



ESMAs Technical Advice to the European Commission on the Short Selling Regulation. February 2018.

This 14 March marks the fifth anniversary of the publication of the Regulation of the European Union (EU) on short selling and certain aspects of credit default swaps (REGULATION (EU) No 236/2012, OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, of 14 March 2012). This Regulation has led to greater coordination of the activities of National Competent Authorities (NCAs) when short selling is suspended, as well as clarification on how to carry out such activities. However, application of certain aspects of the regulation has generated different interpretations in the Member States, which, in coordination with ESMA, have attempted to converge towards one single form of application.

Nevertheless, five NCAs have reported that they do not comply with several aspects of the single ESMA Guideline on short selling as they do not share the interpretation of the Regulation included therein with regard to membership of the category of market maker in order to obtain the exception from reporting and disclosing their net short positions. In order to remove any doubts about how to interpret such aspects, the European Commission (EC) asked ESMA for technical advice on all these aspects in a letter submitted on 19 January 2017. ESMA published its advice on 21 December 2017, which includes not only the response to the EC request, but also other aspects that the NCAs and ESMA believe are important for better interpretive convergence of this Regulation, such as reporting of short positions of market-makers to NCAs. In order to prepare this advice, ESMA conducted a public consultation between 7 July and 4 September.

Specifically, the EC requested that ESMA submit technical advice on the following matters:

- 1) The exemption from reporting and disclosing net short positions resulting from market-making activities and the definition of such activities in accordance with Article 2(1)(k) of the SSR, including the impact of the membership requirement featured in the definition contained in said article.
- 2) A procedure for imposing short-term restrictions on short selling by an NCA (up to the end of the following trading day, with the possibility of extending it for one further day).
- 3) A method of notification and disclosure of net short positions.

ESMA includes a qualification in its advice to the EC as only 20 entities responded to the aforementioned public consultation. ESMA has therefore announced that it will review the advice in the event that the new set of information on transactions which both ESMA and the Member States will have following implementation of MIFID II/MIFIR leads to different conclusions. In addition, ESMA has prepared its advice bearing in mind the definitions used and the measures established in MIFID II / MIFIR regarding market makers.

Main aspects of ESMA's technical advice to the EC:

- 1) On the clarification of the definition of "*market-making activities*" and its eventual alignment of the definitions of "*market-making activities*" under Article 2(1)(k) of the SSR and that of "*market maker*" under Article 4(1)(7) of MiFID II

ESMA is of the view that the differentiation between the concepts of "*market maker*" under MiFID II and "*market-making activities*" under the SSR should remain as the former deals with organisational and voting requirements, while the latter aims not to damage market liquidity. ESMA also considers that the exception should be granted to market-making activities in all types of trading venue (for example continuous auction order book trading systems, quote-driven trading systems, periodic auction trading systems, request-for-quote trading systems, organised trading facilities - the new category introduced by MIFID - and also activities on OTC markets).

- 2) Scope of instruments for the purpose of the exemption for market-making activities

ESMA's advice suggests that, in addition to shares, the exception should also be given to subscription rights and convertible bonds. With respect to sovereign debt, ESMA considers that the exception should be extended to

market-making activities relating to corporate debt which is highly correlated with the sovereign debt in question. The exemption in relation to the above point will be applicable to trading performed in any type of market, including OTC. The exemption will also apply to instruments included in an index while they remain a part thereof.

3) Membership requirement

The ESMA Guidelines on short selling established three preconditions for interpreting the requirement of membership of a platform where market-making activities are performed. ESMA issued these Guidelines based on a legal analysis published by the EC regarding the definition of market making set out in Article 2(1)(k) of the SSR.

The requirements of the ESMA Guidelines are:

- 1) Being a member of the market on which market-making activities are going to be performed
- 2) Dealing as principal in one of the capacities included in the definition of market-making activities: a) by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market; b) as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade; and c) by hedging positions arising from the fulfilment of tasks under points (a) and (b).
- 3) Being a market maker in the instrument for which it notifies the exemption

In its advice to the EC, ESMA proposes revising the definition of membership contained in Article 2(1)(k) in order to require the market maker to be a member of one of the trading venues where the market-making activity effectively takes place. However, at the same time as it proposes easing the membership requirements, ESMA adds that market makers should be dealing strictly on own account and not on behalf of the issuer or third parties and that there should be minimum requirements in terms of presence (hours), size and spread. Third country (non-EU) investment firms should be able to benefit from this exemption providing they operate in the EU in accordance with the requirements established in MIFID II.

4) Application of the requirement on the disclosure of net short position to market makers only in relation to NCAs

Article 17(1) of the SSR exempts firms performing market-making activities from reporting their short positions to NCAs. ESMA concludes in its response to the EC that it would be necessary to amend said article and require the reporting of positions by market makers that maintain a short position above the established threshold (0.2% of the issued share capital) maintained longer than a period to be determined in a regulatory technical standard to be drawn up by ESMA. NCAs will therefore have better knowledge of the markets and instruments that they supervise.

5) Other issues in the context of the definition of market-making activities

ESMA takes the opportunity of the EC petition to request that the drafting of several articles be improved in order to prevent discrepancies in their interpretation.

Specifically, ESMA requests that the following be clarified: 1) Article 13(2), to clarify that transactions used to hedge a long position in 'sovereign' debt instruments the pricing of a corporate bond which has a high correlation with the pricing of a sovereign debt are exempted from the obligation to locate the instrument; 2) Article 17(12) and (13), to ensure that NCAs notify ESMA not only about the list of firms benefiting from the market making exemption, but also the list of instruments to which the exemption is applied; and 3) require that market makers benefiting from the exemption maintain records of orders for which they request the exemption.

6) Short-term restrictions on short selling in case of a significant decline in prices under Article 23 of the SSR

ESMA has analysed the use of the capacities included in Article 23 which allow an NCA to ban short sales in a particular security for one day, which may be extended for one further day, when its price falls by more than the threshold established in the Regulation (10% in liquid securities) or to be defined by the EC in the case of illiquid securities. ESMA's analysis refers to two aspects:

- a) The NCA must adopt the measure in the event that the instrument is admitted on trading venues in various jurisdictions in the EU. In these cases, ESMA proposes to the EC that only the NCA of the most relevant market in terms of liquidity for the instrument can adopt a short-term ban and the other Authorities should be required to accept the measures; and
- b) Instruments subject to the ban, as the current articles only refer to the instrument and not to products referenced to that instrument and therefore the ban may be circumvented by using derivatives or other products based on the instrument for which short sales are temporarily banned. ESMA recommends to the EC that the scope of the ban should be extended to instruments whose underlying is the instrument subject to the short selling

ban. With this proposal, the ban set out in Article 23 would be on net short positions and not only on the instrument that has suffered the price fall.

7) Transparency of net short positions and reporting requirements: thresholds, timing, posting on a central website operated or supervised by the relevant NCA, content of the notifications and reductions in the burden of preparation of the notification

The EC requested that ESMA conduct an analysis and provide technical advice on the threshold as from which market participants have to report their short positions to NCAs (currently fixed on when they exceed 0.2% of the issued share capital). ESMA concludes that the thresholds should not be modified, although NCAs should be allowed to periodically publish anonymised aggregated net short positions on a voluntary basis.

ESMA also ratifies the timing for notification and disclosure (15:30 and 17:30 on the following day, respectively) although it considers that disclosure should be made at 18:00 so as not to coincide with the closing auctions which usually take place at 17:30.

In addition, ESMA informed the EC that it considers that it is appropriate for NCAs to charge a fee for receipt of notifications and maintenance of the website showing the net short positions, which may be centralised on an EU-wide basis through ESMA.

ESMA requests that the content of the information should include the LEI of the holder of the reported net short position. Finally, in order to reduce the workload in preparing net short positions, ESMA considers that it is acceptable to use the issued share capital for each instrument that is published on the issuer's website or by data vendors.

8) Methodology of calculation of net short positions in sovereign debt

As a result of the discrepancies noted in the number of net short positions reported in sovereign debt, ESMA conducted an analysis of the possible causes, concluding that the nominal method should be used in the calculation of net short positions in sovereign debt for both spot and derivative instruments. The proposal means that the positions would not be duration-adjusted (i.e. for the period in which the value of the instrument is not affected by interest-rate changes).

Links of interest:

[Final Report. Technical advice on the evaluation of certain elements of the Short Selling Regulation.](#)