European Securities and Markets Authority (ESMA)
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Submitted by e-mail

Subject: Eumedion's response to the ESMA's Call for evidence on the evaluation of the Regulation on short selling and certain aspects of credit default swaps (ESMA/2013/203)

Ref: B13.09

Amsterdam, 15 March 2013

Dear Sir, dear Madam,

Eumedion welcomes the opportunity to respond to ESMA's Call for evidence on the evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (ESMA/2013/203).

By way of background, Eumedion is the dedicated representative of the interests of 69 Dutch and non-Dutch institutional investors and aims to promote good corporate governance and sustainability in listed companies. Together they have more than € 1 trillion assets under management. They are capital providers to European corporate and sovereign issuers across the spectrum, from equity to corporate and sovereign bonds.

We confine our response to some of the questions raised in part II (Transparency and reporting requirements), part VI (exemptions) and part VII (Intervention powers and emergency measures).

II. Transparency and reporting requirements

Q1. Do you consider that the initial and incremental notification/publication thresholds for net short positions in shares and sovereign debt have been set at the correct levels? If not, what alternative thresholds would you suggest and why?

Eumedion generally supports the initial notification thresholds for triggering private notification (0.2%) and public disclosure obligations (0.5%) of net short positions in *shares* as referred to in the Regulation.[1] The initial thresholds ensure that regulators, investors and other users are provided with relevant information so as to discharge their respective responsibilities, without imposing disproportionate compliance costs on those subject to the requirements.

At the same time, we are slightly concerned that it is required to report all changes of positions at increments of 0.1%, first to the relevant competent authority (from 0.2% until 0.4%) and then also to the market (from 0.6%, 0.7%, 0.8%, etc.). This has resulted in a high number of notifications, which is not necessarily meaningful for market participants and of questionable value for regulators. Also, it has given rise to additional compliance costs for market participants holding short positions, although the bulk of the costs might still be incurred in calculating the short positions to determine whether there is a private notification or a public disclosure obligation.

Accordingly, we would advise ESMA to consider removing the uneven incremental thresholds. That means that changes of positions should no longer be required to be reported to the competent authority at 0.3% and to the market at 0.7%, 0.9% and 1.1%, etc. It would result in wider reporting bands and thus notifications and disclosures which reflect a more meaningful change in the size of the position.

When it comes to the initial reporting thresholds regarding short positions in *sovereign debt*, issuers are grouped in two broad categories with different thresholds (0.1% and 0.5% respectively) taking into account the total amount of outstanding debt issued by a sovereign issuer and the liquidity of the markets measured in terms of total turnover (Article 21 (5) (7) and (8) of the Delegated Regulation (DR)[2]). We believe this provides a proper balance between providing meaningful information on short positions to regulators whilst avoiding a tangle of different percentages used for calculating the monetary thresholds. The method is reasonable and to be preferred above any alternative approach such as, for instance, setting a single threshold for all sovereign issuers or individual thresholds for each single sovereign issuer.

[1] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (“Regulation”).

[2] Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 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.

Q2. What use are you currently making of information made available by competent authorities or the central website operated or supervised by the relevant competent authority on public disclosures of net short positions in shares?

Eumedion's participants, being shareholders in EU listed companies, are using the public available information in the context of their responsibilities to monitor their investee companies. This monitoring role is set out in various shareholder engagement codes such as the Eumedion best practices of engaged share-ownership and the UK Stewardship Code. Quite obviously, the information on net short positions is also be used as a source for their investment decisions. If ESMA enhances harmonisation of the data quality and centralises the publication the Eumedion participants could even enhance their use of this information.

Q3. If you had taken short positions in shares and sovereign debt before the Regulation applied, what impact have the notification/disclosure requirements had on your trading behaviour since 1 November 2012?

Eumedion is aware that a small number of its participants that had taken short positions before 1 November 2012, reviewed their trading strategies as their positions could reach an applicable threshold and they were reluctant to privately or publicly disclose their positions. In light of this and in a broader sense, we note that if too many short sellers adjust their behaviour to stay under any notification disclosure limits, this can increase the magnitude of overpricing and subsequent corrections. ESMA and competent authorities should carefully assess these potential negative consequences of the reporting requirements.

Q4. Do you have any comments on the method of calculating net short positions in shares and sovereign debt (e.g. the requirement to duration adjust cash positions in sovereign debt)?

We generally believe the methods of calculating net short position in shares (e.g. the requirement to delta adjust derivative positions) and net short positions in sovereign debt (e.g. the requirement to duration adjust cash positions) are appropriate. The sensitivity adjusted methods are more adequate than nominal models for the calculation of short positions. There is a downside however. The required methods involve significant complexity in terms of calculation and results in additional investments in IT systems, in parts of the front office and valuation functions of institutional investment firms, and ongoing support from various teams in order to ensure the provision of adequate data on a timely basis.

With regard to including indirectly held positions in the calculations, some of our participants consider it a very burdensome task to constantly monitor and calculate (using publicly available information) net positions regarding a share, where it is one of many in an index, basket or exchange traded fund (ETF). We note that investors primarily use short positions in stock market indices or ETFs for general

hedging purposes and not so as to express negative sentiment with respect to the individual share or sovereign debt within the index or ETF. We seriously doubt whether demanding investors to fragment ETFs and broad-based indices leads to meaningful information either for market participants or for competent authorities, while the efforts to be made in order to meet the requirements are not entirely reasonable.

Hence, we would recommend amending the Regulation and only including indices, baskets and ETFs in the calculation of net positions insofar as a set threshold is crossed. For instance, an index or ETF could be excluded from the calculation, unless the individual share represents more than 20% of the index or ETF or the investor, via its holding in the index, holds more than 1% of the individual share. Such an approach would be in line with existing Dutch and UK regulations for disclosure of interests in 'contracts for differences' and other cash settled equity instruments. Another alternative to enable market participants to prudently hedge their general market risk without the burdensome task to make a look through calculation would be excluding cash settled index derivatives related to the most commonly used liquid indices (like, but not limited to, S&P 500, Topix, FTSE, Stoxx50, Nikkei, AEX and DAX) from the calculation of a net short position.

Q5. What is your view of the decision to adjust the monetary trigger thresholds for reportable short positions in sovereign debt every three months? Is there an alternative you would favour and if so please explain why?

We support the model of monetary trigger thresholds for reportable short positions published on ESMA's website in a clear manner. The concept is practical, as investors exposure needs also to be calculated in monetary amounts and the actual outstanding total issued debt is often difficult to find out. We also support quarterly updates to correct for new issues and redemptions thus ensuring the threshold is more accurate.

Q6. Do you consider that reporting mechanisms are operating efficiently? If not, explain why and how they could be improved.

Given the short period passed since the Regulation came into force, it is – unfortunately – not possible to give factual based comments on this question.

VI. Exemptions

Q25. Do you have any other comments on the provisions of the Regulation concerning exemptions or on how they have operated since 1 November 2012?

Eumedion would like to draw ESMA's attention to several unintended consequences of the Regulation and Art. 12 and 13 DR as well as of some national temporary bans.

1) There are instances where long positions reside in a different legal entity and therefore a set-off is not possible against the short position and where the net short position:
- does not have the purpose to benefit from dropping market prices,
- nor does it lead to the actual delivery of stocks,
- and the purpose of the hedges is only protection (from downward movement of the market), not the generation of profit.

2) There were situations where national competent authorities imposed a more stringent regulatory framework than the Regulation (temporary ban on short sales in shares in exceptional circumstances) and this caused problems for all parties that needed to hedge their general market risk by using index derivatives. In particular, it was not possible for some market participants to prudently hedge their long positions, as the remaining permissible alternative hedges did not match the long positions sufficiently to effectively manage the market risk.

3) We would also like to argue in favour of allowing a legal entity to net its short portfolios with its long portfolios when legitimately hedging its general market risk, regardless which specific entity manages these portfolios, provided that it is explicitly established (in the asset management agreement between the asset management entity and the client) who will take the managed assets into account for calculating net short positions, thus preventing double counting and double reporting of the same positions.

These point can be illustrated by the institutional investor and reinsurance business examples set out below.

i) Case of institutional investment

Legal entity A: is an asset management entity performing asset management activities; in the example managing the long portfolio of legal entity B on basis of a discretionary asset management agreement.

Legal entity B: is an institutional investor with non-management activities, which manages its proprietary short portfolio to hedge (i) liabilities and (ii) its long portfolio that is being managed discretionary by legal entity A.

Where legal entity B has outsourced the asset management of its long positions on a discretionary basis to A and kept full discretion over the hedging activities of its long portfolio, the fact that the long positions are discretionary managed by an asset manager (A, which is like the legal entity B also an affiliate of the group), and these positions thus need to be aggregated with the other managed activities of this asset manager A, implies that the long and short positions of legal entity B cannot be netted.

The hedging activities only aim to reduce the general market risk and do not have the objective to profit of any decrease of (equity) markets.

The consequence of the Regulation in this case is that a net short position is created artificially, where it has never been the intention to create a net short position by legal entity B. The only fact that the management of the short portfolio is not outsourced creates this conflict. Due to this construction, monitoring of the net short positions had to be intensified, going with considerable efforts and costs. The net short positions may lead to reporting/disclosure obligations which could be easily misinterpreted, as it seems that the institutional investor builds up a net short position while economically the institutional investor is only hedging its risks that stem from long positions managed discretionary by an asset management entity.

Therefore we argue to allow a legal entity to net its short portfolios with its long portfolios, regardless which specific entity manages these portfolios, provided that it is explicitly established (in the asset management agreement between the asset management entity and the client) who will take the managed assets into account for calculating net short positions, thus preventing double counting and double reporting of the same positions.

ii) Case of reinsurance

A reinsurer has entered into a reinsurance contract with an insurer (a separate legal entity) to reinsure the guarantee the insurer issued in favour of its policyholders of life insurance policies plus the guarantee on related investments regarding the maturity benefit of fund investments, which are correlated to equity indices. The insurer is the legal owner of the investments, which are long positions within the meaning of the Regulation. A reinsurance contract is not a financial instrument (article 2 (1) of the Regulation with Annex 1 DR 918/2012). The reinsurer has no long positions, but has to hedge its risks by selling futures/options on cash settled index derivatives.

For protection against adverse price movements on the insurer's investments, the reinsurer sells cash settled equity derivatives (futures, options) on equity indices; i.e. enters into short selling transactions resulting in a net short position in cash settled equity indices which are well diversified. These hedges are therefore not aimed at generating profit, but only seek protection for the reinsurer from downward movements of the market.

The equity derivatives that are being used, are all cash settled and cannot lead to any physical short position. For the Short Selling Regulation purposes however, the reinsurer has to monitor and report net short positions when crossing set thresholds.

The net short positions may lead to reporting/disclosure obligations which could be easily misinterpreted, as it seems that the reinsurer builds up an net short position while economically the reinsurer is only hedging its risks that stems from a reinsurance contract.

Besides if local regulators impose a ban on net short positions the reinsurer would encounter problems for not being able to have a perfect hedging match, which leaves the reinsurer with an open risk in its books as it has issued a guarantee in favour of the insurer. The reinsurer has no interest in lower stock prices, only protection is sought for. Higher stock prices would rather benefit the reinsurer (because the reinsurer can reduce the hedging). The action of selling equity futures should not be considered as an attempt to earn money from decreasing stock prices.

In our view, the sale of the futures/options by the reinsurer or other financial institutions in similar circumstances should not be seen as a net short position within the meaning of the Short Selling Regulation, as it does not have the purpose to benefit from dropping market prices.

iii) Case of portfolio management

For the purpose of efficient portfolio management, like portfolio rebalancing, certain asset managers will initiate this process with the use of a designated fund within the management entity that will enter into positions that oppose those in the fund that is looking to execute the amendment. By doing so, market interference is kept to a minimum. Such can be the case with sovereign debt and the use of sovereign credit default swaps.

However, situations could arise where short exposure through sovereign credit default swaps that is exuberantly opposed by long positions in the relevant sovereign debt, could nevertheless be seen to lead to an (impermissible) uncovered short position (Art. 12 (1) (3) DR). The same would seem to apply to equity rebalancing activity, although this situation differs in that it could potentially cause fictitious net short positions with corresponding reporting and publication requirements that will add nothing to the transparency the Regulation is trying to achieve. This kind of artificial short exposure is by no means in conflict with the scope and objectives of the Regulation and we believe it would need to be recognised as such. Therefore we would argue that market integrity and transparency are both best served by excluding artificial short exposure which is the result of efficient portfolio management from the regulation framework.

VII. Intervention powers and emergency measures

Q26. What is your assessment of the effect of temporary restrictions imposed by competent authorities on short selling since the application of the Regulation? Please explain

Eumedion questions the usefulness of in particular the Spanish prohibition measure, which was renewed twice. It appears that there is no conclusive evidence on whether taking short positions on shares issued by Spanish listed companies or related financial instruments, is harmful to the Spanish financial system or to market confidence in Spain. In fact, the prohibition itself may result in investors refraining from investing in Spanish listed companies, as it could lead to loss of price efficiency, liquidity and forgone profits.

Consequently, it is to be doubted whether the condition as set out in Article 20 (1) (b) of the Regulation (*the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits*) was fully fulfilled with respect to the Spanish measure. Although the net short position held on 23 July 2012 was respected by the temporary ban, the delta adjustment requirement could have resulted in the obligation to reduce one's position and might have raised extra costs for reinvestments and might cause an imperfect hedge.

Q 27. In case of emergency bans,

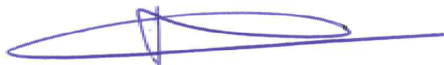
a) is the information to be published according to Art. 25 of the Regulation sufficient?

b) If no, please explain what other/additional information should be provided when introducing an emergency measure.

No. Under the Regulation the use of powers of intervention by competent authorities is subject to specific conditions regarding the financial stability and the necessity and effectiveness of the measure (e.g. Article 18 (1) (a) (b), Article 20 (1) (a) (b) and Article 21 (2) (a) (b) Regulation). Yet the authority which imposes or renews an intervention measure is not explicitly required to provide the public with a detailed and profound explanation why the authority believes that the legislative conditions involved have been met. For reasons of public transparency and legal certainty, we would recommend adding such an explanation requirement to Article 25 (1) of the Regulation.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Wouter Kuijpers (e-mail: wouter.kuijpers@eumedion.nl, tel. +31 20 70 85 882).

Yours sincerely,



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