ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No XX/2012)

Deutsches Aktieninstitut's response

9 March 2012

Deutsches Aktieninstitut appreciates the opportunity to take part in the consultation of the ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No XX/2012). As in previous consultations Deutsches Aktieninstitut would like to bring to ESMA's attention the view of non-financial companies on the issue of short selling.

Non-financial companies are touched in at least two respects by ESMA's consultation document.

Firstly, if they are listed on a European exchange their shares may be shortened which might lead to an unjustified downward pressure on the share price, in particular if negative information is abusively spread by the short seller at the same time. Without knowledge of net short position such information cannot be assessed appropriately by both issuers and investors, so that market inefficiencies arise. Therefore, listed companies are interested in more transparency on the identity of the short seller and the volume of shares sold short.

Secondly, derivative financial instruments are frequently used by non-financial companies in the companies' risk management in order to hedge against various business and treasury risks. Accordingly, non-financial companies are concerned that the EU regulation could limit their ability to hedge appropriately by prohibiting the use of such financial instruments either permanently or as a consequence of a competent authority's emergency measure.

Against this background, Deutsches Aktieninstitut would like to comment ESMA's draft technical advice as follows.

Having a net short position and method of calculation

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

Deutsches Aktieninstitut has always argued for a comprehensive transparency regime that covers short positions in shares as well as in other instruments related to shares. We therefore agree that ESMA takes a broad approach and

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with the suggestion of a non-exhaustive list of instruments that enter into the calculation of the net short position. Also, we agree that only shares already issued should be taken into account in the denominator of the threshold calculation.

However, for practicability reasons ESMA should take a more pragmatic view with regard to **index and basket instruments**. Index and basket instruments are typically used to build a short position with regard to one particular market or sector. They are usually not used to build up a short position in a single share because this would be much more expensive for the short seller than entering directly into the short position. Furthermore, to include any index or basket instrument in the calculation would cause significant additional costs on the side of investors as they would have to break down the various indices to the shares included on a day-to-day basis without having computable data of index compositions in the same frequency.

We therefore suggest to include index and basket instruments only if the respective share has a minimum weight of 20 percent in the index. This is for example the approach taken in Germany with regard to the notification of long positions in (financial) instruments that have a similar economic effect as the holding of shares. Such an approach would eliminate the possibility that tailor made baskets might be used to circumvent the notification requirement and serve the aim of keeping the administrative burden as low as possible.

Misleading notifications may also result in cases in which a listed company grants **phantom stocks or stock appreciation rights** in its own shares to employees and management as part of incentive programmes. It has to be avoided that the granting of these positions would be regarded as a net short position of the issuer in its own shares for notification purposes as this would not appropriately reflect the economic situation. The company has definitely no intention to receive a financial advantage in the event of a decrease in the price of its shares. All incentive programmes serve exactly the opposite purpose as they aim at aligning the interest of shareholders and employees. Also, there is automatically a corresponding long position on the side of the employees and managers. At last, the rules governing phantom stock and stock appreciation rights programmes most commonly exclude a transfer of the rights granted, so that they may not even qualify as financial instruments form legal point of view. These aspects justify a treatment different from "normal" short positions resulting from transactions with third parties

The same exemption should also be made for **all other incentive programmes** where a listed company grants the right to their employees or managers to acquire shares physically either against treasury shares/stocks or shares that are to be issued in the future for this reason. Besides the same general economic rationale as explained above there is no short position at all from an economic point of view in these programmes. In the former case there is no short position on the side of the company because it already holds "own shares" (e.g. purchased via a former share buy back), in the latter case the shares that can be acquired under the incentive programme will be issued in the future. As ESMA correctly states that non issued shares shall not be considered for calculation purposes rights granted to acquire those non-issued shares cannot qualify as a short position as matter of course.

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

No.

Deutsches Aktieninstitut would prefer not to calculate the net short position on a delta-adjusted basis. Delta-adjustment will principally not uncover the full economic net short interest in the respective share.

Take for example the holder of a put option on 100 shares that is "at the money". This option typically has a delta of around -0,5 so that the delta-adjusted short position would signal that the holder is interested in falling prices of roughly 50 instead of 100 shares. We do not deny that delta-adjustment is a common hedging practice. As such, it is for example correct to regard a position in the above mentioned put option as offsetting the price increase of only 50 shares at a certain point of time. This is, however, not the issue that should be asked for here as the notification regime should aim at uncovering the full potential short interest up from the beginning.

Furthermore, delta-adjustment makes the notification regime much more complicated. Since the delta depends on the share price notifications will frequently be triggered by changes in shares prices rather than by real transactions (purchases and sales), so that investors have to recalculate their complete portfolio every day. Also, the notifications may be too complex to be absorbed by the market. Due to delta-adjustment the same investor may be forced to notify the crossing of a threshold in one direction on one day and vice versa on another other day for one and the same short position.

At last, we have always understood the reporting of net short positions to be the complement to the already existing notifications of long positions in shares and other instruments. These are not notified on a delta adjusted basis for good reasons.

Overall, ESMA should reconsider its proposal. The fact that some member states have already implemented a reporting regime based on delta-adjustment should not be an argument for the calculation on a delta-adjusted basis.

Uncovered CDS

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?

We generally agree with the proposed approach.

CDS on sovereigns are used by non-financial companies to hedge against risks stemming from businesses with sovereign debtors or other entities that have a more or less close relation to the sovereign debtor in question. Examples could be ministries, regional governments or simply companies in public or partly public ownership (e.g. state-owned hospital, state-owned railway, state-owned airline). Non financial companies additionally use CDS to protect their assets from expropriation.

Therefore it is correct to have a broad understanding of coverage as it is laid down in the EU regulation as well as in ESMA's draft advice.

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?

We appreciate that ESMA is not limiting the meaning of "correlation" to the mere correlation of prices of financial instruments. Indeed, in many cases there will be no market prices for the assets or liabilities correlated to the CDS. Also, the liquidity of the CDS itself might be relatively low, so that there is no continuous data available for the CDS.

It is therefore right, that correlation can also be understood und proven qualitatively on the basis of economic arguments (see No. 85f.). In any case a direct or indirect involvement of the sovereign to the debtor as well as an ownership connection should be recognized as proofing correlation as this will be often be the cases that non-financial companies have in mind when they consider CDS hedges.

Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

See Q 21.

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

ESMA is also right not to require perfect hedges in the sense that the underlying asset or liability is matched exactly with a CDS in terms of volume and maturity. This will indeed be impossible due to the characteristics of the underlying businesses and the CDS available in the market.

There are at least two situations that need to be recognised as proportionate:

First, non-financial companies often have long-term contracts with public debtors under which a number of similar deliveries and services are billed and settled. As the volume of the receivables under that contract is volatile to some degree non-financial companies typically hedge the average expected exposure. If the CDS position exceeds the volume of the receivables for period of time this should not be regarded as an uncovered CDS.

Second, CDS hedges of non-financial companies relate to a different asset class (trade receivables) than the CDS has been created for (bonds or loans). However, they are both employed to get recovery (or more generally: insurance) in the case of a default. As it is not unlikely that the recovery rate of bonds/loans will be higher than of an outstanding bill for a particular service or delivery after of default, non-financial companies hedge a higher amount than the simple average of deliveries outstanding would indicate.

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?

Yes. At least three month would be appropriate, so that companies have enough time to adjust their positions and take into the mismatched that might occur as described above.

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?

Yes. We would prefer to add “trade finance exposures” to the list.

Adverse events and threats

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

To our impression ESMA does not develop criteria that might help to assess correctly whether or not a certain development constitutes a threat but rather lists what kind of events might be regarded as a threat itself that, in turn, might justify an emergency measure. However, we understand that it might be too complicated to define exactly the respective criteria, so that providing examples could be a second best solution.

We also understand that it is not an easy task to exactly point to a potential threatening situation, so that even the list has to be vague in some extent.

From our point of view there should however be limits to vagueness because the competent authorities and ESMA's discretion in deciding on an emergency measure should not be too big given the severe consequences that the emergency measures could have on markets. For this reason ESMA should only list events that can be objectively observed at least.

“Unsubstantiated rumours” cannot be observed as it is impossible to offer a criteria for unsubstantiated. Also, a competent authority should not act on the basis of market rumours as a matter of course. The same problems arise with “significant downward spirals”, if significance is not specified further, and the term “any type of self-fullfilling phenomena” which cannot be judged in advance by a competent authority.

Overall, Deutsches Aktieninstitut is concerned that the examples provided go too far and are too vague to be the basis for the decision on an emergency measure. ESMA should therefore rethink the wording.