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COVER NOTE

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to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
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Subject:	COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT Accompanying the document COMMISSION DELEGATED REGULATION (EU) supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short shelling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events

Delegations will find attached Commission document SWD(2012) 197 final.

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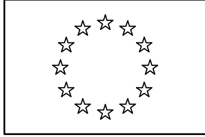

EUROPEAN COMMISSION

Brussels, 5.7.2012
SWD(2012) 197 final

COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

COMMISSION DELEGATED REGULATION

supplementing regulation (EU) N° 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events

{C(2012) 4529 final}
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1. PROBLEM DEFINITION

On 24 March 2012 the Regulation on short selling and certain aspects of credit default swaps ("the SSR") was published in the Official Journal[1]. It will apply on 1 November 2012.

The SSR has two main objectives: (i) to lay down a common regulatory framework for the requirements and powers relating to short selling and credit default swaps (CDS), in particular relating to uncovered short selling and naked CDS and (ii) to ensure a more coordinated and consistent approach by Member States when measures need to be taken in exceptional situations.

The SSR requires the Commission to specify in a delegated act certain elements that will facilitate compliance by market participants with the SSR and its enforcement by competent authorities. The four key issues which are the subject matter of this impact assessment are detailed below.

1.1. Issue 1 - Specifying cases which constitute a covered sovereign CDS

The SSR defines an uncovered sovereign CDS as a CDS which does not serve as a hedge against the risk of the default of the sovereign issuer where the investor holds a long position in the debt of that sovereign issuer, or a hedge against the risk of a decline in the value of the sovereign debt where the investor holds assets or liabilities whose value is correlated to the sovereign debt. In other words, the co-legislators have defined a covered sovereign CDS broadly to encompass "proxy hedging", the use of a CDS to hedge a risk in a correlated exposure rather than in the debt instrument named in the CDS. Proxy hedging is an important tool for hedging exposures to assets and liabilities for which no CDS is available. The specification of cases which constitute a covered sovereign CDS is important for the clarity of the Regulation, to clarify where the boundary lies between legitimate proxy hedging and sovereign CDS positions which are uncovered and therefore banned by the SSR.

[1] OJ L86/1, 24.03.12, Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

The key issue here is how to measure the correlation between the exposure and the sovereign CDS used to hedge. Correlation can in principle be measured quantitatively or qualitatively.

1.2. Issue 2 - Specifying notification thresholds for short positions in sovereign debt

The SSR requires significant short positions in sovereign debt to be notified to competent authorities. The SSR does not specify what the notification threshold shall be, stating only that the threshold shall consist of an initial amount and then additional incremental levels in relation to each Member State and the Union, and these levels are to be specified by the Commission in a delegated act. The SSR requires the Commission to take account of the following criteria in setting the notification threshold: avoiding notifications of positions of minimal value; taking into account the amount of outstanding issued sovereign debt and the average size of market participants; and taking into account the liquidity of each sovereign bond market.

The first issue in relation to setting these thresholds is how to set them at a level which ensures regulators receive data on short positions of possible systemic importance while not overburdening them with reports of little value. The second is how to ensure thresholds are appropriate to the situation of different Member States while limiting the compliance burden of the reporting regime.

1.3. Issue 3 - Specifying liquidity threshold for suspension of restrictions on uncovered short sales of sovereign debt

The SSR imposes certain restrictions on uncovered short sales of sovereign debt, but also allows for these restrictions to be suspended temporarily under certain conditions. These restrictions can be suspended by competent authorities for six months (renewable) where the liquidity of the sovereign debt falls below a threshold which represents a significant decline relative to the average level of liquidity of the sovereign debt concerned. The parameters and methods for calculating this threshold of liquidity are to be determined by the Commission in a delegated act which must be defined based on objective criteria specific to the relevant sovereign debt market, including the total amount of outstanding issued sovereign debt.

The challenge here is to set the threshold for the significant fall in liquidity in such a way that it is triggered when there is a genuine risk of harm to sovereign debt markets, without leaving so much discretion to competent authorities to suspend the restrictions that in effect, the exception becomes the rule.

1.4. Issue 4 - Specifying thresholds for significant price falls

The SSR includes a power for competent authorities to suspend short selling in a financial instrument temporarily where the price of that financial instrument on a trading venue has significantly fallen during a single trading day. The suspension shall apply until the end of the next trading day, which can be extended by a further two days if the fall continues. The Regulation fixes the threshold for a significant price fall in liquid shares at 10%, but fixes no thresholds for other shares and other classes of financial instruments, leaving these to be specified by the Commission in a

delegated act taking into account the specificities of each class of financial instrument and the differences of volatility.

The issue is how to determine what a significant price fall represents for each type of financial instrument. The instruments in scope are those listed in annex I section C of the Markets in Financial Instruments Directive, namely: illiquid shares; sovereign bonds; corporate bonds; money market instruments; units in collective investment undertakings (UCITS); exchange traded funds (ETFs); and derivatives. Issues in relation to setting thresholds for these instruments concern principally the volatility of the instruments, difficulties in expressing a price fall in percentage terms for bonds and the very diverse range of derivative instruments. Also, if the threshold is set too low and is breached too frequently, it may impose a burden on competent authorities which is disproportionate to the regulatory benefit.

2. THE BASELINE SCENARIO AND SUBSIDIARITY

The baseline question addressed here is how the above problems would evolve should the Commission not adopt delegated acts. Apart from the legal obligation on the Commission to adopt delegated acts, failure to specify certain provisions of the SSR would result in legal uncertainty for regulators and market participants, an inconsistent approach to the interpretations and application of the SSR, ineffective supervision, continued regulatory fragmentation and the possible continuation of certain risks associated with short selling which the SSR seeks to address, such as negative price spirals.

3. OBJECTIVES

1. Ensure regulators apply the restrictions on uncovered short sales of sovereign debt and the ban on uncovered sovereign CDS positions in a clear and consistent way;

2. Ensure that regulators have clear and consistent powers to temporarily restrict short selling in the event of a significant price fall;

3. Ensure that regulators and markets obtain useable data on short positions in sovereign debt; and

4. Ensure a coordinated regulatory response by EU Member States to short selling and sovereign CDS.

4. POLICY OPTIONS

The policy options are grouped according to the issues outlined above.

Policy options on the specification of uncovered positions in a CDS

– No action option (discarded as regulation would be unworkable);

– Option 1 – specify in a qualitative way cases in which a CDS is deemed to be covered;

- Option 2 – specify in a quantitative way cases in which a CDS is deemed to be covered.

- Option 3 – specify cases in which a CDS is deemed to be covered by combining a qualitative and a quantitative approach.

Policy options on specification of notification thresholds for net short positions in sovereign debt

- No action option (discarded as regulation would be unworkable);

- Option 1 – specify one common percentage threshold for all Member States, possibly with the addition of a de minimis nominal threshold;

- Option 2 – specify multiple percentage thresholds (between 2 and 27) to tailor thresholds to each sovereign debt market.

Policy options on specification of method to calculate liquidity threshold for suspending restrictions on uncovered short sales of sovereign debt

- No action option (discarded as regulation would be unworkable);

- Option 1 – a threshold of a fall in monthly liquidity below the 5th percentile over a 12 month period;

- Option 2 – a threshold of 1.6 standard deviations below the average over a 6 month period.

Policy options on specification of significant price fall for financial instruments other than liquid shares

- No action option (discarded as regulation would be unworkable);

- Option 1 – specify a threshold for financial instruments other than liquid shares; sub-options include setting thresholds for:

    - illiquid/semi-liquid shares;

    - sovereign bonds;

    - corporate bonds;

    - money market instruments;

    - UCITS;

    - exchange traded funds;

    - derivative instruments.

5. ASSESSMENT OF IMPACTS AND COMPARISON OF THE OPTIONS

The different policy options were tested against the criteria of their effectiveness and efficiency in achieving the related objectives.

5.1. Specification of uncovered positions in a CDS

Option 1 leaves uncertainty for the competent authority and scope for disputes with a position holder as to whether the criteria are fulfilled or not. Option 2 offers a clearer power to competent authorities by setting a clear quantitative threshold for correlation which must be met by a sovereign CDS position to be deemed covered.

Option 1 implies a degree of discretion for competent authorities which could result in a less consistent approach to applying the ban on naked sovereign CDS. Option 2 on the other hand would provide for a clear and consistent approach to applying the ban by applying the same threshold for correlation across the EU.

In terms of macroeconomic costs, responses from stakeholders to the ESMA consultation suggest that a purely quantitative approach would impose economic costs in terms of reduced investment caused by uncertainty about the possibility to hedge. These macroeconomic costs would not be imposed by option 1 or by option 3. Therefore option 2 appears less economically efficient than options 1 and 3.

Although option 1 could be considered somewhat less efficient than option 2 for competent authorities, due to the time-consuming nature of examining the justifications of sovereign CDS position holders for their hedges, a quantitative approach would also need to include a qualitative element in practice. Otherwise, this would exclude from hedging assets or liabilities which are in principle within the scope, at the risk of leading to the above-mentioned indirect economic costs.

Since option 1 appears to be the most economically efficient option, while option 2 seems to be the most effective option, this suggests that the combination of both options as proposed in option 3 would lead to a more optimal outcome than either option 1 or option 2 alone. Option 3 would be more effective than option 1 in ensuring a consistent approach by competent authorities to enforcement. Option 3 would also be more efficient than option 1 as it would reduce the burden for competent authorities to verify compliance when a quantitative approach to demonstrating correlation was used.

The preferred option is therefore option 3 which provides for both qualitative and quantitative ways of demonstrating correlation, with the possibility for position holders to benefit from a safe harbour if they can demonstrate that a quantitative correlation existed.

5.2. Specification of notification thresholds for net short positions in sovereign debt

Option 2 would be more effective than option 1 in ensuring that competent authorities get the right amount of useable data on short positions, since under option 2 the thresholds would be more tailored to the specific situation of each Member State than under the single percentage threshold of option 1. Even allowing for the possible inclusion of a de minimis threshold under option 1, option 2 would also be more efficient than option 1 since competent authorities would receive fewer low

value notifications under option 2 and they would therefore lose less time sifting through information of little systemic relevance. For market participants, it would appear from stakeholder responses that option 2 would in practice not impose a more significant compliance burden than option 1. Both options 1 and 2 would ensure a coordinated response by competent authorities as the thresholds would be fixed by the Commission and would be published for each Member State by ESMA on their web site.

Most stakeholders did not comment on this issue in the ESMA consultation, but most of those that did supported multiple notification thresholds. No respondents were able to provide data on the estimated number of notifications of short positions in sovereign debt or the compliance costs associated with these notifications. Ongoing compliance costs for notifications of short positions in sovereign bonds were estimated to be in the order of €5 million a year in the SSR impact assessment.

In light of the above, the preferred option is option 2, limited to two categories of thresholds (0.1% and 0.5%), as it would achieve the optimal balance between reflecting the diversity of Member States sovereign debt positions and ensuring that competent authorities receive useable and valuable information.

5.3. Specification of method to calculate liquidity threshold for suspending restrictions on uncovered short sales of sovereign debt

The options were compared in terms of their effectiveness in enabling authorities to mitigate any liquidity crisis and in ensuring a consistent approach across Member States and market certainty. Efficiency is measured in terms of the costs to stakeholders – which is driven primarily by how often consideration needs to be given whether to suspend restrictions once the threshold is crossed.

In terms of effectiveness in allowing member states to mitigate the effects of any liquidity crisis, both option 1 and 2 are equally effective since both would give member states the power to act when required. However Option 2 would be less effective in terms of ensuring market certainty; since the threshold would be crossed more frequently, meaning a less consistent approach would result. In addition it would be less efficient due to the increased costs that greater uncertainty and a more inconsistent approach would impose on market participants.

In light of the above, the preferred option is option 2: a significant fall in the average liquidity of a sovereign debt instrument will be deemed to have occurred if the liquidity in any month falls below the 5th percentile of monthly liquidity in the preceding 12 months.

5.4. Specification of significant price fall for financial instruments other than liquid shares

Since larger price movements are more common for illiquid shares, this larger volatility means that the threshold will need to be set higher than for liquid shares. Otherwise, the threshold would be triggered in too many cases that are not exceptional in these markets. Therefore the preferred thresholds for illiquid shares are: a 10% threshold for semi-liquid shares (those listed on the main equity index of a Member State and which are the underlying for a listed derivative); a 20%

threshold for illiquid shares (those whose share price is above € 0.50 cents); and a 40% threshold for very illiquid shares (with a nominal value below € 0.50 cents).

For sovereign and corporate bonds, setting a percentage threshold is problematic in view of the different maturities and related price movements of individual bonds. Therefore the preferred threshold for sovereign bonds is an increase of 7% or more in the yield across the yield curve for the relevant sovereign issuer, and for corporate bonds, an increase of 10% or more in the yield of the bond during a single trading day.

Money-market instruments have maturities ranging from one day to one year and are extremely liquid. Because they are comparably liquid, but less volatile than shares, a 1.5% decrease in their price is the preferred option.

Exchange traded funds (ETF's) are very diverse. Some ETF's are equivalent to shares and are very liquid, so the preferred option is to apply the 10% threshold as for liquid shares. Other ETF's are more like derivatives and should be treated as such.

Derivatives are a very broad category of financial instruments, ranging from options on shares, to interest and exchange rate swaps and commodity derivatives. They cannot be sold short in the same way as securities, but competent authorities could seek to otherwise limit transactions in these instruments. Since the value of derivatives depends mainly on changes in the value of their underlying, the preferred option for derivatives with a financial underlying is that the threshold should be breached when the threshold for the underlying financial instrument has been breached. However, for derivatives whose underlying has no threshold (e.g. commodity derivatives), ESMA was not able to devise any feasible or meaningful workable thresholds. Therefore the preferred option is not to set a threshold at this time for such derivatives and to review this in the review of the SSR by end June 2013.

For UCITS that are not ETFs, the preferred option is not to set a threshold, because although this price may vary freely in the trading venue, it is subject to a rule which keeps the prices close to the Net Asset Value of the UCITS (Article 1.2.b UCITS Directive 2009/65).

6. MONITORING AND EVALUATION

The SSR provides for an early report to the European Parliament and the Council by end June 2013 to review the impact and appropriateness of certain key provisions of the Regulation. It will be necessary for competent authorities, market participants and the Commission to monitor the effective application of the Regulation and evaluate the practical impact that it has.