to question 41.

Q43: Do you agree that 10%, 20% and 30% are the correct percentages to use in relation to the fall in value? If not, what other levels would you propose; please state your reasons.

See response to question 41.

Q44: Do you agree that an increase in the yield across the yield curve is the appropriate measure to use for sovereign bonds? If not, what other measure would you propose, please state your reasons.

[5] During the financial crisis, short selling restrictions negatively affected the convertible bond markets: investors were limited in their ability to manage risk, as a consequence banks found it a lot harder (and more expensive) to issue convertible debt, at a time when they were in desperate need for capital.

[6] See analysis in HFSB consultation response to FSA Consultation (DP 09/01) on Short Selling (05/2009) at http://www.hfsb.org/files/public_comment_on_fsa_short_selling_consultation_(final).pdf , p.2

Yes, notwithstanding the general concerns the HFSB has highlighted throughout this document, the approach is generally acceptable. It should also be noted that changes in the yield curve driven by Central Bank intervention should be excluded for the purposes of this assessment.

Q45: Do you agree that an increase of 5% or more in the yield across the yield curve is the correct percentage to use? If not, please say what alternative threshold you would favour and state your reasons.

See response to Question 41. Since the 5% is calculated as a percentage of the actual yield, a higher threshold should be used for lower yields (e.g. for yields below 5%). Yield movements of 10-20 bps are not uncommon, for example, when yields are at 2%, however, they might exceed the "percentage" threshold (5% x 2% = 0.1% = 10bps). Therefore, it might be useful to apply the following approach: Threshold = max(0.25%, 5%* Yield), thus introducing a lower boundary for the threshold at 0.25%.

Q46: Do you agree that an increase of 7% or more in the yield is the correct percentage to use for corporate bonds? If not please state your reasons.

See methodology suggested in the previous answer (to question 45) for low yield scenarios.

Q47: Do you agree that an increase of 10% or more in the yield curve is the correct percentage to use for money market instruments? If not please state your reasons.

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Q48: Do you agree with the proposed ESMA approach to units in collective investment undertakings? If not please state your reasons.

Yes

Q49: If you consider that a trigger threshold in relation to fall in value in UCITS should be defined, what should be this percentage threshold and why?

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Q50: Do you agree that 10% or more is the correct percentage to use for ETFs? If not please state your reasons.

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Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.

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Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward rate agreement or other derivative instrument, including financial contracts for difference? If not, what alternative would you propose?

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Q53: What could be an appropriate threshold to define a significant fall in price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

See response to question 41.

Q54: Do you agree with the abovementioned proposal for the methods of calculation for various types of financial instrument? Do you have alternative or complementary methods to suggest, in particular in relation to the yield curve calculation method?

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Q55: Do you agree with the proposal for qualitative criteria should be set out?

Q56: Are there any additional criteria or factor that you would suggest adding to the list?

In light of the experience from the last and current crises, the list should cover areas where systemically relevant banks are exposed to risk or enter excessive risk.

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