



European Securities and
Markets Authority

Final Report

ESMA's technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No 236/2012)

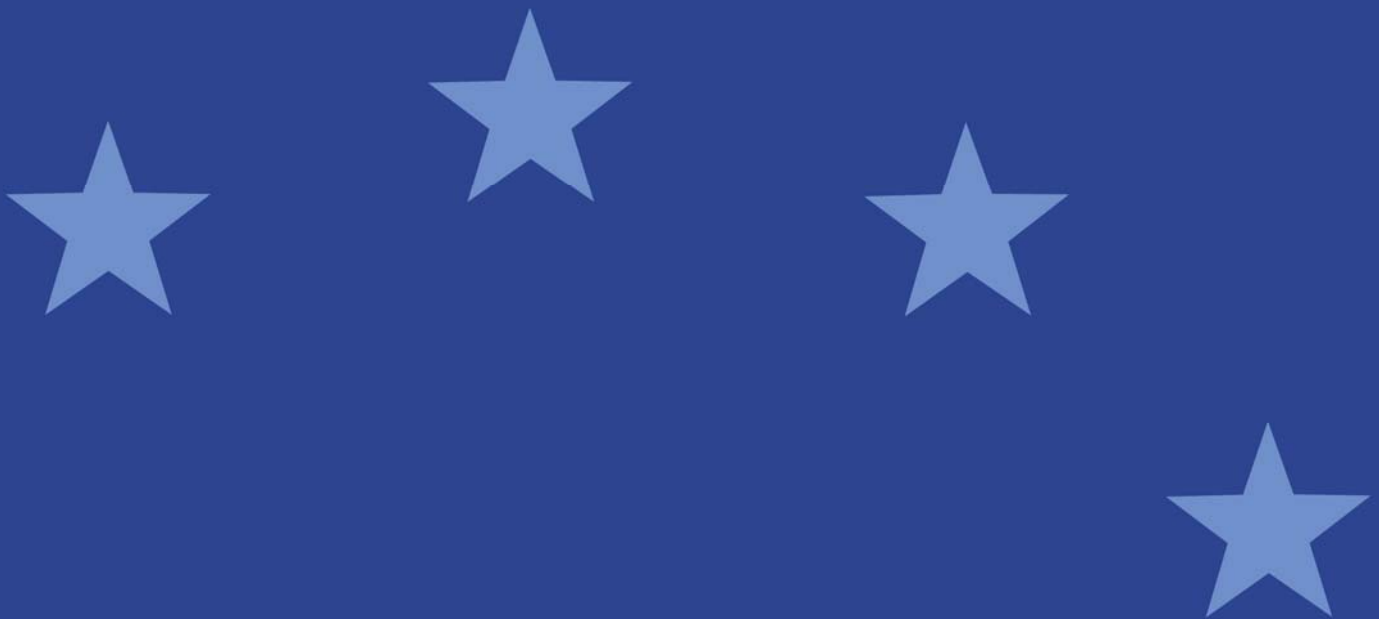


Table of Contents

Executive Summary	5
I. Specification of the definitions laid down in the Regulation and in particular of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale (Article 2(2))	7
II. Specification of the cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2), cases in which a natural or legal person has a net short position for the purposes of Article 3(4) and (5) and the method of calculation of such position, the method of calculating positions for the purposes of Article 3(4), (5) and (6) when different entities in a group have long or short positions or for fund management activities related to separate funds (Article 3(7))	10
II.I. Introduction	10
II.II. Cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2) (Article 3(7)(a))	10
II.III. Concept of having a net short position and method of calculation (Article 3(7)(b))	12
Cases in which a natural or legal person has a net short position for the purposes of Article 3(4) and (5)	12
Method of calculation of net short positions	17
II.IV. Method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds	23
III. Specification of the cases in which a credit default swap transaction is considered to be hedging against a default risk and the method of calculation of an uncovered position in a credit default swap and the method of calculating positions where different entities in a group have long or short positions or for fund management activities related to separate funds (Article 4(2))	34
III.I. Cases in which a CDS transaction is considered to be hedging against a default risk or the risk of a decline of the value of the sovereign debt.	34
III.II. Method of calculating an uncovered position	43
IV. Specification of the amounts and incremental levels of notification thresholds referred to in Article 7(2) for net short positions relating to the issued sovereign debt of a sovereign issuer (Article 7(3))	45
V. Specification of the parameters and methods for calculating the threshold of liquidity referred to in Article 13(3) in relation to the issued sovereign debt for suspending restrictions on short sales of sovereign debt (Article 13(4))	50
VI. Specification of what constitutes a significant fall in value for financial instruments other than liquid shares and draft regulatory standard on the method for calculating the fall (Article 23)	55
VI.I. Draft advice on the Delegated Act relating the significant falls in value (Article 23(8))	55
VI.II. Regulatory Technical Standard on the specification of the method of calculation of the 10 % fall for liquid shares and of the fall in value (Article 23(8))	63

VII. Specification of criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments referred to in Articles 18, 19, 20, 21 and 27 and the threats referred to in article 28(2) arise (Article 30) _____ 65

- Annex I: Commission mandate to provide technical advice
- Annex II: Feedback on the public consultation
- Annex III: Cost-benefit analysis (draft RTS)
- Annex IV: Draft Regulatory technical standards
- Annex V: Tables on outstanding sovereign debt



Acronyms used

CDS	Credit Default Swap
DA	Delegated Act
EFSF	European Financial Stability Facility
EIB	European Investment Bank
ESM	European Stability Mechanism
ESMA	European Securities Market Authority
ETF	Exchange Traded Funds
MiFID	Market in financial instruments Directive (Directive 2004/39/EC of the European Parliament and of the Council of April 2004)
NAV	Net asset value
OTC	Over-the-Counter
RTS	Regulatory technical standard
UCITS	Undertakings for Collective Investment in Transferable Securities

Executive Summary

The Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March on short selling and certain aspects of credit default swaps (the Regulation) was published in the Official Journal of the European Union on 24 March 2012¹ and will be applicable from 1 November 2012.

Beyond the technical standards that ESMA has to submit to the Commission by 31 March 2012 according to the Regulation, ESMA received a letter from the Commission on 24 November 2011 requesting it to also provide an advice on all the delegated acts contained in the Regulation by the same deadline – 31 March 2012.

Taking into account the amount of work, complexity of the issues and the very tight deadlines, the process of preparing technical standards and drafting the advice on all delegated acts is being significantly compressed compared to normal ESMA practices. The most important differences compared to normal practice is the absence of a previous call for evidence (used normally to gather early views to help shape the legal proposals), the length of the consultation period (reduced to 3 weeks) and the absence of a cost-benefit analysis incorporated in the consultation of the technical standards. Nevertheless, it was possible to organise a roundtable with European and international associations representing the various stakeholders at the beginning of December in order to collect views on the approach to be taken in the main technical standards and delegated acts foreseen in the Regulation. On 24 January, ESMA published a consultation paper on draft technical standards (ESMA/2012/30). The public consultation closed on 9 March. The interested parties also had the opportunity to provide their comments on ESMA's proposals at an open hearing held on 29 February 2012.

Reasons for publication

This report includes the technical advice that ESMA gives to the European Commission on a number of possible delegated acts concerning the Regulation as listed in the Commission request for advice after having considered the feedback received from the consultation and the open hearing. In addition, as previously announced by ESMA in the consultation papers on draft technical standards (ESMA/2012/30) and on the draft technical advice on delegated acts (ESMA/2012/98), the report also contains the draft regulatory technical standard (RTS) on the method of calculation of the fall in value of a financial instrument, since it is dependent on the provisions of future Commission's Delegated Acts on the definition of what is a significant fall in value of financial instruments other than liquid shares.

The Regulation (EU) No 1095/2010 establishing the European Supervisory Authority (ESMA Regulation), empowered ESMA to develop draft regulatory technical standards where the European Parliament and the Council delegate power to the Commission to adopt regulatory standards by means of delegated acts under Article 290 TFEU. Articles 10(1) of ESMA Regulation state that before submitting draft technical standards to the Commission, ESMA shall conduct open public consultations on draft regulatory technical standards and analyse the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the scope and impact of the draft technical standards concerned or in relation to the particular urgency of the matter.

¹ OJ L 86, 24.3.2012, p. 1

Contents

In each of the following sections, the ESMA proposal of advice to the Commission is presented supplemented by its explanatory text. Section I specifies the definition of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale (Article 2(2) of the Regulation).

Section II relates to the net position in shares or sovereign debt covering the concept of holding a position, the case when a person has a net short position and the method of calculation of such a position including when different entities in a group have long or short positions or for fund management activities related to separate funds (Article 3(7)).

Section III sets out the advice on the cases in which a credit default swap (CDS) transaction is considered to be hedging against a default risk or the risk of a decline of the value of the sovereign debt and the method of calculation of an uncovered position in a CDS (Article 4(2)).

Section IV defines the initial and incremental levels of the notification thresholds to apply for the reporting of net short positions in sovereign debt (Article 7(3)).

Section V specifies the parameters and methods for calculating the threshold of liquidity on sovereign debt for suspending restrictions on short sales of sovereign debt (Article 13(4)).

Section VI sets out ESMA's proposal of advice on what constitutes a significant fall in value for various financial instruments and also specifies, in the form of a draft RTS, the method of calculation of such falls (Article 23(7) and (8)). The full text of the draft RTS is presented in Annex IV.

Section VII also specifies the criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments arise (Article 30).

I. Specification of the definitions laid down in the Regulation and in particular of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale (Article 2(2))

Extract from the Commission's request

ESMA is invited to provide its technical advice on specifying the definitions laid down in the Regulation, in particular specifying when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale.

Box 1

Draft advice on “owning” a financial instrument for the purpose of the definition of short sale

1. Ownership of shares and debt instruments due to article 2(1)(b) of the Regulation means legal or beneficial ownership according to the respective civil law or securities law applicable for the relevant sale. A share or debt instrument is considered to be owned by the ultimate beneficial owner, including in cases where it is held by a nominee.
2. Without prejudice to the applicable civil law or securities law and in order to specify the definition of a short sale and the cases mentioned in article 2(1)(b)(i) to (iii) of the Regulation, the definition of a short sale does not include:
 - a. the selling of financial instruments transferred under a securities lending or repo agreement, if the securities will either be returned or the transferor recalls the securities so that settlement can be effected when it is due;
 - b. the selling of financial instruments by a person who has purchased them prior to the sale but has not yet taken delivery of them at the time of the sale;
 - c. the selling of financial instruments by a person who has exercised an option or a similar claim on them, if the securities will be delivered so that the settlement can be effected when it is due.

Explanatory text

1. The aim of the Delegated Act is to specify when a natural or a legal person is considered to own a financial instrument for the purposes of the definition of short sale set out in article 2(1)(rb) of the Regulation.
2. According to Article 2(1)(b) a "short sale" in relation to a share or debt instrument means any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement.
3. This definition does not include:

- a. a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price;
 - b. a transfer of securities under a securities lending agreement; or
 - c. entering into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a future date.
4. The concept of ownership in the Member States concerning securities is not harmonized. This issue may be considered by the Commission in its future proposal on the Securities Law Directive. This Delegated Act should not anticipate that proposal. For the meantime, it seems appropriate to define legal and beneficial ownership according to the respective civil law or securities law applicable for the relevant sale. In cases of beneficial ownership the relevant financial instrument is considered to be owned by the beneficial owner, even if the legal ownership under the applicable law rests with the nominee. Instead of attempting to provide a specific harmonised definition of ownership for the sole purposes of the Regulation, ESMA has identified additional cases, like the ones mentioned in Article 2(1)(b) where some Member States might have some problems in aligning their civil law or securities law concepts of ownership with the definition of a short sale.
5. One additional example not already mentioned in Article 2(1)(b) of the Regulation might be the sale of financial instruments transferred under a securities lending or repo agreement, if the transferor recalls and receives the financial instrument within the standard settlement period of that sale. The seller may not own the shares or debt instruments from a civil law or securities law point of view, but does so from an economic one. If in addition he recalls the securities so that settlement can be effected when it is due, the exclusion of such cases from the definition of a short sale also involves no risks as regards the timely settlement of the transaction in the concerned financial instruments. This is also the case where the securities on loan will be returned on a scheduled date in time to effect settlement of the lender's sale without the need for recall (e.g. switching of the loan to another lender).
6. A further example should also be included. Under the civil law or securities law of some Member States, the ownership of a financial instrument is not transferred immediately after the sale of that financial instrument. The buyer receives ownership only when the settlement has taken place and the financial instrument is booked to his account. During that time (usually 2 or 3 days) the purchaser has the "economical ownership". During this period, he is able to sell the securities in all Member States. In some Member States, the purchaser is legally considered to sell his "entitlement" to the financial instrument. It is a common market practice to be able to sell securities that one has purchased without having yet received delivery of those securities. Without the ability to do so, financial markets would not work properly, because it would be impossible to buy and sell securities within a short timeframe. Therefore the possibility to sell financial instruments before the settlement (of a previous buy) has taken place, without the transaction being considered to be a short sale, must be maintained. This should include cases when emergency measures set out in Chapter V of the Regulation are implemented.
7. In addition to the above examples, ESMA has, in the light of the responses in the consultation, decided to include another case which should be excluded from the definition of a short sale. The exercise of an option or similar claims due to Article 12(1)(b) or 13(1)(b) is to a large extent parallel to the recall of securities by the transferor. Such an exclusion, as long as the options or similar

claims produce the actual delivery of the shares and are not merely settled in cash, does also not involve risks as regards the timely settlement of the transaction in the concerned financial instruments.

8. Finally, the Delegated Act gives the Commission the possibility to specify any of the other definitions laid down in Article 2(1) of the Regulation if needed. ESMA considers that at the moment there is only a need to specify the definition of a short sale.

II. Specification of the cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2), cases in which a natural or legal person has a net short position for the purposes of Article 3(4) and (5) and the method of calculation of such position, the method of calculating positions for the purposes of Article 3(4), (5) and (6) when different entities in a group have long or short positions or for fund management activities related to separate funds (Article 3(7))

II.I. Introduction

Extract from the Commission's request

ESMA is invited to provide its technical advice on specifying the cases in which a natural or legal person is considered to hold a share or debt instrument, cases in which a natural or legal person has a net short position and the method of calculation of such position, the method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds. The method of calculation should take into account, in particular, whether different investment strategies are pursued in relation to a particular issuer through more than one separate fund managed by the same fund manager, whether the same investment strategy is pursued in relation to a particular issuer through more than one fund, and whether more than one portfolio within the same entity is managed on a discretionary basis pursuing the same investment strategy in relation to a particular issuer.

9. Investors (natural or legal persons) are required to report net short positions which they hold in relation to the issued share capital of a company to the relevant competent authority (i.e. notification under Article 5 of the Regulation) and to the public (i.e. public disclosure under Article 6) as well as in relation to sovereign debt and uncovered CDS referenced to sovereign debt, to the relevant competent authority (i.e. notifications under Article 7 and 8), when their position equals or crosses up or down specified thresholds.
10. To comply with the transparency duty in relation to the positions held, investors must calculate their net short positions. This has to be done by netting short positions and long positions. Therefore it is a precondition to
 - a. define short positions and long positions, taking into account that a long position (Article 3(2)(a) of the Regulation) is composed of holding a share or a sovereign debt instrument and entering into a transaction in instruments whose value depends on the value to the share or sovereign debt (Article 3(2)(b)); and
 - b. to determine the method of calculation of these positions, in particular when different entities in a group have long or short positions or for fund management activities related to separate funds.

II.II. Cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2) (Article 3(7)(a))

Extract from the Commission's request

ESMA is invited to provide its technical advice on specifying the cases in which a natural or legal person is considered to hold a share or debt instrument.

ESMA should take into account that while article 2 refers to the "owning" of a financial instrument, article 3 refers to "holding" a financial instrument. The term "holding" is also the wording used in the Transparency Directive, which requires notification of major holdings. Adopting a similar approach to calculating positions under both the Transparency Directive and this Regulation may minimise the administrative burden on shareholders. However, both the scope and the purpose of the notifications under both pieces of legislation are different. Differences therefore appear to be necessary, notably with regards to financial instruments which are held in the trading book, but also with regard to the contracts which are to be included, and the way in which they are accounted for.

Box 2

Draft advice on “holding” a share or sovereign debt for the purpose of determining a long position

Holding a share issued by a company and holding a debt instrument issued by the sovereign issuer for the purposes of Article 3(2)(a) of the Regulation means:

1. ownership of the instrument as defined in the Delegated Act regarding Article 2(2) of this Regulation;
or
2. without having ownership, having a legally enforceable claim to be transferred ownership in cases not mentioned in Article 3(2)(b) of the Regulation according to the respective civil law or securities law applicable for the relevant sale.

Explanatory text

11. This Delegated Act should specify cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2)(a) of the Regulation.
12. The meaning of holding a position under the Regulation differs from the approach taken under the Transparency directive considering that both the objectives of the two legislative texts and the scope of the financial instruments covered are different and that the method of calculation under the Regulation follows the netting approach.
13. A long position (Article 3(2)(a) of the Regulation) is composed of holding a share or a sovereign debt instrument and entering into a transaction in instruments whose value increases with the price of the share or sovereign debt (Article 3(2)(b)).

II.III. Concept of having a net short position and method of calculation (Article 3(7)(b))

Extract from the Commission's request

ESMA is invited to provide its technical advice on specifying cases in which a natural or legal person has a net short position and the method of calculation of such position.

Cases in which a natural or legal person has a net short position for the purposes of Article 3 (4) and (5)

Box 3

Draft advice on cases in which a natural or legal person has a net short position in shares or sovereign debt

Net short position in shares

Long positions

1. The Delegated Act on Article 3(7)(a) defines holding of an instrument regarding Article 3(2)(a). A holding of a share via a long position in a basket of shares should, in relation to this specific share, also be taken into account to the extent that the share in question is represented in the basket.
2. Any exposure through an instrument other than the share which confers a financial advantage in the event of an increase in the price of the share as set out in Article 3(2)(b) means in particular any exposure to issued share capital through any one or more of the following non-exhaustive list of instruments, on the condition that their value depends on the value of the share in respect to which a net short position has to be calculated, and which confer a financial advantage in the event of an increase in the price or value of the share:
 - options
 - covered warrants
 - futures
 - index related instruments
 - contracts for difference
 - shares/units of exchange traded funds
 - swaps
 - spread bets
 - packaged retail or professional investment products

- complex derivatives (e.g. options on future; structured product)
- certificates linked to shares
- global depositary receipts

In this context it is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

3. Instruments that give a claim to shares not in issue should not be taken into account as long positions when calculating a net short position. In particular subscription rights, convertible bonds and other comparable instruments are not long positions within the meaning of Article 3(2)(b).

Short Positions

4. A short sale is defined in article 2(1)(b) of the Regulation and in the Delegated Act on Article 2(2). A short sale via a short sale of a basket of shares should, in relation to this specific share, also be taken into account to the extent that the share in question is represented in the basket.
5. In relation to the short position set out in Articles 3(1)(a) and 3(3) of the Regulation where a position in an instrument such as those listed in subparagraph 2 above confers a financial advantage in the event of a decrease in the price or value of the share, this position should be taken into account in calculating the short position.
6. It is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.
7. Instruments that give a claim to shares not in issue should not be taken into account as short positions when calculating a net short position. In particular short positions on subscription rights, convertible bonds and other comparable instruments are not short positions within the meaning of Article 3(1)(b).

Net short position in sovereign debt

Long Positions

8. The Delegated Act on Article 3(7)(a) of the Regulation defines holding of an instrument regarding Article 3(2)(a). A holding of a debt instrument via a long position in a basket of sovereign debt instruments of different sovereign issuers should, in relation to this specific share, also be taken into account to the extent that the sovereign debt in question is represented in the basket.
9. Any exposure through an instrument other than the sovereign debt which confers a financial advantage in the event of an increase in the price of the sovereign bond regarding Article 3(2)(b) of the Regulation means in particular any exposure through any one or more of the following non-exhaustive list of instruments, on the condition that their value depends on the value of the sovereign debt in respect to which a net short position has to be calculated, and which confers a financial advantage in the event of an increase in the price or value of the sovereign debt:
 - options

- futures
- index related instruments
- contracts for difference
- swaps, especially sovereign credit default swaps
- spread bets
- complex derivatives
- certificates linked to sovereign debt

In this context it is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

10. Under the assumption that a high correlation exists, all net holdings of sovereign debt of the correlated sovereign issuer as set out in Article 2(1)(d) of the Regulation should be included. Debt instruments from issuers outside the union should not be included.
11. For assets with a liquid market price a high correlation between the yield of a debt instrument of another sovereign issuer and the yield of the debt of the given sovereign issuer should be measured on a historical basis using daily accumulated weighted data for the 12 month period before the position in the sovereign debt is taken out. For assets for which there is not a liquid market price or where there is not a sufficiently long price history, a good proxy of similar duration should be used.
12. High correlation is assumed when the correlation coefficient between the yield of the debt instrument of another sovereign issuer and the yield of the given sovereign debt is at least 70%.
13. If the position subsequently ceases to meet the test of high correlation based on the 12 month timeframe, then the sovereign debt of the previously highly correlated sovereign issuer can no longer be taken into account when calculating a long position. However, temporary fluctuations in the level of correlation of the sovereign debt are acceptable provided that it is at least of 50% for no longer than 3 months.

Short positions

14. A short sale is defined in article 2(1)(b) of the Regulation and in the proposed advice on the Delegated Act on Article 2(2). A short sale via a sale of a basket of sovereign debt instruments of different sovereign issuers should, in relation to this specific sovereign debt instrument, also be taken into account to the extent that the sovereign debt in question is represented in the basket.
15. In relation to the short position set out in Articles 3(1)(a) and 3(3) of the Regulation where a position in an instrument such as those listed in subparagraph 8 above confers a financial advantage in the event of a decrease in the price or value of the sovereign debt, this position should be taken into account in calculating the short position.
16. It is irrelevant whether a cash settlement or physical delivery of underlying assets has been agreed.

17. CDS referenced to the sovereign issuer have to be included in calculating net short positions in sovereign debt. Sales of CDS (i.e. exposures to the credit of a sovereign issuer) should be counted as long positions while purchases of CDS should be counted as short positions.
18. If a sovereign CDS position is hedging a risk other than the referenced sovereign debt, the value of the hedged risk cannot be treated as a long position for the purposes of calculating whether a person has a net short position in the issued sovereign debt of a sovereign issuer.

Explanatory text

Introduction

14. This Delegated Act should define cases in which a natural or legal person has a net short position due to Article 3(7)(b) of the Regulation.
15. A precondition for netting off short positions and long positions for the purpose of calculating net short positions is to define short positions and long positions.

Calculating Long Positions

16. ESMA considers that, as recommended in paragraph 8 of CESR's Model for a Pan-European Short Selling Disclosure Regime of March 2010 (CESR/10-088), instruments that give a claim to shares not in issue (i.e. subscription rights, convertible bonds) should not be taken into account in calculating a net short position.
17. A long position is composed of a) positions obtained by holding the instrument itself (Article 3(2)(a) of the Regulation) and b) positions obtained by entering into a transaction in instruments whose value depends on the value of the share or sovereign debt in respect to which a net short position has to be calculated, and which confer a financial advantage in the event of an increase in the price or value of the share or sovereign debt (Article 3(2)(b) of the Regulation).
18. A long position in a sovereign debt instrument shall be calculated by including any long position in relation to the issued sovereign debt of a sovereign issuer and any net long position in debt instruments of a sovereign issuer the pricing of which is highly correlated to the pricing of the given sovereign debt (Article 3(5) of the Regulation). In relation to highly correlated sovereign debt, the interpretation of the Regulation has been taken that only net long position rather than gross long position had to be taken into account.
19. ESMA has considered how 'highly correlated' should be defined for these purposes. The choice was between setting a specific percentage measure of correlation which must be reached or using instead a qualitative measure.
20. As the test is one of high correlation, it may be feasible to set a percentage threshold rather than simply relying on a purely qualitative definition. ESMA is aware that there is currently no definition of the term 'highly correlated' elsewhere in EU legislation which could be used as a benchmark in this Delegated Act and recognises that there may not be currently a commonly agreed standard for the level of statistical correlation required. However, setting a quantitative threshold would provide a clear, objective and measurable standard against which regulators and market participants could judge whether the condition of highly correlated set in the Regulation is or is

not met. It is also relevant that the comparison is one between financial instruments of the same class for which pricing data is generally available. On balance therefore ESMA is minded to propose using a quantitative definition and considers that a percentage of 70% would seem to be appropriate for the purposes of calculating a net short position in sovereign debt.

21. Further to the public consultation ESMA has considered that the calculation of correlation for assets with a liquid market price should be carried out on a historical basis using daily accumulated weighted data for the 12 month period (250 trading days) before the position in the sovereign debt is taken out, with proportionally more weight given to the recent data². This method would limit the backward looking effect of a historical basis measurement and take into account the recent trends on the market. However, ESMA recognizes that new sovereign debt instruments are regularly issued and will not have a 12 month trading history. There are also some sovereign debt instruments in which there is little trading as they are mostly 'buy and hold' assets. For debt instruments for which there is not a liquid market price or where there is not a sufficiently long price history, a good proxy debt instrument of that sovereign issuer should be used in undertaking the measurement of correlation. Such a good proxy could be another debt instrument, whose duration is similar to the one to calculate.
22. If the position subsequently no longer meets the test of high correlation based on the 12 month timeframe then the sovereign debt of the previously highly correlated sovereign issuer can no longer be taken into account in calculating a long position. Considering that a quantitative measure for assessing high correlation is set, ESMA believes necessary to introduce a provision for periods when there might be temporary fluctuations in the level of correlation between the price of the sovereign debt of different sovereign issuers. To cater for such situations ESMA proposes a temporary buffer period during which a lower level of correlation would be acceptable. With the level of correlation set at 70%, it could be acceptable for a period of three months that a level of at least, respectively, 50% was met. Clearly, if the level of correlation fell below the prescribed measure for more than this buffer period or if the level of correlation fell below the lower reference level, the test of "highly correlated" would no longer be met.
23. Under the assumption that a high correlation exists between a long position in a particular debt instrument of a sovereign issuer and any debt instrument of another sovereign issuer, all net long positions in debt instruments of the former sovereign issuer in the sense of Article 2(1)(d) of the Regulation should be included. There is no restriction that the net long position in the former sovereign issuer has to be in equivalent debt instruments to those in which a short position in the latter sovereign issuer for which the net short position has to be calculated is held.
24. So for example, in calculating whether a net short position exists in relation to the sovereign debt instruments of Germany and assuming that a high correlation exists, a net long position in the debt instruments issued by Bavaria can be included, because Germany is a federal state. According to Article 2(1)(d) of the Regulation debts issued by one of the members making up the federation are defined as sovereign debts. Similarly, if an investor holds net long positions in the sovereign debt of country X and assuming that the pricing of this debt is highly correlated to that of the sovereign debt of country Y, the investor can take account of his net holdings in sovereign debt of country X in calculating whether he has a net short position in sovereign debt of country Y.

² Over 250 days, the first day of the period is weighted 1/250, the 2nd day 2/250...and the last day (i.e. the most recent one) is weighted 1.

Calculating Short positions

25. A short position is composed of a) positions obtained by a short sale of an instrument (Article 3(1)(a) of the Regulation) and b) positions developed by entering into a transaction in instruments, whose value depends on the value of the share or sovereign debt, in respect to which a net short position has to be calculated, and which confer a financial advantage in the event of a decrease in the price or value of the share or sovereign debt (Article 3(1)(b) of the Regulation).
26. The holding of special “short instruments”, e.g. shares in reverse ETFs, which create a short position in the referenced share(s) or debt should also be taken into account when calculating a short position.

Method of calculation of net short positions

27. According to article 3(4) of the Regulation, *“the position remaining after deducting any long position that a natural or legal person holds in relation to the issued share capital of a company from any short position that that natural or legal person holds in relation to that capital shall be considered a net short position in relation to the issued share capital of that company”*.
28. According to article 3(5) of the Regulation, *“the position remaining after deducting any long position that a natural or legal person holds in relation to the issued sovereign debt of a sovereign issuer and any long position in debt instruments of a sovereign issuer the pricing of which is highly correlated to the pricing of the given sovereign debt from any short position that natural or legal person holds in relation to the same sovereign debt shall be considered a net short position in relation to the issued sovereign debt of that sovereign issuer”*.
29. There might be several possible methods of calculation. The Regulation does not specify the models or methods to be chosen. The following Box sets out ESMA’s draft advice on the method of calculation of the position in relation to the issued share capital of a company and to the issued debt of a sovereign issuer.

Box 4

Draft advice on the method of calculation of net short position

In relation to shares

1. ESMA recommends a delta adjusted model for shares as proposed by ESMA/CESR in May 2010 in the document “Technical details of the pan-European short selling regime” (CESR/10-453). This model has been already implemented by some jurisdictions and it is operating satisfactorily.
2. Calculations of a long and short position in relation to shares should be done using the same methods.
3. Positions shall be calculated by taking into account transactions in all financial instruments (inside or outside a trading venue) that confer a financial advantage in the event of a change in price or value of the share.
4. Any derivative and cash position would be accounted for on a delta adjusted basis (cash position

having delta 1). Delta indicates how much a financial instrument's theoretical value would move in case of an underlying instrument's price variation. In order to calculate the delta of a derivative, investors shall take into account the current implied volatility of the derivative and the closing price (or last price) of the underlying instrument. Therefore, in order to determine a position having equity or cash investments and derivatives at the same time, investors shall calculate the individual delta-adjusted position of every derivative that is held in the portfolio, plus or minus all cash positions.

5. Investors should be aware that a nominal cash short position might not be offset in some cases by an equivalent nominal long position taken in derivatives. Delta-adjusted long positions in derivatives may not compensate identical nominal short positions taken in other financial instruments due to the delta adjustment. Persons entering into derivatives contracts giving rise to potentially reportable short positions should calculate net position changes in their portfolio arising from changes in the delta.
6. Any transaction that confers a financial advantage in the event of a change in price or value of the share held as part of a basket, index or exchange traded fund (ETF) shall be included when calculating the position in each individual share. Positions on these financial instruments shall be calculated taking into account the weight of that share in the underlying basket, index or fund. Investors shall perform calculations in these financial instruments following the principles set out in article 3(3) of the Regulation: the principle of acting reasonably having regard to publicly available information as to the composition of the relevant index, basket of securities or interests held in a ETF and the principle that stipulates that no person shall be required to obtain any real-time information as to such composition from any person.
7. Net short position is calculated then by netting long and short delta-adjusted positions in a given issuer.
8. As for the issued share capital of the company, it is defined in article 2(1)(h) of the Regulation and means the total of ordinary and any preference shares issued by the company but does not include convertible debt securities. When issuers have several share classes it would be necessary to take into account the total number of shares issued in each class and to add them up.
9. Calculation of positions needs to take into account changes in the share capital of the issuer (like capital raising, bond conversion, capital amortisation etc.) that can trigger or eliminate notification obligations. Persons entering into short positions should be able to calculate net position changes arising from any change in the issued share capital of the company.
10. New shares issued from a capital increase shall be accounted for the calculation of the total issued share capital from to the day they are admitted to trading on a trading venue.
11. The net short position expressed as a percentage of the company issued share capital is then obtained by dividing the net short position in equivalent shares by the total issued share capital of the company.

In relation to the issued sovereign debt of a sovereign issuer

12. Positions shall be calculated by taking into account transactions in all financial instruments that confer a financial advantage in the event of a change in price or value of the issued sovereign debt of a

sovereign issuer.

13. Cash positions and positions in derivatives (bond futures, options on bond futures, other derivatives, etc.) shall be taken into account using their nominal amount. Options and other derivative instruments shall be then adjusted by their delta. D delta calculations of derivatives should be performed in accordance with paragraph 4. Therefore, in order to determine a position having cash investments and derivatives at the same time, investors shall calculate the individual delta adjusted position of every derivative that is held in the portfolio, plus or minus all cash positions (cash position having delta 1).
14. Nominal positions in bonds issued in other currencies than the Euro shall be converted to Euros using “bona fide” practice taking the last reliable updated spot currency price available. The same principle applies to other financial instruments.
15. Other derivatives, in particular forward bonds, shall be also adjusted using the same principles.
16. Any economic interest or position that creates a financial advantage to the issued sovereign debt of a sovereign issuer held as part of a basket, index or exchange traded fund (ETF) shall be included when calculating the position in each individual debt of a sovereign issuer. Positions on these financial instruments shall be calculated taking into account the weight of that “sovereign exposure” in the underlying basket, index or fund. Investors shall perform calculations in these financial instruments following the principles set out in article 3(3) of the Regulation: the principle of acting reasonably having regard to publicly available information as to the composition of the relevant index, basket of securities or interests held in a ETF and the principle that stipulates that no person shall be required to obtain any real-time information as to such composition from any person.
17. Calculations for sovereign debt instruments with high correlation follow the same methods of calculation of long positions in debt instruments of a sovereign issuer. Long positions in debt instruments of a sovereign issuer the pricing of which are highly correlated to the pricing of the given sovereign debt can be taken into account for calculation purposes. When these positions no longer meet the test of high correlation then they shall not be taken into account to offset short positions.
18. Nominal long positions of CDS shall be included in the calculation as short positions. In calculating an investor sovereign CDS position its net positions should be used (i.e. sales of CDS in the referenced sovereign counted as long positions). Positions intended to be covered or hedged through the purchase of a CDS that are not sovereign bonds (like any other assets, liabilities or any other kind of counterparty default risk) will not be taken into account as long positions. CDS are considered to have delta 1.
19. The net short position is calculated then by netting nominal delta adjusted equivalent long and short positions in the issued sovereign debt of a sovereign issuer.
20. As for the issued sovereign debt of a sovereign issuer it is defined in article 2(1)(g) of the Regulation and means the total of sovereign debt issued by a sovereign issuer that has not been redeemed.
21. The net short position is expressed as a monetary amount in Euros.
22. Calculation of positions needs to take into account changes in correlations and in the total sovereign debt of a sovereign issuer. Persons entering into short positions should be able to calculate net posi-

tion changes arising from any changes in correlations and total sovereign debt of a sovereign issuer.

23. Only long positions in debt instruments of a sovereign issuer of an EU Member State the pricing of which is highly correlated to the pricing of sovereign debt of an EU sovereign issuer shall be taken into account to offset short positions in the said sovereign debt. A given long position of a highly correlated debt can only be used once to offset a short position in cases where the investor maintains several short positions of different sovereign issuers (the same amount of the long position cannot be applied several times to net off different short positions taken in highly correlated sovereign debt).
24. Investors with multiple allocations of long positions of highly correlated debt across several different sovereign issuers should be in a position to have records that show their allocation methods.
25. Article 3(6) of the Regulation states that “the calculation under paragraphs 1 to 5 for sovereign debt shall be for each single sovereign issuer even if separate entities issue sovereign debt on behalf of the sovereign issuer”. Positions shall be then calculated for every sovereign issuer of the EU in which an investor (market participant) holds a short position.

Explanatory text

30. Recital 10 of the Regulation states that “*In order to ensure a comprehensive and effective transparency it is important that the notification requirements cover not only short positions created by trading shares or sovereign debt on trading venues but also short positions created by trading outside trading venues and net short positions created by the use of derivatives, such as options, futures, index-related instruments, contracts for differences and spread bets relating to shares or sovereign debt*”.
31. Recital 12 of the Regulation states that “*the calculation of short positions or long positions should take into account any form of economic interest which a natural or legal person has in relation to the issued share capital of a company or to issued sovereign debt of a Member State or of the Union. In particular, it should take into account such an economic interest obtained directly or indirectly through the use of derivatives such as options, futures, contracts for differences and spread bets relating to shares or sovereign debt, and indices, baskets of securities and exchange traded funds. In the case of positions relating to sovereign debt it should also take into account credit default swaps relating to sovereign debt issuers*”.
32. Article 5(2) of the Regulation states that “*a relevant notification threshold is a percentage that equals 0,2% of the issued share capital of the company concerned and each 0,1% above that*”. The Regulation is thus requesting the notified net short position to be at least expressed as a percentage of the company’s issued share capital. Calculation and notification in percentage of issued share capital allows market participants and competent authorities a quick and accurate assessment of the significance of the short position.
33. ESMA understands that for notification purposes a figure expressing the percentage of the net short position in relation to the total outstanding sovereign debt of a sovereign issuer is necessary, although according with Article 7(2) of the Regulation the relevant notification thresholds will be set up in nominal terms (See Chapter IV below).

34. Article 9(2) of the Regulation states that “*the relevant time for calculation of a net short position shall be midnight at the end of the trading day on which the natural or legal person holds the relevant position. That time shall apply to all transactions executed irrespective of the means of trading used, including through either manual or automated trading, and irrespective of whether the transactions have taken place during normal trading hours*”.
35. ESMA recognises that there might be several appropriate methods of calculation of net short positions in relation to the issued sovereign debt of a sovereign issuer. However, the choice essentially comes down to whether to adopt a nominal model, as with shares, or a sensitivity adjusted method to take into account the fact that different issues of sovereign debt have different maturities. The two respective methods are set out below but it should be emphasised that neither method is intended to offer any guidance or basis for portfolio or bond valuation at all. The choice of the methods should be determined by whichever better meets the goal of the Regulation that notification of significant short positions shall provide important information to assist regulators in monitoring whether such positions are creating systemic risk or being used for abusive purposes. A further determining criterion is that the method selected should be straightforward and easy to apply for all market participants.
36. In the light of some responses received ESMA considers appropriate to acknowledge that there are several models to calculate delta currently in use by market participants. As a way of illustration and without any intention to prescribe any of them ESMA would like to mention that Black-Scholes, Black 76 and binomial model are some of the most commonly used pricing models for derivatives in shares and in indexes.
37. Total sovereign debt issued by a sovereign issuer that has not been redeemed includes, where applicable, debt issued by sovereign issuers as defined in article 2(1)(d) of the Regulation. It contains specifically the debt issued by the Member state, ministry, agency or SPV of the member state.

Sensitivity adjusted method (Value of a basis point, Duration or Modified Duration)

38. The following paragraphs set out the main lines of a “sensitivity adjusted” method of calculation of the position in relation to the issued sovereign debt of a Member State or of the Union. Any “sensitivity adjusted method” (value of a basis point, duration or modified duration) offers a comparison between relative or absolute price changes in a debt instrument and relative or absolute yield changes. This method would basically share many of the main features and calculation rules of the “nominal” method proposed by ESMA. ESMA assumes that the value of basis point (PVBP or PV01) is the method most often used for market participants to assess interest rate risk. However, duration or modified duration methods could equally be used as are very closely related.
39. Positions should be calculated by taking into account transactions in all financial instruments that confer a financial advantage to the issued sovereign debt of a sovereign debt issuer.
40. Bond positions should be adjusted (multiplied) by their PV01, modified duration or duration figure. To calculate a portfolio’s PV01, modified duration or duration, the same principle applies.
41. Bond futures positions should first be converted to an equivalent cash position and then adjusted (multiplied) by the PV01 (modified duration or duration) of the cheapest to deliver bond.

42. Options on bond futures should be converted to an equivalent cash position by their delta and then adjusted by the PV01 (modified duration or duration) of the underlying future.
43. Other derivatives, in particular forward bonds, should be calculated using the same principles.
44. Nominal values in bonds issued in other currencies than euro should be first converted to Euros using bona fide practice taking the last reliable updated price available.
45. The net short position is then calculated by netting long and short PV01 adjusted positions (modified duration or duration adjusted) in a given sovereign issuer.
46. Accordingly, the total sovereign debt issued by a sovereign issuer that has not been redeemed would be adjusted (multiplied) by their PV01, modified duration or duration figure.
47. The net short position expressed as a percentage of the total PV01 adjusted (modified duration or duration adjusted) issued sovereign debt of a sovereign issuer is then obtained by dividing the nominal net short PV01-adjusted position (modified duration or duration adjusted position) by the total issued PV01-adjusted position (modified duration or duration adjusted) of the sovereign debt of a sovereign issuer.
48. The advantages of using a sensitivity adjusted method are that it better reflects the fact that taking short positions in issues of different duration will have different market impacts – a short position in Treasury Bills will have less impact than an equivalent position in for example, 10 year bonds. Adjusting positions by “sensitivity” captures adequately the level of risk to changes in yields and the associate interest rate exposure in such circumstances. However, a sensitivity adjusted method is less useful than the nominal method in times of market stress and would inevitably entail more complexity in terms of calculation of positions

Nominal model and general considerations

49. In contrast the nominal model offers great simplicity for calculation and might prove very useful when the market in debt instruments is mostly led by events other than interest rate risk (credit risk or distress situation). These are also the kind of situations when the knowledge of short positions becomes more important for regulators. ESMA acknowledges that in normal market conditions the usefulness of the nominal information for supervisors is less relevant since it is difficult to grasp the kind of strategy that a market participant is carrying out without a measure of the impact on its position of a yield curve movement. ESMA is also aware that the nominal approach may have the disadvantage of not always accurately reflecting the nature of a position, in particular when it results from the aggregation of debt instruments of different maturities (e.g. simultaneous sale of a 10 year maturity bond and purchase of a short term debt instrument).
50. Both methods therefore have their advantages and disadvantages and neither is perfect. The ideal solution might be to be able to apply the method which best suits the prevailing market conditions but ESMA recognises that such a pick and mix approach may be difficult to reconcile with setting one standard around which market participants can design their reporting systems. Taking into account that the purpose of Regulation is to assess the market impact that a net short position is able to produce as well as to obtain complete and accurate information about a person's position, ESMA considers that, on balance, concerning debt instruments, calculating and reporting net short positions in nominal terms better accomplishes both goals. In this respect positions taken in one part of the yield curve should not be given a greater weight than another.

II.IV. Method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds

Introduction

51. The aim of the Delegated Act is to specify the method of calculating long, short and net positions relating to the issued share capital of a company or the issued sovereign debt of a sovereign issuer when different entities in a group have long or short positions or for fund management activities related to separate funds.
52. In light of the feedback received, ESMA has largely amended its advice in the matter compared to the proposal set out in its consultation paper (ESMA/2012/98), which provided for a three-layer approach. The overwhelming concern expressed by the respondents related to the complexity of the proposed method. However, the objective pursued by ESMA in its advice is to find a balanced though practical approach between comprehensiveness in reporting and risks of multiple reporting.

Extract from the Commission's request

ESMA is invited to provide its technical advice on specifying [...] the method of calculation of such position [net short position], the method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds. The method of calculation should take into account, in particular, whether different investment strategies are pursued in relation to a particular issuer through more than one separate fund managed by the same fund manager, whether the same investment strategy is pursued in relation to a particular issuer through more than one fund, and whether more than one portfolio within the same entity is managed on a discretionary basis pursuing the same investment strategy in relation to a particular issuer.

Box 5

Draft Advice on the method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds

1. Definitions for the purpose this advice:
 - a. Group: for the purpose of the delegated act, a group is a legal entity constituted of several legal entities it controls as defined under article 2(1)(f) of the Transparency directive³.
 - b. Investment Strategy: the strategy that is pursued by a management entity, regarding a particular issuer, to have either a net short or a net long position taken through transactions in various financial instruments issued by this particular issuer or that relate to that issuer.
 - c. Management activities: management of funds irrespective of their legal form and portfolio

³ Directive 2004/19/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC

management in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments.

- d. Management entity: legal person or entity (e.g. division, unit, department, etc.) managing, on a discretionary basis, funds or portfolio under mandate.

For management activities related to several funds or managed portfolios

2. The calculation of the net short position in a particular issuer should be made in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) for each individual fund, irrespective of its legal form and for each managed portfolio.
3. The management entity should aggregate the net short positions of the funds and portfolios under its management for which the same investment strategy is pursued in relation to a particular issuer.
4. When applying the method described above, the management entity should:
 - a. take into account the positions of the funds and portfolios the management of which has been delegated by a third party;
 - b. exclude the positions of the funds and portfolios the management of which it has delegated to a third party.
5. The management entity shall report, and disclose where relevant, the net short position that results from paragraphs 3 and 4 above when it reaches or exceeds a relevant notification or disclosure thresholds.
6. Where a single legal entity is performing management activities together with other non-management activities, it shall
 - a. apply the method described above in paragraphs 2 to 4 to its management activities only and report, and disclose where relevant, the resulting net short positions; and
 - b. for the rest of its activities, perform the calculation of the net short position in a particular issuer in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) and report, and disclose where relevant, the resulting net short positions.

When different legal entities within a group have long or short positions in relation to a particular issuer

7. The calculation of the net short position shall be made in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) for each legal entity constituting the group. The relevant legal entity (or on its behalf, the group it belongs to) shall report, and disclose where relevant, the net short position in a particular issuer when it reaches or exceeds a relevant notification or disclosure threshold. Where one or more of the legal entities constituting the group are management entities, they shall apply the method described above under paragraphs 2 to 5 for fund and portfolio management activities.
8. The net short and long positions of all the legal entities constituting the group and of the group itself

(i.e. the controlling company) shall be aggregated and netted, with the exception of the positions of the management entities that perform management activities. The group shall report, and disclose where relevant, the net short position in a particular issuer when it reaches or exceeds a relevant notification or disclosure thresholds.

9. When net short position is reaching or crossing a relevant notification or disclosure thresholds

- a. A legal entity within the group shall report, and disclose where relevant, its net short position in a particular issuer calculated according to paragraph 7 above provided that no net short position at group level calculated according to paragraph 8 above reaches or crosses a notification or disclosure threshold;
- b. A group shall report, and disclose where relevant, its net short position in a particular issuer calculated according to paragraph 8 above when:
 - no notification or disclosure threshold is reached or crossed by any legal entity constituting the group, or
 - a notification or disclosure threshold is reached or crossed simultaneously both by the group itself and any legal entity constituting that group.

Explanatory text

53. Although under the Regulation the notification or disclosure requirements fall on the legal entity in relation to net short positions in the issued share capital of a company or the issued sovereign debt of a sovereign issuer, Article 3(7)(c) requires that the method of calculating the positions should be specified under a Delegated Act in two specific instances:

- a. when different entities in a group have long or short positions;
- b. for fund management activities related to separate funds.

54. The most relevant recital for the aim of the Delegated Act is recital 11 of the Regulation: *“To be useful to regulators and markets, any transparency regime should provide complete and accurate information about a natural or legal person's positions. In particular, information provided to the regulator or the market should take into account both short and long positions so as to provide valuable information about the natural or legal person's net short position in shares, sovereign debt and credit default swaps.”*

55. Therefore, in line with the CESR report “Technical details of the pan-European short selling disclosure regime” (10-453; May 2010), ESMA considers that the objectives are to achieve a maximum transparency and avoid non-compliance with notification and disclosure requirements through:

- a. concealing an otherwise notifiable or discloseable net short position by using a group structure; and/or

- b. diluting an otherwise notifiable or discloseable net short position by allocating such a position through different entities within an organization or to different funds all of which are managed by the person which took the position.
56. In this respect and for the purpose of article 3(7)(c), ESMA considers that it is necessary to address separately and specifically the cases of fund management activities regardless of whether they are conducted within a group or within a single legal entity.
57. For the purpose of the net short position notification and disclosure requirements, ESMA considers that the definition of group to be used should relate to the already known concept of controlled entity as set out in the Transparency directive⁴. This approach has been widely supported in the feedback from the public consultation.
58. ESMA considers that fund management activities referred to in Article 3(7)(c) of the Regulation should be understood as the discretionary management of investments on behalf of investors regardless of the legal form. Consequently, such investors (shareholders/participants in a fund irrespective of its legal form or persons mandating the management of their portfolio of investments) do not interfere in the investment decisions. These are taken by the management entity in accordance with the investment policy set in the rules of the fund or with the mandate given by the investor in the case of portfolio management and always in the interests of the fund shareholders/participants or the portfolio mandating investors.
59. Considering the above, where the management activities are carried out by one or several legal entities within a group (or by a department/unit with a legal entity when such an entity has different business lines), it is assumed that the investment decisions under the management activities are managed independently from the parent company of the group and from other entities within the group that are not conducting management activities. As a consequence, the positions resulting from the management activities should be excluded from any calculation of net short positions at group level for the other activities carried out.
60. This approach should also apply for a legal entity constituted of several different non-legal entities with different activities with one of them being fund or portfolio management. This situation would for instance cover the case of credit institutions or investment firms performing, within a single legal structure, several types of different activities, such as proprietary trading and individual portfolio management on a discretionary basis. However, the legal entity in question has also to conduct a separate calculation for its management activities and report the resulting net short position in a particular issuer. Therefore, though in some instances that legal entity may have to notify two reports, there will never be a double counting of the same position.

⁴ Article 2(1)(f) of the Transparency directive.

A controlled undertaking' means any undertaking:

- (i) in which a natural person or legal entity has a majority of the voting rights; or
- (ii) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time a shareholder in, or member of, the undertaking in question; or
- (iii) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders' or members' voting rights, respectively, pursuant to an agreement entered into with other shareholders or members of the undertaking in question; or
- (iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.

For a group and the legal entities constituting it

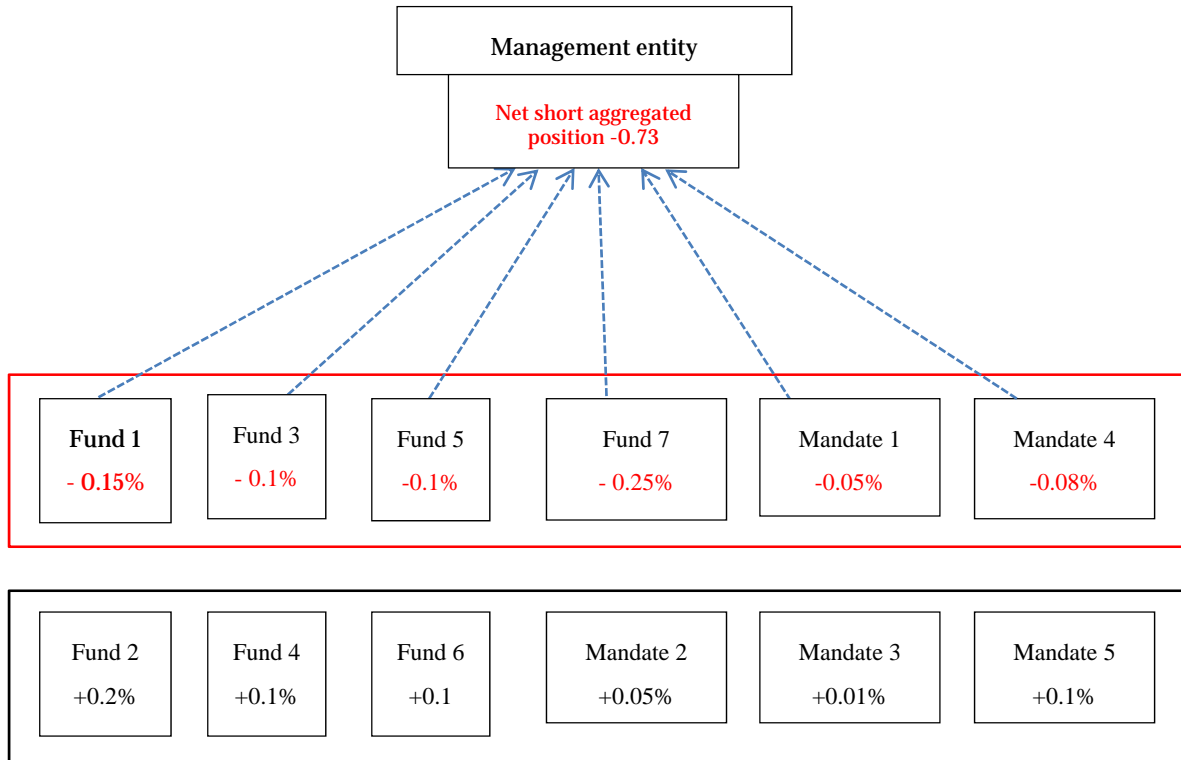
61. With respect to a group constituted of several legal entities and provided the exclusion described for management activities is applied where relevant, ESMA is willing to avoid any risk of non-compliance with the notification and disclosure requirements.
62. Therefore, ESMA recommends that the net short position in a particular issuer should be calculated in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) at the level of each individual entity constituting the group.
63. In addition, ESMA considers that, at group level, the parent company should also conduct an overall netting of the net short positions with net long positions in a particular issuer held by the parent company and all the controlled legal entities. The positions resulting from the management activities should be excluded from this netting.
64. To reduce the risks of double counting and to avoid double reporting by controlled legal entity level and group itself that could be misleading for both regulators and the market, ESMA recommends that net short positions should be reported, and disclose where relevant, either at individual legal entity level or at a group level only whenever a notification/disclosure threshold is reached or crossed, except when a single entity that belongs to a group and the group itself cross a threshold simultaneously, in which case only the group has to report.

For fund and portfolio management activities

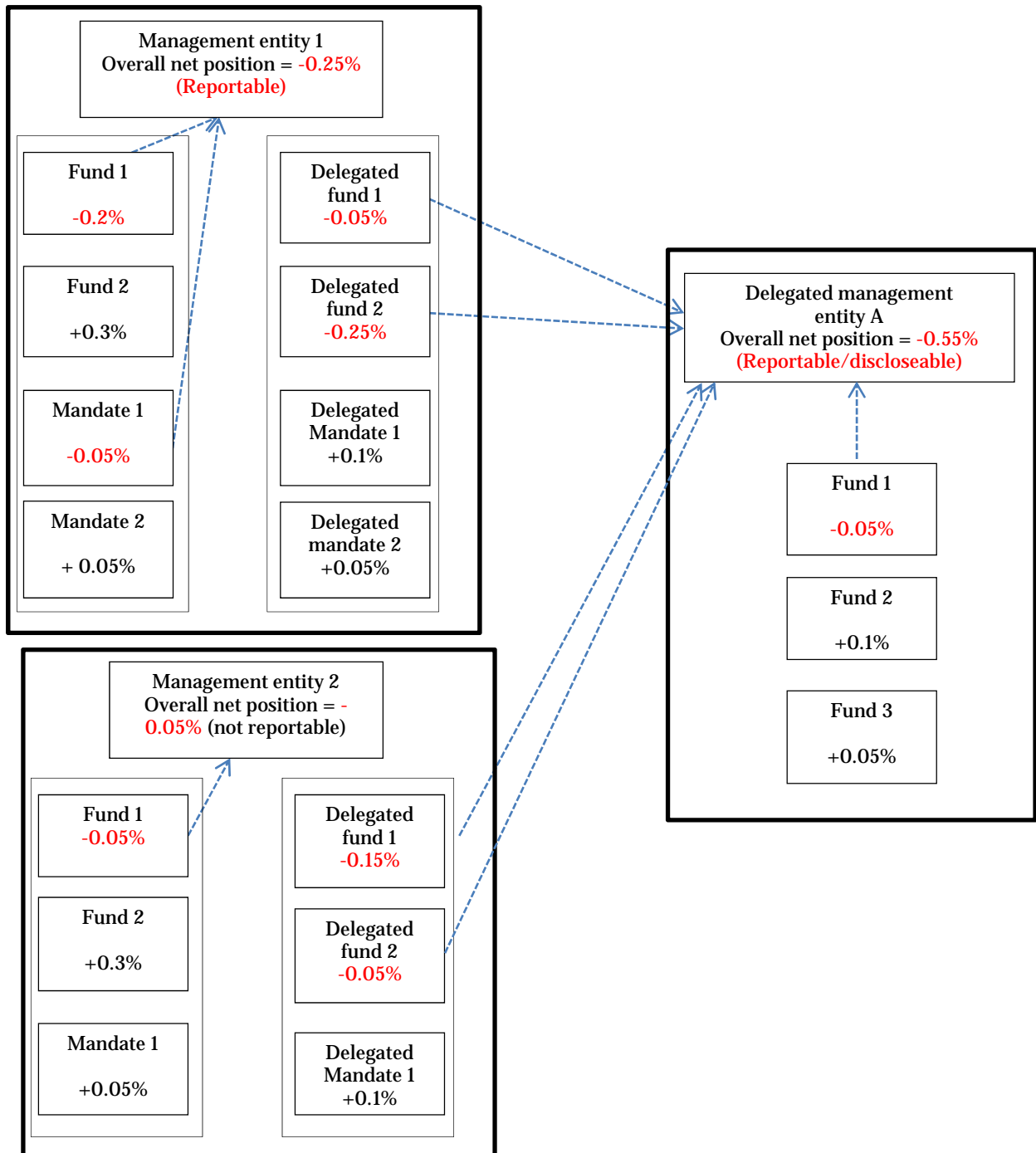
65. The specific treatment of fund management and portfolio management stems from the last paragraph of Article 3(7)(c) of the Regulation and is conditioned by the discretionary nature of the management activities under consideration.
66. Further to the public consultation (ESMA/2012/98) and with the view to provide a workable and manageable framework, ESMA has reviewed its approach to take into consideration as required under the Regulation whether, in relation to a particular issuer, different investment strategies are followed and to minimise the risk of avoidance of compliance with the reporting requirements.
67. Article 3(7)(c) introduces the concept of investment strategy in order to cater for the specific cases to be considered in the method of calculation where fund management and portfolio management are concerned. An investment strategy that is pursued by a management entity, regarding a particular issuer, is implemented by taking positions through transactions in various financial instruments issued by this particular issuer or that relates to that issuer. Ultimately, an investment strategy is either being long or short on a particular issuer.
68. In addition, ESMA considers that a consistent approach should apply to both funds, irrespective of their legal form, and to portfolios managed under mandate.
69. For the purpose of Article 3(7)(c) ESMA considers that the calculation of the net short position in a particular issuer, in accordance with the advice on Delegated Act relating to article 3(7)(a) and (b) should be conducted at the level of (i) each individual fund holding such a net short position, though ESMA is aware that in some jurisdictions, funds may not be legal persons (they can have a corporate or contractual form) and (ii) each individual portfolio under management.

70. To take into consideration when the same investment strategy is pursued in relation to a particular issuer through more than one fund or portfolio, the positions of all the funds and portfolios having a net short position should be aggregated by the management entity which reports, and discloses where relevant, that position whenever a notification threshold is reached or crossed. With such an approach, the market impact of building a net short position can be assessed through a single figure being reported both by the regulator and the public in case of discloseable positions. In addition, any fund that has an individual net short position reaching or crossing a notification threshold is not required to report individually, as this position is included in the aggregated net short position to be reported by the management entity. Thus the fund is deemed to have discharged its reporting obligation through the reporting of the management entity.
71. This approach covers the case of delegation of the management of funds or portfolios. Several management companies may individually decide to delegate the management of some or of all the funds or portfolios under their responsibilities to the same management entity, a legal entity independent from them. There may be cases when the management of a single fund has been delegated by a management company to two different and independent management entities. In these situations, the delegating management entity should not include in the calculation, aggregation and netting the positions of the delegated funds or portfolios. The management entity to which investment management has been delegated should perform this for all the funds or portfolios under its management, whether delegated or not.
72. When several management entities belong to the same group and considering the specific method of calculation proposed for fund management activities, ESMA considers that no aggregation or netting of position should be conducted at parent company. This would clearly avoid double counting of the same net short position and double reporting.
73. Finally, it should be noted that when a management entity has only one fund or one portfolio under management, the notification requirements fall on the fund itself or the client. Nonetheless, the management entity may report on the fund/client's behalf.

Example of calculation within a management entity

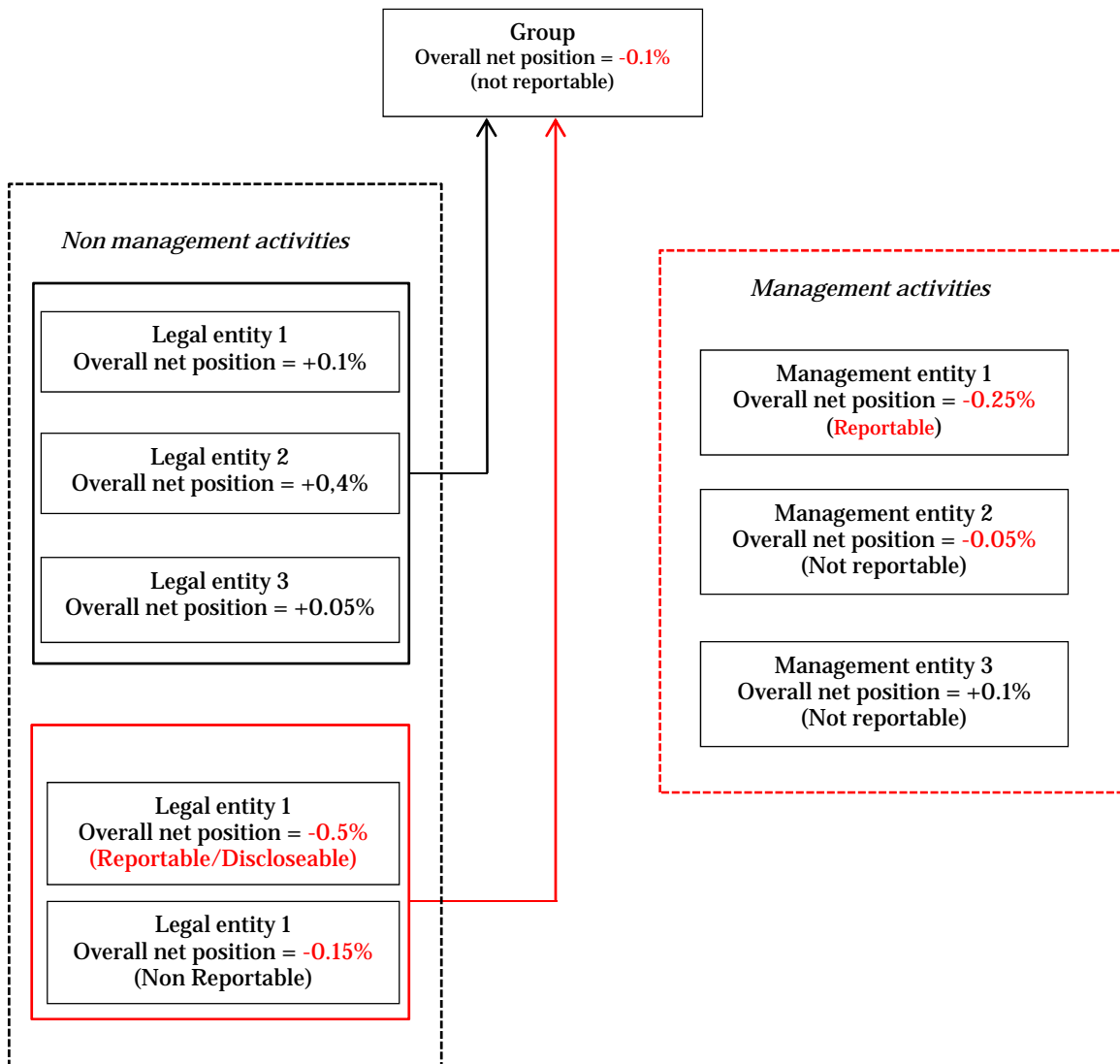


Example of calculation: delegation of management



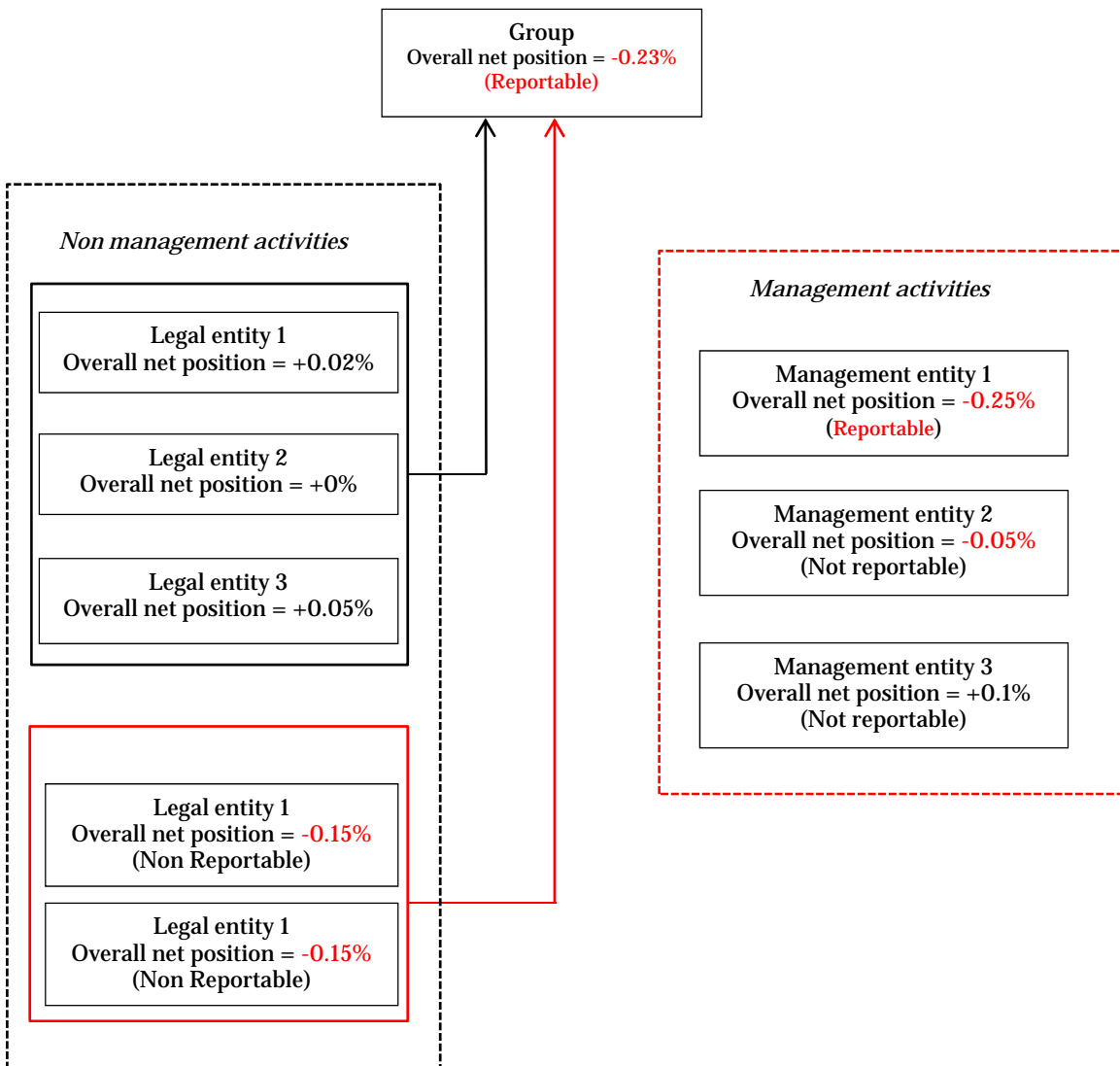
Examples of calculation within a group

- 1) Only the legal entity belonging to the group reports/discloses

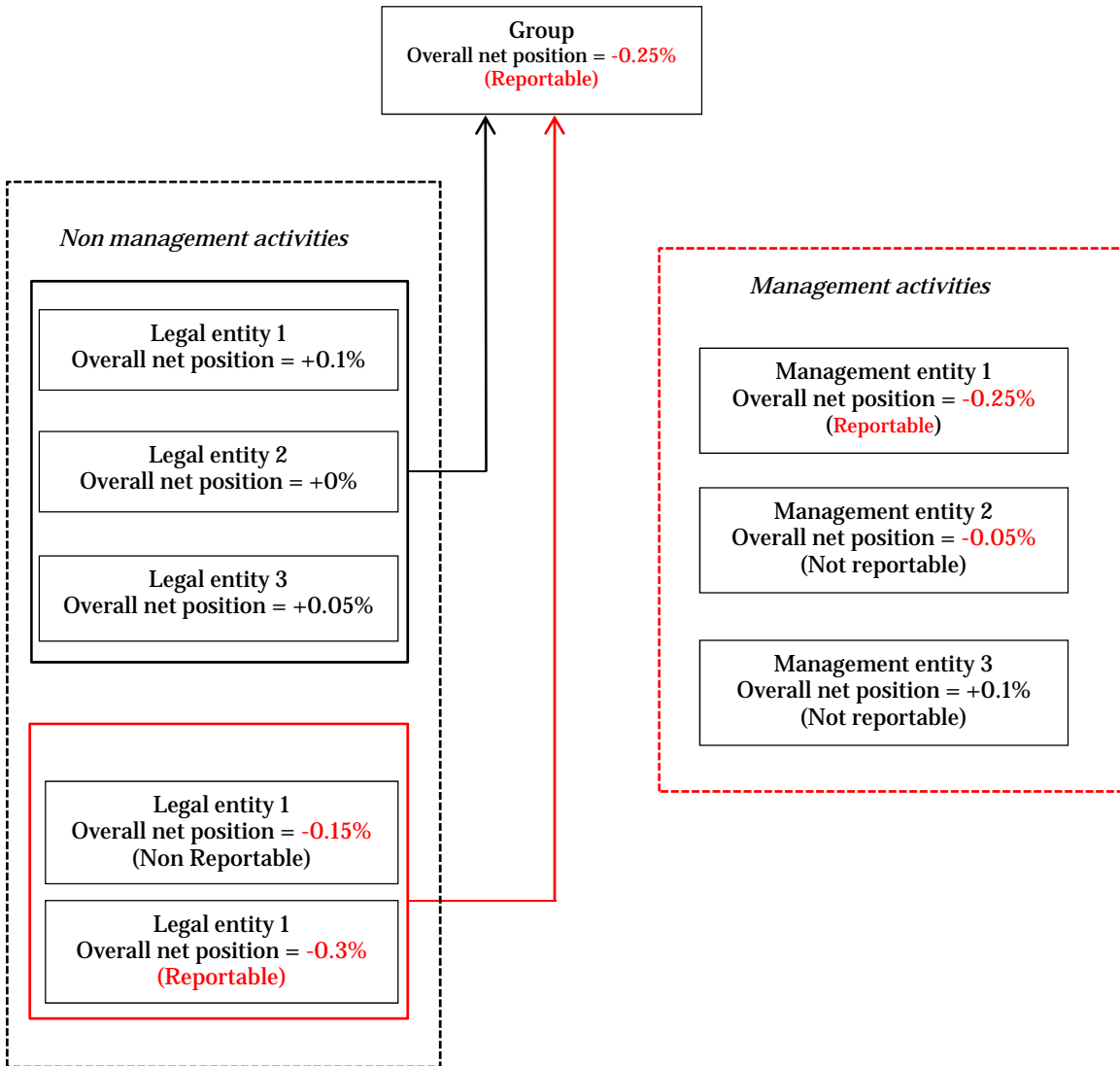


2) Only the group reports/discloses

Case 1



Case 2



III. Specification of the cases in which a credit default swap transaction is considered to be hedging against a default risk and the method of calculation of an uncovered position in a credit default swap and the method of calculating positions where different entities in a group have long or short positions or for fund management activities related to separate funds (Article 4(2))

Extract from the Commission's request

ESMA is invited to provide its technical advice on cases in which a credit default swap transaction is considered to be hedging against a default risk and the method of calculation of an uncovered position in a credit default swap, the method of calculating positions where different entities in a group have long or short positions or for fund management activities related to separate funds.

Introduction

74. The aim of this Delegated Act is to set out for the purpose of Article 4(1) of the Regulation:

- a. cases in which a sovereign CDS transaction is considered to be hedging against a default risk or the risk of a decline of the value of the sovereign debt and the method of calculation of an uncovered position in a sovereign CDS;
- b. the method for calculating positions where different entities in a group have long or short positions or for fund management activities relating to separate funds.

75. This chapter sets out ESMA's draft advice on when a CDS position should be considered to be a covered one and on the method for calculating whether a position is covered or uncovered. The issue of determining the positions of groups and funds is dealt with under our general advice on this topic in chapter II-IV of this Consultation Paper.

III.I. Cases in which a CDS transaction is considered to be hedging against a default risk or the risk of a decline of the value of the sovereign debt.

Box 6

Advice on cases in which a sovereign CDS transaction is considered to be hedging against a default risk or a risk in the decline of the value of assets or liabilities correlated with the value of the referenced sovereign debt

General Conditions

1. In order not to qualify as an uncovered position, a sovereign credit default swap (CDS) position must meet the following conditions:
 - a. It must serve to hedge against either or both of the circumstances set out in Article 4(1) of the Regulation.
 - b. In relation to hedges for the purpose of Article 4(1)(b), the CDS position must serve to hedge

against the risk of a change in the value of exposures which are correlated with the risk of the decline of the value of the obligations of the sovereign which are within the scope of the CDS. There will therefore need to be meaningful positive or, in the case of a liability, negative correlation for more than just a very temporary period between the value of the exposure being hedged and the value of the obligations of the sovereign which are within the scope of the CDS.

- c. A sovereign CDS position referencing a Member State (including any ministry, agency or special purpose vehicle of the Member State, or in the case of a Member State that is a federal state, one of the members making up the federation) may be used to hedge any assets or liabilities meeting the correlation test provided that the obligor of (or counterparty to) such asset/liability is located in the same Member State as the reference sovereign for the CDS. However, as exceptions to this general rule, there are certain circumstances where the cross-border use of sovereign CDS as a hedging tool would be allowed:
- i. where there is a parent company in one Member State and a subsidiary in another Member State and a loan has been made to the subsidiary. Where there is either explicit or implicit credit support to the subsidiary by the parent, it would be permissible to purchase sovereign CDS in the Member State of the parent rather than the subsidiary;
 - ii. where there is a parent holding company and a subsidiary operating company in different Member States. If the parent company is the issuer of the bond but the assets and revenues are in the subsidiary, it would be permissible to buy sovereign CDS referenced to the Member State of the subsidiary;
 - iii. to hedge an exposure to a company in one Member State which is heavily invested in the sovereign debt of another Member State. Where there is greater correlation between the risk and the debt of the second Member State than between the risk and the debt of the Member State in which the company is located it would be permissible to buy sovereign CDS referenced to the second Member State;
 - iv. in Member States where the market for sovereign CDS is very illiquid. Exposures to entities in these Member States may be hedged by using CDS positions referenced to other Member States whose sovereign debt is correlated;
 - v. where the company is a multinational one with operations across Europe or where the exposure being hedged is otherwise a pan-EU or pan-Eurozone one, it would be permissible to hedge it with a pan-European or pan-Eurozone index on sovereign bond CDS;
 - vi. where the counterparty is a supra-national European body (e.g. a special purpose vehicle for a number of Member States or the European Investment Bank) it would be permissible to hedge the counterparty risk with an appropriately chosen – as based on the correlation test- basket of sovereign CDS referencing that entity's guarantors or shareholders.
- d. For hedges against risk of default of the sovereign issuer and hedges against the risks of change in the value of exposures correlated with the risk of decline of the value of the obliga-

tions of the sovereign which are within the scope of the CDS, the CDS position must be proportionate to the risks it is hedging.

2. Those entering into a sovereign CDS position as a buyer of protection should, on the request of the competent authority, be able to justify to that competent authority that at the time of the sovereign CDS position was entered into it met the above conditions.

Demonstrating Correlation

3. Ways to evidence correlation include:
 - a. showing meaningful correlation on a historical basis using data for the 12 months of trading days period before the sovereign CDS position is taken out, weighted to the most recent time. A different timeframe may be used if it can be demonstrated that the conditions prevailing in that period were similar to those at the time that the sovereign CDS position is to be taken out or which would occur in the period of the exposure being hedged. For assets for which there is not a liquid market price or where there is not a sufficiently long price history, a good proxy should be used;
 - b. the fact that the exposure being hedged relates to an enterprise which is owned or majority owned by the sovereign issuer or whose debts are guaranteed by the sovereign issuer;
 - c. the fact that the exposure being hedged relates to a regional, local or municipal government of the Member State;
 - d. the fact that the exposure being hedged relates to an enterprise whose cash flows are significantly dependent on contracts from a sovereign issuer or a project which is funded or significantly funded or underwritten by a sovereign issuer (e.g. an infrastructure project);
 - e. the fact that the size of any other exposure of the enterprise to the sovereign issuer whose obligations are within the scope of the CDS is so large that the enterprise would be seriously affected if the sovereign issuer's propensity to default increased;
 - f. the fact that the exposure being hedged relates to an enterprise which would be significantly impacted by an economic or financial crisis within a Member State or the wider EEA.
4. The above list is not exhaustive and in other cases it would be for the party entering into the sovereign CDS position if requested by a competent authority to be able to justify that the correlation test was met at the time that the sovereign CDS position was entered into.

Proportionality

5. In determining whether the size of the sovereign CDS position is proportionate to the size of the exposures it is hedging, where a perfect hedge is not possible, an exact match is not required and limited over-provision would be permissible.
6. Where justified by the nature of the assets/liabilities being hedged and their relationship to the value of the obligations of the sovereign which are within the scope of the CDS, a greater value of sovereign CDS can be held to hedge a given value of exposures. However, this should only be permissible where

it can be clearly demonstrated that a larger value of sovereign CDS is necessary to match a relevant measure of risk associated with the reference portfolio, taking into account such factors as the size of the nominal position, the sensitivity ratio of the exposures to the obligations of the sovereign which are within the scope of the CDS and whether the hedging strategy involved is dynamic or static.

7. It is the responsibility of the position holder to ensure that their sovereign CDS position remains proportionate at all times and that the duration of the sovereign CDS position is aligned as closely as practicable given prevailing market conventions and liquidity with the duration of the exposures being hedged or the period during which the person intends to hold the exposure. If exposures being hedged by the CDS position are liquidated or redeemed, they must either be replaced by equivalents or the CDS position must be accordingly reduced. However, provided that a sovereign CDS position was covered at the time it was entered into, it should not be treated as becoming uncovered if the sole reason for this is a fluctuation in the value of the hedged exposures or the value of the sovereign CDS.
8. In all circumstances, where parties accept a sovereign CDS position as a consequence of their obligations as members of a central counterparty (CCP) which clears sovereign CDS transactions and as a result of the operation of the rules of that CCP, such a position will be treated as an involuntary one rather than one the party has entered into and so would not fall to be considered as uncovered.

Illustrative cases of assets/liabilities which could be hedged through a sovereign CDS position provided the general conditions are met

9. The following list is not intended to be exhaustive:
 - a. a long position in the sovereign debt of the relevant issuer;
 - b. any position or portfolio used in the context of hedging exposures to a sovereign referenced in the CDS;
 - c. any assets or liabilities which refer to public sector entities in the Member State whose sovereign debt is referenced in the CDS. This includes exposures to central, regional and local administration, public sector entities or any exposure guaranteed by the referred entity. The assets and liabilities include but are not limited to financial contracts, a portfolio of assets or financial obligations, interest rate or currency swap transactions where the sovereign CDS is used as a counterparty risk management tool for hedging exposure on financial contracts or trade finance exposures including foreign trade contracts;
 - d. Exposures to private sector entities established in the Member State which is referenced in the CDS. The exposures in question include but are not limited to loans, counterparty credit risk (including potential exposure when regulatory capital is required for such exposure), receivables and guarantees. The assets and liabilities include but are not limited to financial contracts, a portfolio of assets or financial obligations, interest rate or currency swap transactions where the sovereign CDS is used as a counterparty risk management tool for hedging exposure on financial contracts or trade finance exposures including foreign trade contracts;
 - e. Any indirect exposures to any of the above entities obtained through exposure to indices, funds or special purpose vehicles.

Explanatory text

76. Article 4(1) of the Regulation states that “...an uncovered position in a sovereign credit default swap [is] when the sovereign credit default swap does not serve to hedge against:
- a. *the risk of default of the issuer where the natural or legal person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates, or*
 - b. *the risk of a decline of the value of the sovereign debt where the natural or legal person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is correlated to the sovereign debt.”*
77. In drafting the advice on this Delegated Act it is important to reflect the scope of the circumstances in which sovereign CDS can be used for hedging as envisaged under Article 4(1) of the Regulation. While the CDS obviously provide protection in the case of a default by the referenced sovereign itself (the case cited by Article 4(1)(a)), they can also play an important role as a hedging tool against a wider range of exposures as set out in Article 4(1)(b). In this latter case their utility to the position holder will not necessarily depend on there being an actual default by the referenced sovereign issuer or other credit event which triggers a payment on the CDS. Instead their use as a hedging tool may result from an increase in value of the CDS, due to a change in credit spreads. Nor under Article 4(1)(b) is it a pre-condition that the CDS must specifically be hedging against credit risk, although in practice this will often be the case. The Delegated Act therefore needs to cover both the situations set out in Article 4(1) but clearly it is the second scenario (Article 4(1)(b)) where greater elaboration is required. The advice therefore focuses more on this aspect.
78. Both the text of the Regulation and the relevant Recital 21 make clear that it is envisaged that a very wide range of exposures could potentially be eligible for hedging through a sovereign CDS position. ESMA therefore considers that seeking to set out an exhaustive list of particular cases where risks could legitimately be hedged via sovereign CDS would not be a sensible approach. Such a list would be highly unlikely to cover all such cases and would not be able to take account of future developments. Hedging strategies which met the criteria set out in the Regulation itself might therefore be unreasonably excluded.
79. ESMA therefore considers a better approach is to set out the conditions which need to be met in order for a sovereign CDS position to be a valid hedge for a given exposure and thus to be treated as a covered position under the terms of the Regulation. However, these conditions should be supplemented by as many illustrative examples as possible of cases which would be treated as eligible for hedging. This would provide the most useful information to market participants as to what would or would not fall into the category of covered CDS positions.

Scope

80. Recital 21 sets out a wide range of risks, assets and liabilities which could be hedged through a CDS position and these obviously need to be included in the list of illustrative cases. However, from the language of the Recital it is clear that this is certainly not intended to be a comprehensive list. The key tests for the purposes of Article 4(1)(b) are that the sovereign CDS position should serve a hedge for a risk and that the value of the asset or liabilities being hedged should be correlated to the value of the sovereign debt referenced by the CDS. Hence ESMA considers that there

should not be any restrictions as regards the scope of the assets/liabilities which can be hedged provided that they meet the conditions of correlation and proportionality.

81. The one exception to this is that the location of the obligor or counterparty referenced in the asset or liability being hedged by the sovereign CDS should be in the same Member State whose sovereign debt is referenced in the CDS. It was the intention of the co-legislators that the geographical scope of the provision should not be drawn too widely and hence a general freedom to use sovereign CDS positions to hedge cross-border risks would be too broad. However, in certain circumstances ESMA considers appropriate to enable sovereign CDS positions referencing one sovereign issuer to be used to hedge exposures in another sovereign issuer or for a position in a sovereign CDS index to hedge a pan-EU or pan-Eurozone exposure provided the correlation test is met. The draft advice sets out these cases. In addition, in cases where the counterparty is a supra-national European body (e.g. a special purpose vehicle for a number of Member States or the European Investment Bank), the relevant sovereign risks will be those of the entity's guarantors and not the sovereign where it is physically located. Accordingly, it should be permissible to hedge the counterparty risk with an appropriately chosen basket of sovereign CDS.

Level of Correlation

82. As noted above, correlation is a key condition as regards eligibility. To what extent does the value of a non-sovereign debt exposure need to be correlated with the obligations of the sovereign which are within the scope of the CDS for the sovereign CDS to be treated as hedging a risk or a decline in value? ESMA has considered whether to recommend specifying a correlation in statistical terms – which was one of the options the Commission mentioned in its request for advice on this topic. This would have the benefit of setting out a clear measure against which to judge whether the correlation test had been met.
83. However, it should be noted that the test set out in Article 4(1) of the Regulation is a general one – simple correlation. The Regulation does not prescribe any particular degree of correlation (unlike in Articles 3(5) and 13(2) dealing respectively with calculations of net short positions in sovereign debt and uncovered short sales in sovereign debt where in both cases a test of high correlation is set.) In addition, whereas Articles 3(5) and 13(2) cover a relatively narrow group of assets – sovereign debt instruments themselves – for which in general there should be price data available to undertake a quantitative measurement of correlation, this is not the case with regards to the exposures encompassed by Article 4(1). As noted above, a very wide range of exposures can potentially be considered as being eligible for hedging by a sovereign CDS and the correlation test will have to be applied in cases where there may not be a sufficient run of data or where the historic correlation is not necessarily a good guide to current/future correlation. Finally, it is also clearly relevant that, whereas Articles 3(5) and 13(2) of the Regulation are drafted in terms of the pricing of the respective sovereign debt being highly correlated, Article 4(1) specifies correlation in terms of value. For these reasons ESMA therefore considers that as regards the Delegated Act relating to Article 4 it is better not to produce a very precise quantitative definition as to the extent of the correlation required. There must be a meaningful positive (or negative) correlation⁵ but a general qualitative statement should be sufficient and would not risk setting an overly precise boundary.

⁵ Where the sovereign CDS is hedging a liability as opposed to an asset, the correlation could be a negative one: if the price of the sovereign debt was decreasing, the absolute value of the liabilities which the CDS was hedging could be going up.

Evidencing Correlation

84. As regards evidencing correlation between the value of an exposure and the obligations of a sovereign within the scope of the CDS, ESMA considers that this can be done in a number of ways. Demonstrating historical correlation using data for a sufficiently long period (at least 12 calendar months of trading days) would be one obvious means of doing so. However, a correlation which has existed in the most recent 12 months may not always be relevant for hedging a risk going forward. For example, circumstances may have recently changed or there may be good reasons to consider that they will change. So while choosing the most recent 12 calendar months of data may be the most suitable in some cases, in other cases it may be more appropriate to choose a different timeframe if this is more relevant to the prevailing or developing conditions.
85. For exposures to be hedged via a sovereign CDS where there is no liquid market price or an insufficiently long price history, it is open to use a suitable proxy where it is considered appropriate.
86. However, ESMA recognises that demonstrating historic correlation between an exposure and a CDS is not the sole way of evidencing correlation. There will be cases where the relationship between the exposure to be hedged and the obligations of the sovereign issuer within the scope of the CDS will be sufficiently clear to provide confidence that the correlation condition is evidenced without needing to use historical data. The draft advice sets out the circumstances which ESMA considers would evidence correlation. But there may be additional cases not on the list so it should not be considered as exhaustive. The key consideration is that in all cases the position holder must be able to justify that, at the time, the sovereign CDS position was entered into, the correlation condition was satisfied. A subsequent breakdown in correlation would not invalidate the covered nature of the CDS position.

Proportionality

87. A further condition which ESMA sees as essential if a sovereign CDS position is to be treated as a covered one is proportionality. The value of the exposures hedged by the sovereign CDS should be broadly proportionate to the value of the obligations of the sovereign within the scope of the CDS at the time the position is entered into. A position holder cannot be considered to have a covered CDS position if the value of the sovereign CDS is disproportionately large in comparison with the size of the exposures it is intended to hedge. However, ESMA recognises that obtaining a perfectly hedged position may not be possible. In addition, the Delegated Act should cater for cases where, because of the nature of the exposures being hedged, it would be legitimate to hold more sovereign CDS than the notional value of the exposure (e.g. if every 1% change in the value of the referenced sovereign debt was matched by a 2% change in the value of the hedged exposure). Where the position holder has a CDS position which is greater than the value of the exposures being hedged, they would need to be able to demonstrate that this was justified for the purposes of the hedge taking into account such factors as the size of the nominal position, the sensitivity ratio of the asset/liability to the referenced sovereign debt and whether the hedging strategy involved is dynamic or static. This issue is discussed further below in the section dealing with method of calculating positions.
88. The principle that a CDS position should be proportionate to the exposures it is hedging should be the case not only at the point at which the CDS transaction was entered into but also for the duration of the position. It would clearly frustrate the purpose of Article 4 if, after the CDS position was taken out, the exposures it was hedging were subsequently reduced or removed (e.g. through the liquidation of the hedged exposures) without any change in the size of the CDS position, thus

leaving a wholly or partially uncovered position. ESMA therefore considers that the general principle must be that the position holder is responsible for ensuring that their sovereign CDS position remained proportionate for the duration of the position. If exposures being hedged by the CDS position are liquidated, they must either be replaced by equivalents so that the exposure or portfolio of exposures being hedged stay proportionate to the position or the CDS position itself must be accordingly reduced.

89. However, ESMA recognises that there will be cases where, due to fluctuations in the value of the exposures being hedged and/or the sovereign CDS used as the hedge, what was a matched position at the time the sovereign CDS was entered into could become unmatched even though there had been no change in the portfolio. The fact that the position had become partially uncovered would not be the result of any actions on the part of the position holder and it would seem unjustified to treat these cases as infringements of the restriction on holding uncovered positions. Hence ESMA considers that, as a derogation from the general principle of the responsibility of the position holder to ensure the position remained proportionate, the Delegated Act should recognise that changes in market valuations without any active change of position by the CDS purchaser would not affect the covered status of the sovereign CDS position.

Involuntary uncovered sovereign CDS positions

90. ESMA also considers that the provision needs to be made under the Regulation for parties which are required to accept uncovered sovereign CDS positions on an involuntary basis. The prime example of this would be general clearing members of central counterparties (CCPs) which clear sovereign CDS transactions. There are a number of circumstances in which such a party might find itself with an involuntary sovereign CDS position.
91. One circumstance results from the fact that CCPs require daily (and sometimes intraday) valuations in order to calculate the variation and initial margin that each member needs to post. It is not always possible to guarantee that real prices for the relevant OTC derivatives such as sovereign CDS can be observed in the market at the precise times required by the CCP. Hence many CCPs have a process by which their members are contractually obliged to provide prices at certain times to the CCP. In order to ensure that the price provided are as "real" as possible, there is a process by which randomly selected crossed pairs of trades may be obliged to actually settle i.e. the member has to enter into the trade at the price provided. This is an extremely effective way of ensuring sufficient attention is expended and avoiding manipulation of the prices provided. For sovereign CDS, however, this crossing process could oblige members to enter into a CDS position which would be uncovered according to the Regulation if they did not have assets/liabilities which were eligible for being hedged by the CDS position.
92. A second circumstance involves the default of a member of the CCP. When this happens, the CCP has a range of tools at its disposal to manage down the market risk that their member has left it exposed to. These include macro hedging and auctioning off the portfolio of the defaulted member. If the auction fails, some CCPs fall back to a process called Forced Allocation where the portfolio of the defaulted member is divided up and given (along with margin) to some or all of the remaining members. This process could result in one or more of the members of the CCP being allocated a sovereign CDS position. Again the member might not own the underlying sovereign debt or an eligible offsetting asset/liability. A similar circumstance could arise if the clearing member was required by the CCP to bid for the defaulting member's portfolio and the clearing member then won the bid, or if a clearing member was obligated by the CCP to take over the portfolio of its

defaulted customer. The CCP might also decide to void trades in a default situation and this might again result in a clearing member left holding an uncovered position.

93. ESMA does not consider that any of these situations are cases which the restriction on uncovered sovereign CDS positions was intended to address. Any sovereign CDS positions a clearing member of the CCP was obliged to accept would be a by-product of processes designed to ensure the prudent operation and stability of the CCP rather than the result of any party voluntarily entering into a directional position in the CDS. As such, they should not fall to be treated as uncovered CDS. However, any involuntary uncovered sovereign CDS positions which were obtained would be expected to be closed or rendered covered by the holder as soon as practicable taking into account factors such as market conditions, the size and complexity of the uncovered positions, orderly execution and risk management practices.

III.II. Method of calculating an uncovered position

Box 7

Draft Advice on method of calculation of an uncovered sovereign CDS position

1. In calculating a party's sovereign CDS position its net position should be used (i.e. deducting any sales of CDS in the referenced sovereign from its CDS purchases).
2. In calculating the value of the eligible risks hedged/to be hedged by a sovereign CDS position a distinction should be drawn between static and dynamic hedging strategies. For static hedging (e.g. direct exposures to sovereign or public sector bodies in the sovereign, such as holding of bonds) the metric used should be the jump to default measure of the loss if the entity to which the position holder is exposed defaults. The resulting value can then be compared against the net notional value of the sovereign CDS position.
3. In determining the value of market value adjusted risks (e.g. swaps, credit valuation adjustment) for which a dynamic hedging strategy is required, the calculations can be undertaken on a risk-adjusted rather than notional basis, taking into account the extent to which an exposure might increase (or decrease) during its duration and the relative volatilities of the exposures being hedged and of the referenced sovereign debt. A beta adjustment should be used if the exposure for which the CDS position is being used as a hedge is different to the obligations of the sovereign within the scope of the CDS.
4. Indirect exposures to risks (through indices, funds, special purpose vehicles etc.) and to CDS positions should be taken into account in proportion to the extent the reference asset/liability/CDS is represented in the index, fund or other mechanism.
5. The value of the eligible portfolio of exposures to be hedged should then be deducted from the value of the net CDS position held. If the resulting number was positive it would be an uncovered CDS position.

Explanatory text

94. ESMA is requested to provide advice on the method of calculation of an uncovered position in a sovereign CDS. This breaks down into calculating the value of the CDS position itself; the value of the exposures the CDS position is intended to hedge; and how to determine what size of CDS position is required to hedge a given value of risk – as previously explained this will not necessarily be on a one for one basis. This section of the advice also deals with the issue of how indirect exposures (e.g. through indices, funds, etc.) should be treated
95. As regards calculating the value of the sovereign CDS position, it is necessary to decide whether the position should be the net one (i.e. deducting any sales by the position holder of the relevant sovereign CDS from the purchased CDS) or the gross. The argument in favour of using the net position is that if a market participant has sold protection via a CDS referencing a sovereign debt issuer, it is exposed to risk related to that sovereign issuer. It is reasonable to hedge its risk by purchasing sovereign CDS and to treat its own purchases as offsetting its sales (in the same way that a short position in shares offsets a long position and should be deducted in calculating the net posi-

tion). The net approach would be consistent with the objective of the Regulation and the approach taken in relation to short positions in shares and sovereign debt.

96. How is the value of the exposures which the CDS is intended to hedge to be calculated? ESMA considers that there should be different methods for assessing the size of the exposure depending on the nature of the hedging strategy. For 'static' hedges dealing with default risk (e.g. where the CDS position is hedging against a direct exposure to the sovereign) the notional value of the assets/ liabilities would be a suitable choice as well as being easy to compute. The metric would be the straightforward jump to default measure (i.e. how much you would lose if the entity defaults).
97. However, CDS positions are also used to hedge dynamic risks (e.g. swap positions). Using the notional value of the exposures is not suitable for assets/liabilities which are explicitly market value adjusted. For these cases, using the notional values alone would not reflect the fact that the exposure of the position holder could increase during the lifetime of the contract (e.g. due to currency fluctuations). Thus the extent of the exposure would not necessarily remain the same as the actual exposure at the time the CDS position was entered into. In addition, the value of an exposure may be more (or less) volatile than the value of the sovereign debt referenced. So it would be reasonable to apply an adjustment factor to take into account the relative volatilities (risk adjusted values). Thus the CDS position could be risk adjusted (e.g. "beta-adjusted") to translate this risk into the same terms as the risk associated with the assets and liabilities which it is intended to hedge. For example, an asset valued at € 10m whose beta with the referenced sovereign debt is 1.2 could be hedged by a €12m CDS position. A sensitivity approach should be used in calculating the effect of the hedge as well as the sensitivity of the asset/liability. This makes calculations more complicated but provides that the value of the sovereign CDS position permitted is more closely tied to value of the hedged asset and reflects the purpose of the hedge.
98. How should indirect exposures (e.g. through indices, funds, etc.) be treated? Recital 21 explicitly makes clear that indirect exposures (through indices, funds, special purpose vehicles etc.) should be taken into account when considering the assets/liabilities which a sovereign CDS is used to hedge. ESMA considers there is no sensible alternative here to taking those exposures into account in proportion to the extent that the reference asset/liability is represented in the index, fund etc.
99. Having calculated the value of the portfolio of exposures to be hedged (risk adjusted as appropriate), there would be an uncovered position if the value of the sovereign CDS position being used as the hedge exceeded this value.
100. In determining the size of an uncovered sovereign CDS position in circumstances where a competent authority has temporarily suspended the restriction on holding such positions, the value of the CDS position should be calculated on the same basis as that used for determining whether an investor holds a net short position in relation to the sovereign debt instruments of a sovereign issuer.

IV. Specification of the amounts and incremental levels of notification thresholds referred to in Article 7(2) for net short positions relating to the issued sovereign debt of a sovereign issuer (Article 7(3))

101. Investors (natural or legal persons) are required to report net short positions that they hold in relation to the issued sovereign debt of a sovereign issuer to the relevant competent authority, when those positions equal or cross up or down specified notification thresholds.

Extract from the Commission's request

ESMA is invited to provide its technical advice on amounts and incremental levels of notification thresholds for net short position related to the issued sovereign debt of a sovereign issuer.

Box 8

Draft Advice on the amounts and incremental levels of notification thresholds for net short positions relating to the issued sovereign debt of a sovereign issuer

1. The relevant measure for the threshold that triggers notification to the relevant national authority of net short positions related to the issued sovereign debt of a sovereign issuer is built from a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer.
2. The reporting threshold corresponds to a monetary amount. This monetary amount is fixed on the basis of the conversion (rounding up to the nearest million Euros) of the percentage threshold applied to the outstanding sovereign debt of the sovereign issuer.
3. The monetary amount implied by the percentage threshold is revised and updated quarterly in order to reflect changes in the total amount of outstanding issued sovereign debt of each sovereign issuer.
4. The monetary amount implied by the percentage threshold and the total amount of outstanding issued sovereign debt are calculated in accordance with the method of calculation for net short positions in sovereign debt.
5. The initial amounts and additional incremental levels for sovereign issuers are set using the following factors:
 - a. The thresholds will not require notifications of net short positions of minimal value in any sovereign issuers.
 - b. The total amount of outstanding issued sovereign debt for sovereign issuers and average size of positions held by market participants relating to the sovereign debt of that sovereign issuer.
 - c. The liquidity of the sovereign debt market of each sovereign issuer, including, where appropriate, the liquidity of the futures market for that sovereign debt.
6. Taking into account these factors, the relevant notification thresholds for the initial amount to be considered for each sovereign issuer are a percentage that equals 0.1 % and 0.5 % of the total amount of outstanding issued sovereign debt. The relevant percentage to be applied for each issuer shall be determined in application of the criteria described in par 5, so that each sovereign issuer is assigned

one of the two percentage thresholds used to calculate the monetary amounts that will be relevant for notification.

7. The full data required for the application of the criteria set out in the Regulation and in par 5 are currently not available. Therefore, the criteria used when setting the notification thresholds to be applicable by the publication date are the total amount of outstanding issued sovereign debt of the sovereign issuer and the existence of a liquid futures market for that sovereign debt. Based on these parameters and the data available regarding the sovereign debt markets of sovereign issuers, the three threshold categories are defined as follows:
 - a. An initial threshold of 0.1 % applicable where the total amount of the outstanding issued sovereign debt is 0 to 500 billion Euros;
 - b. A threshold of 0.5 % applicable where the total amount of the outstanding issued sovereign debt is above 500 billion Euros or where there is a liquid futures market for the particular sovereign debt.
8. The additional incremental levels will be set at 50 % of the initial thresholds. Therefore, the incremental levels will be:
 - a. each 0.05 % above the initial notification threshold of 0.1 % (0.15 %, 0.2 %, 0.25 % etc);
 - b. each 0.25 % above the initial threshold of 0.5 % (0.75 %, 1 %, 1.25 % etc).
9. Where a change in the sovereign debt market of a sovereign issuer (in terms of the factors specified in paragraph 5) warrants this, the sovereign issuer shall move to the appropriate threshold group.

Explanatory text

General approach to setting the thresholds – percentages of total issued sovereign debt and corresponding monetary amounts

102. The Regulation stipulates that the relevant notification thresholds shall consist of an initial amount and then additional incremental levels in relation to each sovereign issuer. Article 7(3) specifies that when devising the relevant notification a number of factors should be taken into account. First, these thresholds should not be set at such levels which would imply that net short positions of minimal value are required to be notified to the relevant competent authority. Second, the proposed thresholds should take into account the total amount of outstanding issued sovereign debt for each sovereign issuer, and the average size of positions held by market participants relating to the sovereign debt of that sovereign issuer. Last, the liquidity of each sovereign bond market is also to be taken into account.
103. In providing its draft advice on this Delegated Act, ESMA has also taken into account Recital 8 of the Regulation. This states that “*A requirement to notify regulators of significant net short positions relating to sovereign debt in the Union should be introduced as it would provide important information to assist regulators in monitoring whether such positions are in fact creating systemic risks or being used for abusive purposes.*”

104. ESMA proposes that the relevant measure for the threshold that triggers notification to the relevant national authority should be defined as a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer. The rationale for this approach is that it is the percentage of the outstanding issued sovereign debt that is relevant in terms of potential volatility. Using a percentage threshold also caters for the differing sizes of issued debt in the various sovereign issuers. Finally, defining the threshold as a percentage would avoid the necessity of adjusting the initial threshold as the outstanding issued sovereign debt levels changes with time. Setting a threshold purely in terms of a monetary amount, unrelated to the outstanding sovereign debt, could mean that the threshold becomes either too high or too low as the case may be in the light of developments in the size of individual sovereign debt markets.
105. However, ESMA also sees the need to take into account the fact that there are frequent new issues of sovereign debt and issues which are maturing. For many sovereign issuers therefore the amount of total issued sovereign debt is frequently changing. To provide some stability and clarity for market participants ESMA therefore proposes that the percentage thresholds should be converted into monetary amounts (rounded up to the nearest million Euros). This monetary amount would be recalculated on a quarterly basis by competent authorities to take into account changes in the issued sovereign debt over the previous quarter. The figures for both the total amount of outstanding issued sovereign debt and the monetary amount implied by the percentage threshold would be published by ESMA based on the data provided by competent authorities. Both these values (the numerator and the denominator in the calculation of the percentage threshold) would be calculated in accordance with the proposed method of calculation for net short positions in sovereign debt [see chapter II.IV 2)]. As defined in Article 2(1)(d)(ii) of the Regulation, the total amount of outstanding issued sovereign debt of a Member State also includes debt issued by a government department, an agency, or a special purpose vehicle of that Member State. The figures for the threshold amounts and the total issued debt would then remain valid until the following quarter for the purposes of determining whether a notifiable net short position was held. This approach would be broadly in line with that taken for the reporting of significant long positions under the Transparency Directive.

What thresholds should be set for sovereign issuers?

106. In specifying the notification threshold for significant net short positions in sovereign debt for sovereign issuers ESMA has considered a number of possible alternatives, analysing the advantages and disadvantages of each option.
107. One option would obviously be to set a single percentage to calculate the thresholds for all sovereign debt issuers. This would be in line with the approach taken by the Regulation in relation to shares where there is one uniform percentage trigger applicable to all shares whatever the size of the issued share capital or liquidity or the Member State in which the share is traded. However, ESMA considers that setting a single percentage to define the threshold for all sovereign issuers would not be optimal as it would be difficult to find an appropriate one-size-fits-all threshold valid for all sovereign issuers. It would also appear difficult to reconcile such an approach with the provisions of Article 7(3) of the Regulation. For example, depending on the level of the threshold and the size of the outstanding issued sovereign debt, having only one specified percentage threshold may mean that for some sovereign issuers a large number of net short positions, including those which are of minimal value, are always reported, whereas for other sovereign issuers the same threshold may imply that no reporting at all takes place. Such a result would not be in line with the intention of the Regulation to enable authorities to identify and monitor those net short posi-

tions likely to have some impact on the sovereign debt of each sovereign issuer and which might contribute to creating systemic risks or potential market abuse.

108. Another alternative would be to set individual percentages to establish the monetary amount threshold for each sovereign issuer. On the one hand, this would provide the possibility to set thresholds precisely tailored to the situation of each individual sovereign issuer, ensuring the notifiable positions best reflect the liquidity and size of the market and maximising the likelihood that the reports generated would be of some value to national authorities.
109. On the other hand, from a practical point of view, it would mean that market participants would have to cope with a great array of percentages, one for each sovereign issuer. Setting nearly 50 different percentage thresholds would to some extent run counter to the harmonising intent of the Regulation, leaving a fragmented situation of individual requirements for the reporting of net short positions in sovereign debt. So while a one-size-fits-all solution is not recommended by ESMA, neither is setting a multiplicity of divergent percentages in order to establish the monetary thresholds.
110. Instead, ESMA considers that the best approach is a solution which would group sovereign issuers into broad categories according to the factors set out in the Regulation. This would provide a balance between providing meaningful information on short positions to national authorities whilst avoiding a confusing panoply of different percentages used for calculating the monetary thresholds. In determining the categories of thresholds it is necessary to take into account the size of the outstanding issued sovereign debt⁶ and the liquidity of the sovereign debt market in absolute terms, i.e. as measured by total turnover. As a starting point, it might be considered that the larger and the more liquid a particular sovereign debt market is, the higher the notification threshold should be set. In some sense these measures would also provide a proxy for the average size of positions of the market participants as this parameter should be positively correlated to the size and absolute liquidity of the sovereign debt market. However, it is important to note that it should by no means be assumed that a small sovereign debt market is necessarily an illiquid one and hence the size of the market should obviously not be the sole determinant.
111. Other factors also need to be taken into account. For example, in determining absolute liquidity, the existence of a liquid futures market for sovereign debt can be very important. A highly liquid market for sovereign bond futures implies a high turnover. Indeed there may be much more trading taking place in the bond futures market than in the actual market for the sovereign debt. In addition, the existence of a bond futures market makes it easier for market participants to take short positions (in fact they may have larger positions in the futures market than the cash market). In such markets a given short position may have less market impact than in those of other sovereign issuers. Correspondingly, requiring reports of such positions may have much less value for the national authorities in terms of checking for systemic risk or potential market abuse. Another factor to consider is the organisation of the secondary market, including market making arrangements, for the sovereign debt in question which may also contribute to the liquidity of the market.

⁶ Annex V: table showing the total outstanding sovereign debt at the end of 2010 for the 27 Member States along with a bar chart on these nominal values. The table indicates the implied monetary amount for different alternatives of percentage thresholds. In addition, a table with the total outstanding sovereign debt issued by the 16 German federal states and the monetary amount for different thresholds is also attached, in order to give a picture of the implications for the Member States that are federal states.

112. The full data required for the application of the criteria set out in the Regulation are currently not available. Therefore, the criteria used when setting the notification thresholds to be applicable by the publication date are the total amount of outstanding issued sovereign debt of the sovereign issuer and the liquidity of the futures market for that sovereign debt.
113. Taking into account the criteria outlined above and the information available to it regarding the sovereign debt markets of sovereign issuers ESMA considers that three different categories of threshold can be set as follows:
 - a. An initial threshold of 0.1 % applicable where the total amount of the outstanding issued sovereign debt is 0 to 500 billion Euros;
 - b. A threshold of 0.5 % applicable where the total amount of the outstanding issued sovereign debt is above 500 billion Euros or where there is a liquid futures market
114. For each category the additional incremental levels are set at 50 percent of the initial threshold. For those sovereign issuers that would apply an initial threshold of 0.1% the incremental levels will thus be 0.15 %, 0.2 %, 0.25 % etc.; and for the 0.5% threshold the incremental levels will be 0.75 %, 1 %, 1.25 %, etc.
115. In all cases, these percentages would be used to calculate the appropriate monetary amount that would be published for each sovereign and that would be the relevant reference to ensure compliance with the disclosure obligations under the Regulation.
116. If there is a significant change in a sovereign issuer's sovereign debt market in terms of the factors listed above which would require a change in its categorisation for the purposes of the reporting thresholds, this would need to be announced to the market a month before the new reporting thresholds came into effect.
117. ESMA believes that this solution will enable and facilitate the reporting and the monitoring of those net short positions which are indeed significant, while at the same time catering for the diversities of the sovereign debt markets in the Union. It also accounts for the size of the issued sovereign debt, thereby most likely also capturing the average size of positions held by market participants, and the liquidity of the sovereign debt markets, taking into account both cash and futures markets. It also has the advantages of simplicity and practical easiness of application. Investors, whether legal or natural, would find it easier when they have to deal with only two thresholds instead of keeping track of all the different thresholds varying by sovereign issuer. Thus, this option facilitates legal certainty while at the same time reducing the administrative burden for market participants.
118. In terms of the need for a review mechanism for the thresholds, Article 45 specifies that the Commission shall, after discussions with the competent authorities and ESMA, report to the European Parliament and the Council on the appropriateness of, among others, the reporting and disclosure thresholds of significant net short positions related to the issued sovereign debt.

V. Specification of the parameters and methods for calculating the threshold of liquidity referred to in Article 13(3) in relation to the issued sovereign debt for suspending restrictions on short sales of sovereign debt (Article 13(4))

Extract from the Commission's request

ESMA is invited to provide its technical advice on the parameters and methods for calculating the threshold of liquidity for suspending restrictions on short sales of sovereign debt. The parameters and methods for Member States to calculate the threshold shall be set in such a way that when the threshold is reached, it represents a significant decline relative to the average level of liquidity for the sovereign debt concerned. This threshold shall be defined based on objective criteria specific to the relevant sovereign debt market, including the total amount of outstanding issued sovereign debt for each sovereign issuer.

Box 9

Draft advice on the parameters and methods for calculating the threshold of liquidity of the issued sovereign debt for suspending restrictions on short sales

1. The measure of liquidity of the issued sovereign debt to be used by each competent authority is the turnover, defined as the total nominal value of debt instruments traded, in relation to a basket of benchmarks with different maturity buckets.
2. The temporary suspension of restrictions on uncovered short sales in sovereign debt may be triggered when the turnover of a month falls below the 5th percentile of the monthly volume traded in the previous twelve months.
3. To make these calculations each competent authority should use the representative data readily available, from one or more trading venues, from OTC trading or from both, and inform ESMA of the data used.
4. Before the competent authorities exercise the power to lift the restrictions on short-selling related to sovereign debt, they should ensure that the significant drop in liquidity is not the result of seasonal effects in liquidity.

Explanatory text

119. The Regulation on Short Selling and certain aspects of Credit Default Swaps foresees the circumstances in which a natural or legal person may enter into a short sale of sovereign debt, imposing a 'locate rule', in order to restrict the potential risk of settlement failure and volatility that may stem from uncovered short sales.
120. Market makers as well as primary dealers are exempted from these requirements.
121. The Regulation specifies that where the liquidity of sovereign debt falls below a threshold to be defined by the Commission, the restrictions on entering into a short sale may be temporarily suspended by the relevant competent authority. Before suspending these restrictions, the relevant

competent authority shall notify ESMA and other competent authorities about the proposed suspension.

122. The key issues at stake are (i) calculation data; (ii) measure of liquidity, and (iii) definition of the threshold (and its calculation's time frame).

Calculation data

123. In view of the rationale behind the power conferred to the competent authorities to suspend restrictions on uncovered short sales when there is a significant fall in the average level of liquidity for the sovereign debt, it is considered any lifting of such restrictions should be done for the sovereign debt as a whole rather than particular debt instruments.

124. In this scenario, theoretically, each Member State may calculate one threshold for the whole sovereign debt:

- a. proceeding with the calculation of the liquidity for each and every issue;
- b. taking a representative sample, such as a basket of benchmark issues with different maturity buckets, or using a single benchmark, for instance the 10 year Bond, as a proxy for the whole sovereign debt.

125. The first option acknowledges that the behaviour in the secondary market for different sovereign debt instruments is not homogeneous. However, it requires gathering data and monitoring of the liquidity in relation to each and every sovereign debt instrument for that issuer.

126. The second option is easier to implement and, in principle, it may be assumed that if the basket is suffering a significant decline in liquidity, then the sovereign's other issues will be suffering too. Equally, it seems unlikely that liquidity in other issues will suffer a significant decline without this also being the case with the basket.

127. ESMA considers that using the liquidity of a basket of benchmark issues with different maturity buckets as a proxy for the liquidity of the sovereign bond market as a whole would make calculation and monitoring simpler, and does not impair an accurate understanding of the sovereign bond market as a whole.

128. The other issue to be dealt with is the market (in a broad sense) from which the data (transactions, prices and/or offers) will be used.

129. In discussing this issue, one should bear in mind the peculiarities of the sovereign debt markets. In general, in this market most participants (typically primary dealers) take up their positions in auctions and maintain them in secondary markets. In addition, unlike shares, sovereign debt instruments are not always admitted to trading on a trading venue (such as a regulated market or a MTF) and, even when they are, they are regularly traded OTC rather than on the venue itself, which may impair the liquidity of the debt instruments on the trading venue.

130. Besides being negotiated often OTC, the level of concentration/fragmentation of the trading venues in which sovereign debt is traded is not homogeneous. While in one Member State, it may be possible to identify a single representative trading venue, in others the data will need to be collected from a number of trading venues.

131. MIFID requires investment firms to report to the competent authority transactions executed in financial instruments admitted to trading on a regulated market (article 25).
132. In these circumstances, ESMA considers that each competent authority should use the representative data readily available, from one or more trading venue, from OTC trading or from both.
133. In order to calculate the liquidity, each competent authority will have to decide what trading venues are to be considered and/or if it will use data from OTC trading and inform ESMA accordingly.
134. The competent authorities shall cooperate with each other for the purpose of calculating the liquidity measure of the sovereign debt, as each Member State is not the home Member State of all trading venues and will have to obtain trading data on sovereign debt from each trading venue considered.

Measure of liquidity

135. The definition of a measure of liquidity to be used by each Member State is crucial as it is going to be used for the determination of the thresholds.
136. There are several measures of liquidity which may be grouped in one variable measure or composite measures. The measures that take only one variable into account are, for instance, those based on the trades (turnover, number of trades) or on the orders (spread bid/offer, volume offered, number of bids). A measure that combines properties of different types of measure would be one that combines, for instance, turnover and bid-offer spread.
137. Composite measures have the disadvantage of using as inputs several variables, which makes them more complex and difficult to calculate. This difficulty worsens if one considers that the data in question may come from different trading venues with different characteristics⁷.
138. It is possible to calculate a composite liquidity measure of sovereign debt that combines, for instance, the turnover traded and the spread bid-offer. Such a measure implies determining, first of all, the weighting of each factor (for instance 75% to turnover and 25% to the bid-offer spread) and defining bid-offer spread (e.g. spread at a specific moment/period or the minimum spread of the trading day). In order to compute it, each competent authority will have to store data on all trades and orders for all trading venues to be considered and calculate the bid-offer spread. This would be a significant task.
139. In ESMA's view, the more appropriate measure to calculate the liquidity of the sovereign debt should be the turnover: total nominal value of bonds traded. Reasons are that it is simple to apply, it is used very often and such information is easy to obtain when compared with those required for other measures, notably those involving orders. It is also worth noting that, in the sovereign debt market, a measure based on bid/offer spread would be affected by the market makers activity.

⁷This has certainly been considered, when establishing the criteria for the determination of liquid shares, for MiFID purposes, which takes into account non composite measures (article 22 of MIFID Regulation 1287/2006).

Definition of the threshold and reference time frame

140. The thresholds can be defined in an absolute or a relative way.
141. An absolute threshold corresponds to the determination of a specific amount of liquidity. For example, when using turnover as the measure of liquidity, a threshold would be "XXX M €." When used in relation to several instruments, the disadvantage of this choice relates to the need to define a different threshold for each financial instrument, since the levels of liquidity can vary from instrument to instrument. So a certain threshold could thus be suitable for a particular instrument, but inappropriate for others. With regard to a basket of benchmarks, the drawback of an absolute threshold is the fact that it may not take into account changes in market conditions.
142. A relative threshold would correspond to the determination of relative values of liquidity. For example, "75% of the average market liquidity in the previous 12 months," or "two standard deviations below the average market liquidity in the previous 12 months", or "the 5th percentile of the monthly volume traded in the last 12 months"⁸.
143. ESMA recommends to adopt a relative threshold which considers the distribution of the liquidity and, therefore, when it is reached it represents a significant decline relative to the average level of liquidity. ESMA consider that the most suitable is "the 5th percentile of the monthly volume traded in the last 12 months." The 5th percentile criterion⁹ has the advantage of providing a value for the threshold comprised in the distribution of data considered for liquidity, which does not happen in the other two cases. In theory and assuming a normal distribution of the data, crossing a threshold would happen once in 20 months. Evidence in one European country shows that over

⁸ For instance, if the reference time for calculation of the liquidity corresponds to a sample of twelve monthly observations, as foreseen above:

75% of the average market liquidity in the previous year: This measure consists of calculating the average of 12 monthly observations of liquidity (number of bonds traded in terms of nominal value), month to month from -13 to -2. Then the result of such calculation is multiplied by 75% and the end result is compared with the liquidity figure recorded in the last month (-1). If the end result is greater than the value of the liquidity of the month -1, there is a significant decline in liquidity.

Two standard deviations below the average market liquidity in the previous year: This measure consists of calculating the average of twelve monthly observations of liquidity, month to month from -13 to -2. Two standard deviations are then calculated and subtracted from the average. If the end result is greater than the value of the liquidity of the month -1, there is a significant decline in liquidity.

The 5th percentile of the monthly volume traded in the last 12 months: This measure consists in sorting the monthly observations of liquidity in ascending order. The rank of the observation that corresponds to the 5th percentile is then calculated and rounded to the nearest integer. Lastly, one picks out the value that corresponds to the observation rank rounded. If the liquidity of the last month (-1) is lesser than the value of the liquidity of the month with the lowest value of liquidity in the period -13 to -2, there is a significant decline in liquidity. For example, if we wanted to assess the liquidity to January (-1), knowing that the monthly distribution of liquidity over the previous 12 months was as follows:

Month (Obs.)	Jan (-13)	Feb (-12)	Mar (-11)	Apr (-10)	May (-9)	Jun (-8)	Jul (-7)	Aug (-6)	Sep (-5)	Oct (-4)	Nov (-3)	Dec (-2)	Jan (-1)
Liquidity	4.1	3.5	6.2	4.6	5.0	3.7	2.4	5.1	3.2	4.4	5.8	3.3	2.2

then the conclusion would be that we were facing a period of low liquidity, since the value of liquidity in January (-1), which is 2.2, is lower than the minimum value of liquidity over the last 12 months, which is 2.4, corresponding to July(-7).

⁹ According to this criterion, the threshold is triggered when the liquidity of the reference month falls below the lowest monthly liquidity of the previous 12 months.

the last 21 years, it would have happened 22 times¹⁰ but it should be noted that the concentration of the contraction of the liquidity has happened in various months of 6 years in that example.

144. The two standard deviation criterion allows a great drop in liquidity if the series includes significant variation among the data (e.g. only the seasonal effect or the lack of homogeneity among the number of trading days per month). A drop of 25% in the volume could trigger the application too late when the situation might have entered into a drying spiral of liquidity.
145. In calculating such thresholds, additional questions would be (i) the period of time for comparison, (ii) the reference time to establish the fall in liquidity, and (iii) the frequency of the analysis of the competent authority.
146. As far as the first question is concerned, in the examples above, the relevant period for comparison data is set at 12 months (365 calendar days). ESMA considers this is the minimum length of time necessary to be considered. A shorter period, for instance 3 or 6 months, runs the risk of basing the decision on a period which may not be properly representative of the usual level of trading in the sovereign debt. Setting a 12 month period as the frame of reference will also help to enable seasonal variations in liquidity (e.g. during the summer holidays or the Christmas/New Year period) to be taken into account. When the competent authorities exercise the power to lift the restrictions on short-selling related to sovereign debt, they should ensure that the significant drop in liquidity is not the result of any of the above mentioned seasonality effects.
147. However, with regard to the time frame of the input data needed to calculate the fall in liquidity, one month (30 calendar days) would be enough, to ensure prompt action from the competent authority. ESMA considers it reasonable and in line with the intention behind Article 13 that national authorities would want the ability to intervene promptly in the face of a significant decline of liquidity in order to prevent a downward spiral in liquidity developing.
148. Hence, the liquidity of a given month period shall be compared with the market liquidity for the previous 12 month period.
149. Finally, ESMA considers that the decision on how often the competent authority calculates the liquidity in order to decide whether or not to suspend the restrictions on uncovered short sales is to be taken by each competent authority. Thus, competent authorities can, for example, calculate the liquidity of the sovereign debt market on a daily, weekly or monthly basis, but always in relation to the previous 30 calendar days.
150. In this particular issue, it should be recalled that Recital 22 (although not directly applicable as it relates to the parallel issue of suspension of restrictions on uncovered CDS in sovereign debt) mentions that the competent authority should be empowered to suspend such restrictions «at the first initial signals that the sovereign debt market is not functioning properly».

¹⁰ Based on a simulation on sovereign bond of a Member State during the last 21 year on monthly basis the 2 standard deviation (2 sigma criterion) threshold only triggered twice, the “75% of the average market liquidity” (a drop of 25%) happened 20 times, the 10th percentile occurred 32 times and the 5th percentile 22 times.

VI. Specification of what constitutes a significant fall in value for financial instruments other than liquid shares and draft regulatory standard on the method for calculating the fall (Article 23)

VI.I. Draft advice on the Delegated Act relating the significant falls in value (Article 23(8))

151. Where the price of a financial instrument on a trading venue has significantly fallen during a single trading day in relation to the closing price on that venue on the previous trading day, the competent authority of the home Member State for that venue shall consider whether it is appropriate to prohibit or restrict natural or legal persons from engaging in short selling of the financial instrument on that trading venue or otherwise limit transactions in that financial instrument on that trading venue in order to prevent a disorderly decline in the price of the financial instrument.
152. Any measure taken by the competent authority shall apply for a period not exceeding the end of the trading day following the trading day on which the fall in price occurs. If at the end of that next trading day (the second trading day) there is, despite the measure being imposed, a further significant fall in value of the financial instrument from the closing price of the first trading day, the competent authority may extend the measure for a further period not exceeding two trading days after the end of the second trading day. The further significant fall in value shall be an amount that is half the initial amount specified.

Extract from the Commission's request

ESMA is invited to provide its technical advice on what constitutes a significant fall in value for financial instruments other than liquid shares, taking into account the specificities of each class of financial instrument and the differences of volatility.

Box 10

Draft advice on what constitute a significant fall in value for financial instruments other than liquid shares

1. For a share other than liquid shares, a significant fall in value during a single trading day in relation to the closing price of the previous trading day is:
 - a. a 10% or more decrease in the price when the share is included in the main national equity index as identified by the relevant competent authority of each Member State - and is the underlying financial instrument for a derivative contract admitted to trading on a trading venue;
 - b. a 20% or more decrease in the price where the share price is EUR 0.50 or higher (or the equivalent in the local currency), or otherwise a 40% or more decrease in the price.
2. A significant fall in value during a single trading day for a sovereign bond is reflected by an increase of 7% or more in the yield across the yield curve for the relevant sovereign issuer.
3. A significant fall in value for a corporate bond is reflected by an increase of 10% or more in the yield of that the bond during a single trading day.
4. A significant fall in value for a money-market instrument is a decrease in price of 1.5% or more - of a

money-market instrument during a single trading day.

5. A significant fall in value for an Exchange Traded Fund, including the ones that are UCITS, is a decrease of 10% or more in the price during a single trading day. A leveraged ETF should be adjusted by the relevant leverage ratio to reflect a 10% fall in the price of an equivalent unleveraged direct ETF. A reverse ETF should be adjusted by a factor of -1 to reflect a 10% fall in the price of an equivalent unleveraged direct ETF.
6. For options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference,
 - a. Where the derivative instrument has as the sole underlying a financial instrument that is traded on a trading venue and for which a significant fall in value is specified, a significant fall in value in that derivative instrument occurs when the underlying financial instrument has reached its fall in value as established above.
 - b. For derivative instruments that do not have a sole underlying financial instrument that is traded on a trading venue, it has not been possible, in the limited time available, to devise any feasible or meaningful workable thresholds.
7. No threshold for a significant fall in the value of the unit price of a listed UCITS (except for ETFs that are UCITS) is proposed as 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).

Explanatory text

153. ESMA proposes that the following criteria should be used to represent a significant fall in value of the financial instruments mentioned below.

Transferable securities

Illiquid shares

154. Article 22 of Regulation No 1287/2006 (Article 27 of Directive 2004/39/EC) sets out the determination of liquid shares as:

A share admitted to trading on a regulated market shall be considered to have a liquid market if the share is traded daily, with a free float not less than EUR 500 million, and one of the following conditions is satisfied:

- (a) the average daily number of transactions in the share is not less than 500;*
- (b) the average daily turnover for the share is not less than EUR 2 million.*

However, a Member State may, in respect of shares for which it is the most relevant market, specify by notice that both of those conditions are to apply. That notice shall be made public.

155. ESMA publishes a list of 'Shares Admitted to Trading on EU Regulated Markets' on its website, which currently lists 6,153 shares. This list includes both liquid and illiquid shares. The number of liquid shares according to the MiFID list is 785. The total number of financial instruments admit-

ted to trading on trading venues in the EU is much larger than this figure therefore the vast majority of financial instruments fall outside the definition of liquid shares.

156. Within the number of illiquid shares admitted to trading on trading venues in the EU there will be a range of shares from some that are relatively liquid to others that are almost totally illiquid. In order to accommodate such a diverse group ESMA considers that it is necessary to have at least three categories.
157. ESMA is proposing the following criteria to be used to measure a significant fall in value in the price of an illiquid share.
 - a. for a share that is included in the main national equity index as identified by the relevant competent authority of each Member State and is the underlying financial instrument for a derivative contract admitted to trading on a regulated trading venue, a fall in value of 10% or more in relation to the closing price of the share on that venue on the previous trading day;
 - b. where the share price is EUR 0.50 or higher (or the equivalent in the local currency), a fall in value of 20% or more in relation to the closing price of the share on that venue on the previous trading day;
 - c. Where the share price is less than EUR 0.50 (or the equivalent in the local currency), a fall in value of 40% or more in relation to the closing price of the share on that venue on the previous trading day.
159. In determining the parameters for triggering consideration of whether to temporarily suspend short selling in non-liquid stocks, ESMA thinks two key factors should be taken into account. First, the level of price fall must clearly be significant and beyond the normal level of volatility for the type of stock in question. However, the trigger should not be set at a level which is rarely if ever reached since this would defeat the purpose of this Article. Taking into account the views expressed by stakeholders in their responses to the Consultation Paper and additional data provided on both UK and German markets, the percentage fall for a share where the price is less than EUR 0.50 (or the equivalent in the local currency) is increased from 30% to 40%. Guided by these considerations, ESMA has consulted representatives of equity exchanges on the appropriate levels to set and, taking into account the views they have expressed, it considers that a fall in price of 10% or more for relatively less liquid shares, a fall in price of 20% or more for more illiquid shares and a fall in price of 40% or more for the remaining group of illiquid shares should be proposed¹¹.

Sovereign Bonds

¹¹ On the basis a test run in 5 countries mainly on shares admitted to trading on regulated markets, the number of instances when a thresholds was triggered between September and November 2011 ranged:

- From 7 to 67, for MiFID Liquid shares and Non liquid but being part of a main index and derivative underlying (i.e. 10% fall)
- From 1 to 20, for others illiquid shares but no "penny stocks" (i.e. 20% fall)
- From 2 to 99, for "Penny stocks" (i.e. 30% fall)

160. ESMA considers that for sovereign bonds the best measure to trigger action by a competent authority should relate to an increase in the yield across the yield curve for the sovereign issuer. The yield curve is a graph that depicts the relationship between the bond yields to maturity of a series of bonds issued by the same issuer or issuer with similar credit risk and the maturities of those bonds. Although there are different methods to calculate the yield curve, the one that replicates the observable yields reflects most accurately the market situation (bootstrapping).
161. ESMA envisages that, if any competent authority was considering temporarily suspending short selling of sovereign bonds on a trading venue they would wish to do so in relation to all the debt of that sovereign issuer traded on that venue rather than just for a particular issue. Hence it appears sensible to choose a threshold which would apply to the sovereign issuer. The yield curve is considered to be the most relevant reference point from this perspective. The yield curve could adopt different shapes which represents the effect of a combination of factors. Hence, there are events that will impact on some tranches of the curve and not others. Those events are not deemed to be of especial relevance because they reflect on-going investors' analysis. However, any event that affect yields across the whole yield curve is really relevant and would require the national competent authority to consider whether a restriction on short selling sovereign bonds should be put in place.
162. After taking soundings with central banks and debt management agencies and taking into account the views expressed by stakeholders in their responses to the Consultation Paper, ESMA proposes that an increase of 7% or more in the yield across the yield curve (i.e. to move from a YTM of 5.00% to 5.35%¹²) would be an appropriate trigger for the competent authority of the home Member State for the venue to consider whether it is appropriate to take any action. If the Member State does not have enough outstanding bonds to calculate a yield curve¹³, the yield increase threshold should apply to the benchmarks that its debt management office has established (three benchmarks is the most typical structure but it could also be two or one: it will depend on the size of the total outstanding sovereign debt).

Corporate Bonds

163. Taking into account the views expressed by stakeholders in their responses to the Consultation Paper, ESMA proposes that the competent authority of the home Member State for the venue will consider whether it is appropriate to take any action when there is a 10% or more increase in the yield of the of the bond during a single trading day. An increase of 10% or more in the yield is considered to be outside the normal range of volatility while representing a significant fall in the price.
164. The price of any corporate or financial bond is related, in normal circumstances (i.e., not in a distress situation), to the yields of the sovereign bonds where the company is settled. Investors in fixed income set the price of a corporate bond adding a yield spread which covers the excess of credit risk of the corporate over the sovereign. Taking into account the different spreads on interest rates for corporate bonds of different categories of credit risk, which have a range from minus some basis points (bp) to more than 500 bp (non-investment grade)¹⁴, and the threshold set for

¹² The yield to maturity of each bond included in the curve should increase at least a 7%

¹³ Usually 10 bonds are necessary for drawing up a curve.

¹⁴ As a proxy of the spreads on interest rates for corporate bonds the indexes Itrx Europe (which encompasses CDSS of 125 investment grade of European corporate bonds), Itrx HiVol (which includes the CDS of 30 non-financial corporate bonds with the highest spreads), and Itrx Xover (it is made up of the 50 most liquid non-investment grade corporate bonds) can be used. In 2011, on

sovereign bonds of 7%, ESMA proposes that an increase of 10% on the yield to maturity in one day for a particular corporate bond reflects, on average, a significant fall in the price¹⁵.

Money-market instruments

165. Money-market instruments have maturities ranging from one day to one year and are extremely liquid. Following the consultation process, ESMA proposes that the competent authority of the home Member State for the venue will consider whether it is appropriate to take any action when there is a decrease in price of 1.5% or more in the price of a money-market instrument during a single trading day. ESMA considers that this is a better measure of a fall in value of a money-market instrument than that proposed in the Consultation Paper. Again, a decrease in price of 1.5% is considered to be outside the normal range of volatility while representing a significant fall in the price for a money-market instrument.

Units in collective investment undertakings

166. Short selling is a regular activity in financial markets which allows the prices of the securities to be aligned with their theoretical value or their economic fundamentals. However, this activity requires certain conditions that could be met in different ways. First, there must be trading in the financial instruments; second the price of the financial instruments could vary significantly from their fundamentals or theoretical value; third the existence of a lending market for the financial instrument or at least a sufficient amount of the financial instrument to allow borrowing to take place and thus settlement to be effected when it is due; four, the capacity to buy back the financial instrument in order to net the position (intraday trade) or to give the loan back. These conditions are mostly found in equities (liquid stocks, with enough liquidity to be bought back), derivatives launched by a futures exchange on equities, sovereign bonds, currencies or commodities (through holding a short position). They are much less present in sovereign debts instruments, corporate bonds and money market instruments. However, it is possible to find a situation where there will be short selling activity on the last three kinds of securities.
167. Undertakings for Collective Investment in Transferable Securities (UCITS) do not fulfil these conditions. Initially, all UCITS may be listed although there are some that are not listed. In any case, all UCITS must be assessed by the Management Fund daily so that the units' holders know the market value of the financial instruments included in the portfolio (Net Asset Value -NAV). In addition, any holders of units are able to sell them to the Management Fund directly or in the market. Although the price of a unit of any UCITS may vary freely in the market the price is subject to a rule which keeps the prices close to the NAV of the UCITS (Article 1.2.b UCITS Directive 2009/65). Consequently, the prices do not move away from the NAV and the interest of selling short those assets is negligible. There is also empirical evidence of a lack of lending activity on units of UCITS. Under these circumstances, ESMA considers that it is not worth setting a significant price fall threshold for this type of financial instruments.
168. In some countries, ETF are UCITS. In such cases, the provision related to ETF should be applicable.

average, these indices show the following levels: 133.76 bp, 195.70 bp, 536.61 bp, respectively. The average of those figures is 288.69 bp.

¹⁵ As an illustration, using that approach on the evolutions of indexes Itrx Europe, Itrx HiVol, and Itrx Xover, the threshold would have been crossed respectively 6, 4 and 5 times over the period from 1/1/2008 to 17/1/2012

Exchange Traded Funds (“ETF”)

169. ETFs are regulated, open-ended investment funds that trade on a stock exchange, just like any other listed financial instrument. ETFs hold a portfolio of securities or derivatives which aims to track and replicate the performance of a specific index, a commodity or a basket of assets like an index fund. The listing on an exchange means the ETF shares or units can be bought and sold by investors on an intra-day basis and using real-time pricing, much like an equity security. Because of the highly liquid nature of ETFs, ESMA proposes that the competent authority of the home Member State for the venue will consider whether it is appropriate to take any action when there is a fall in value of the price of an ETF of 10% or more during a single trading day in relation to the closing price on that venue on the previous trading day.
170. ETFs that are leveraged or reverse ETFs should be considered in relation to their leverage ratio. Therefore, a leveraged ETF should be adjusted by the relevant leverage ratio to reflect a 10% fall in the price of an equivalent unleveraged direct ETF and a reverse ETF should be adjusted by a factor of -1 to reflect a 10% fall in the price of an equivalent unleveraged direct ETF. So, for example, the significant fall in price of a leveraged ETF (leverage ratio of 2) would be a 20% fall in price. For a reverse ETF, the price movement to consider as significant for the purpose of whether an action should be triggered would be a 10% increase.

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

171. When considering what constitutes a significant fall in value for derivatives traded on trading venue (exchange traded derivatives), there are several issues to consider.
172. Such exchange traded derivatives can have a single underlying that is a share or a bond. There can also be exchange-traded derivatives whose underlying is a different asset (commodities, emissions, currencies, interest rates, credit risk, etc.). Technically, it is not possible to sell short a derivative (investors simply sell it or buy it but the notion of short selling is not directly applicable). Therefore, when considering what is a significant fall in price, ESMA will consider that the relevant use of this concept will be for competent authorities to consider, under the provisions of Article 23 of the Regulation whether to “... *limit transactions in that financial instrument on that trading venue on order to prevent a disorderly decline in the price of the financial instrument.*” This will typically include temporary suspension of trading but the measures could be different under the circumstances and the powers of each competent authority.
173. On all derivatives (irrespective of their underlying) the characteristics of each contract make it especially complex to establish a concept of significant fall in price looking only at the evolution of the price of the derivative itself. The sensitivity of the price of the derivative to changes in the underlying can be also different across products due to their inherent characteristics, like the leverage (multiplying factor) of each contract, the direction (whether it is a put or a call option, a reverse or direct index derivative, etc.). The range of derivatives traded on-exchange currently can be expected to increase in the future, for several reasons including regulatory ones. So what is basically a futures and options market today can be significantly enlarged by Contracts For Differences, swaps, covered warrants, etc. In these markets, product ranges are very wide, including products embedding exotic options and structures whose price behaves very differently from the price of other apparently related or similar derivatives with the same underlying (like warrants with knock-out/knock-in options with different barriers).

174. Establishing a threshold that depends solely on the evolution of the derivative price could lead to unintended or conflicting results when competent authorities have to consider taking action: Firstly, it could trigger the obligation to consider whether to take action when the price of the derivative is falling because the price of the underlying is rising, as can be the case with put options when the underlying share price is rising heavily or similar cases on reverse derivatives (those that pay out the buyer when the price of the underlying share falls). Secondly, it could trigger the obligation to consider whether to take action in different moments during the same period for the same underlying (for instance, when different derivatives with the same underlying share hit their thresholds on different times in a volatile session). Thirdly, it would require setting thresholds (in the price of the derivative itself) that are delta-adjusted, increasing significantly the number of thresholds and making supervision much more complex.
175. ESMA considers that due to the specifics of the exchange-traded derivatives markets, it is better to draw a distinction between two categories:
 - a) derivatives whose sole underlying financial instrument is a 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 (e.g. share, bond), and
 - b) derivatives whose underlying is different from the above.
176. For the first category, ESMA thinks that the only practicable solution is to consider that the concept of significant fall in price should be coherent and compatible in time with the conditions to consider whether to take action on the relevant underlying. In this approach, the competent authority should consider whether to take action both on the financial instrument that is traded on a trading venue and for which a significant fall in value has been specified and in the related exchange-traded derivatives at the same time. For this reason, ESMA proposes to assume that a significant fall in value in the derivative has occurred when the underlying financial instrument has reached its fall in value as established according to the regulation, irrespectively of the size or the direction of the actual change in value of each of the different related derivatives.
177. For the second category, given that it covers such a wide range of derivative instruments and underlyings, ESMA in the Consultation Paper suggested that the simplest criterion would be to rely on margins that are required by central clearing counterparties (CCP) on those products that are centrally cleared. The respondents to the Consultation Paper rejected this approach, pointing out a series of possible complications and inconsistencies attached to that method.
178. The category encompasses a wide variety of derivatives in terms of both their own characteristics and structures (different leverage, existence of barriers, etc.) and their underlying assets: basket of shares, indices, commodities, etc.
179. If there were a significant fall in their value to be defined for them, it should be based on the actual price of the concerned derivatives. However, defining a significant fall in value for each and every type of such derivatives appears to be an impossible task, in particular considering the financial creativity of the market participants issuing them. ESMA in the Consultation Paper suggested that a workable approach might be to set out a single figure for a significant fall in price value for all these kinds of derivatives. This would avoid having to design a highly complex mechanism though ESMA acknowledge the difficulty in defining the appropriate unique threshold. The respondents

to the Consultation Paper pointed out that no one threshold would be appropriate for all derivatives.

180. Due to the multiplicity and complexity of derivatives in the second category, it has not been possible for ESMA to devise any feasible or meaningful workable thresholds.

VI.II. Regulatory Technical Standard on the specification of the method of calculation of the 10 % fall for liquid shares and of the fall in value (Article 23(8))

Background

181. In order to ensure consistent application of Article 23 of the Regulation, ESMA is mandated to develop draft regulatory technical standards (RTS) specifying the method of calculation of the 10 % fall for liquid shares according to Article 23(5) and of the fall in value specified by the Commission as referred to in Article 23(7). The draft RTS is presented in Annex IV.

Approach

182. The advice on the Delegated Act relating to the significant falls in the price or value of a financial instrument sets out different approaches as to how the fall is expressed. Depending on the type of financial instruments concerned. Consequently, the method of calculation should be designed accordingly.
183. Regarding shares the Regulation itself includes in Article 23(1) a definition of the starting point of the calculation of the fall. The fall should be calculated in relation to the closing price on that venue on the previous trading day. However the RTS could specify some additional conditions for such a closing price.
184. Taking into account the different definitions of closing prices regarding relevant turnover, timeframe etc. and the fact that Article 23 refers to the closing price on the relevant trading venue, this price must be defined in the context of the relevant rules of the trading venue where the share concerned is actually traded. Therefore a closing price for the purpose of Article 23(1) should be defined as the official closing price at the relevant trading venue as defined under their relevant rules.
185. The same method should also apply for any other financial instrument referred in the Delegated Act on Article 23(7) for which the fall in price or value is expressed in terms of percentage variation of the closing price (e.g. ETFs; money market instruments).
186. In relation to shares only, ESMA considers that downward movements of the price resulting from a share split, a corporate action or similar measures affecting the issued share capital of a company should not fall within the scope of the method of calculation. The purpose of Article 23 of the Regulation is to slow down market movements based on market reactions. In many cases there might be a fall of the price after such a corporate action. However, this fall is not caused by a market movement but by an activity of the company in respect of its issued capital. Such price movements are not the falls that Article 23 aims at preventing.
187. For financial instruments where the draft advice on the Delegated Act on Article 23 (7) refers to an increase in a yield of the financial instrument (e.g. corporate bonds), the starting point of the calculation is the yield of that instrument at the time trading closed on the trading venue. That yield should be established on the basis of the data available at that time. It should be compared to the actual yield for that instrument at the time of the calculation.
188. A similar approach should apply to a debt instrument issued by a sovereign issuer that is traded on a trading venue. In this case, as explained in the draft advice on Delegated Acts (Chapter VI.I above), the method consists in calculating an increase across the whole yield curve of that sover-

eign issuer. The yield curve of the previous trading day should be established on the basis of the available data at the time of closing of the trading on the venue where the debt instruments are admitted to trading. Reliance could be placed on publicly available information about the yield curve for a specific sovereign issuer, including where available the yield curve calculated and disclosed by the competent authority for that sovereign issuer.

189. Considering the approaches recommended in the technical advice on the significant fall in value of the various types of derivatives instruments, the technical standard will not prescribe any method for the calculation of this fall in value.

VII. Specification of criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments referred to in Articles 18, 19, 20, 21 and 27 and the threats referred to in article 28(2) arise (Article 30)

Extract from the Commission's request

ESMA is invited to provide its technical advice on criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments arise.

190. The possible outcomes of those adverse developments and threats are:

- serious threats to the financial stability or to market confidence in one or more Member States;
- serious threats to the orderly functioning and integrity of financial markets or to the stability of part of or the whole of the financial system in the Union.

Box 11

Advice on criteria and factors to be taken into account in determining when adverse events or developments and threats arise

Non-exhaustive list of qualitative events or acts that might suppose a serious threat to the financial stability, market confidence, orderly functioning and integrity of the markets in the EU

1. Any act, result, fact, or event that is or could reasonably be expected to lead to the following:
 - a. Any indication of serious financial (monetary, budgetary, financing) instability or uncertainty concerning an EU Member State or of a systemically important financial institution operating within the EU when this may threaten the orderly functioning and integrity of financial markets or the stability of the financial system in the Union.
 - b. Unsubstantiated rumours about a rating action regarding, or the possibility of a default by, any EU Member State or a systemically important financial institution operating within the EU that causes or could reasonably be expected to cause severe uncertainty about their solvency or produce a self-fulfilling effect.
 - c. Substantial selling pressures and unusual volatility causing significant downward spirals in any financial instrument related to any EU systemically important financial institution operating within the EU and sovereign issuers as the case may be.
 - d. Any relevant damage to the physical structures of systemically important financial issuers, market infrastructures, clearing and settlement systems, supervisors etc., which may adversely affect markets in particular where such damage results from a natural disaster or terrorist attack.
 - e. Any relevant disruption in any payment system or settlement process, in particular when it

is related to interbank operations, that causes or may cause significant payments or settlement failures or delays within the EU payment systems, especially when these may lead to the propagation of financial or economic stress in a systemically important financial institution or in a Member State of the EU.

2. In considering the above non-exhaustive criteria ESMA will take into account the possibility of any spillovers or contagious effects on other systems or issuers and, especially, the existence of any type of self-fulfilling phenomena.
3. Systemically important financial institutions include not only banks but also other financial institutions deemed important to the global financial system such as insurance companies, market infrastructure providers and asset management companies.

Explanatory text

191. Subject to the fulfilment of specified criteria and factors (along with some other considerations such as necessity of the “restrictive measure”, potential effects on the financial markets and proportionality), competent authorities (articles 18, 19, 20 and 21 of the Regulation) or ESMA (articles 27 and 28 of the Regulation) may take some restricting measures (requiring special notifications or publication of positions, obligation to notify significant changes in lending fees, prohibition of short selling or constitution of new short position, limitation of CDS transactions etc.).
192. Such measures could be necessary due to a variety of adverse events or developments including not just financial or economic events but also for example natural disasters or terrorist acts. Furthermore, some adverse events or developments requiring measures could arise in one Member State only and not have any cross border implications. Such powers need to be flexible enough to enable competent authorities to deal with a range of different exceptional situations. In taking such measures, the competent authorities must pay due regard to the principle of proportionality.
193. The Regulation considers it necessary that ESMA itself needs to have the power to take measures where short selling and other related activities threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union (Articles 9 and 18 ESMA Regulation EU No 1095/2010).
194. The list of criteria and factors should be non-exhaustive and general. It should cover those situations which can cause risks and threats to financial stability without offering unlimited discretion for competent authorities and ESMA for taking action. However it is essential to make sure that competent authorities and ESMA can take steps before the risk situation spreads. The possibility of the development of self-fulfilling phenomena, like rumours of bank runs or sovereign or financial issuer defaults is a particular factor to watch when assessing adverse market conditions.
195. The Commission has noted, as expressed in its formal request to ESMA for technical advice on Delegated Acts, that the criteria and factors to be taken into account by competent authorities in determining when adverse events or developments could be either qualitative in nature, quantitative, or a combination of both. In this respect, ESMA acknowledges that on one hand it may be useful to offer a list of quantitative indicators to determine the market conditions in which ESMA or competent authorities could introduce the restrictive measures foreseen in the Regulation. However, on the other hand ESMA considers that a very prescriptive and detailed list of quantita-

tive events could lead to implementation problems regarding the restrictive measures. If ESMA or competent authorities need to wait to the fulfilment of quantitative indicators to introduce restrictive measures there is always the risk of a deferred decision that may make them ineffective. Quantitative criteria may be also perceived to be somehow misleading if market participants presume that ESMA or competent authorities would only act when these quantitative indicators or events are met. Consequently, ESMA only proposes a non-exhaustive list of qualitative events or acts that might involve a serious threat to the financial stability, market confidence, orderly functioning and integrity of the markets in the EU.

196. Systemically important financial institutions are those institutions included in the list of such institutions provided and updated annually by the Financial Stability Board. However, for the sole purpose of applying this regulation, ESMA or competent authorities may also look at other financial institutions not included in the list whose distress or disorderly failure because of their size, complexity and systemic interconnectedness, may cause significant disruption to the wider financial system and economic activity to decide if those are deemed to be systematically important.



Annex I - Commission's mandate to provide technical advice

http://ec.europa.eu/internal_market/securities/short_selling_en.htm

http://ec.europa.eu/internal_market/securities/docs/short_selling/mandate-%2021112011_en.pdf

Annex II: Feedback on the public consultation

Box 1 - Specification of the definitions laid down in the Regulation and in particular of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale (Article 2 (2))

1. The vast majority of respondents to the consultation agreed with the proposed concept of ownership contained in the Consultation Paper.
2. Some respondents asked for clarification on the cases already excluded from the definition. Two respondents mentioned the case whereby a lender is replaced by another lender by its agent (lender substitution). Further, ESMA was asked to include the case where an option or a similar claim is exercised to deliver the financial instruments at the relevant time for settlement.
3. Some respondents also questioned the concept of using the relevant “civil law or securities law applicable for the relevant sale”.

ESMA’s response: ESMA amended the technical advice on Article 2(1)(b) in the light of the feedback received. An exemption has been added to clarify that the exercise of an option or similar claims due to Article 12(1)(b) or 13(1)(b) is excluded from the definition of a short sale. Such cases are to a large extent similar to the recall of securities by the transferor and should therefore not be treated differently. Furthermore, in addition to the recalling of the securities by the lender, the case of the return of securities due to the agreement within the timeframe for settling the lender's sale was added.

No change to the scope of the advice is needed in relation to lender substitution. ESMA considers that such cases are not considered to be uncovered short sales according to the regulation.

Finally, ESMA has not modified the advice concerning the applicable law. In some Member States the relevant provisions are within the civil law while in other Member States the securities law is concerned. However in all cases the law of the sale has to be applied.

4. A few respondents asked for further clarification on other definitions of Article 2(1). These statements especially refer to the definition of a CDS and the definition of sovereign issuers. On the later, one respondent requested that ESMA publishes a list of sovereign issuers. On CDS, a few respondents asked for clarification on whether particular forms of CDS (e.g. contracts referring to a “reference entity” and to one or more “credit events” but with a payment not contingent to the occurrence of the credit event) are within the scope of the regulation.

ESMA’s response: ESMA has decided not to add further definitions to the advice at the current time. It should be recalled that a list of sovereign issuers will be published on the ESMA website in accordance with Article 7(2) of the Regulation and the Delegated Act (DA) on Article 7(3).

ESMA considers that the mentioned CDS problems do not require additions to the definition itself, since they can be solved within the framework of the DA on Article 4 (2).

Box 2 - Specification of the cases in which a natural or legal person is considered to hold a share or debt instrument for the purposes of Article 3(2), (Article 3(7)(a))

5. There was a general support to this part of the advice. However a few respondents proposed to use the definition of holding from the Transparency Directive to avoid two parallel concepts on similar issues.

ESMA's response: ESMA left this part of the proposal unchanged. The definition of holding stemming from the Transparency Directive could not be used within the framework of Regulation (EU) No 236/2012 considering the different aims of the two legal acts.

Box 3 - Specification of the cases in which a natural or legal person has a net short position for the purposes of Article 3(4) and (5) (Article 3(7)(b))

6. There was general support from the respondents to the proposal in relation to the concept of having a net short position. However there were some suggestions to change the advice on several points.
7. Some respondents proposed that a “de minimis” approach should be applied in relation to indices or baskets of securities. For instance, the position held in a security that represents part of an index or a basket should only be included in the calculation of a net short position if the respective security has a minimum weight of 20 percent or more in the index or basket of securities or if the index or basket is not sufficiently diversified (e.g. less than 5 components). Other respondents advocated for the inclusion of convertible bonds or similar instruments in the calculations of net short positions.

ESMA's response: ESMA decided not to include a minimum threshold for indices or baskets in the advice. While ESMA recognizes the complexity of calculating net short positions when the respective financial instrument is included in other products like index or basket products, such a “de minimis” approach could be used to circumvent the notification and disclosure requirements, in particular considering the current technology easily allowing arbitrage and the high weighting threshold suggested by respondents. In addition ESMA likes to point out, that the text of Regulation does not seem to allow the possibility to include such an exception.

ESMA maintains the view expressed in the Consultation Paper that instruments referring to non-issued securities such as convertible bonds or similar instruments could not be taken into account when calculating short and long positions. In addition, ESMA would like to highlight that some respondents incorrectly referred to the inclusion of convertible bonds in the scope of the temporary measures imposed by some regulators in August 2011 as these measures had a different objective. They aimed at restricting short selling transactions and did not relate to a transparency regime.

8. On the issue of high correlation for sovereign debt issues, there was also a general support of the proposal. However a significant number of respondents were in favour of using a qualitative method for the determination of high correlation rather than a quantitative as proposed in the Consultation Paper. On some details of the proposal there were also requests for modification.
9. Concerning the high correlation threshold proposed by ESMA, the common view was that 90% is too high. The alternative thresholds suggested ranged 50% to 82%. In relation to the timeframe for the historical measurement of correlation, most respondents were in favour of a shorter period than the 24-month period suggested by ESMA. There were also some respondents who supported widening the scope of the debt instruments that could be used to calculate the net short position in sover-

eign debt to highly correlated debt instruments from issuers outside the EU. A few respondents held the view that ESMA should include in the advice a provision whereby there is an automatic correlation between all issuers within the same Member State.

ESMA's response: In the light of the responses received, ESMA has decided to reduce the timeframe and the percentage for high correlation. To keep a sufficiently long timeframe ESMA proposes a 12-month period, but to capture the most recent trends it should be calculated in a weighted form giving more weight to the most recent data. Furthermore, ESMA proposes a 70% threshold which is sufficiently high to be considered as "highly correlating".

Taking into account the definition of sovereign issuers in article 2(1)(d) of the Regulation, ESMA considers that debt instruments from issuers outside the EU irrespective of the level of their correlation with the EEA issuer, cannot be included in the calculation of a net short position. As to the automatic correlation between sovereign issuers within the same Member State (e.g. members of a federation), ESMA has refrained from including this in the advice. Due to different developments regarding size of debt and the economic growth between such issuers a high correlation does not always exist.

10. From the responses received, the common view was that using a proxy to measure correlation for assets with no liquid market price or with no sufficiently long price history would be a practical solution. However the views and proposals were split as to the kind of instrument that would be a good proxy. Some respondents were of the view that ESMA should use a duration based approach instead of a maturity based one.

ESMA's response: In the light of the feedback, ESMA specified in its advice that the proxy to use should be another instrument with a similar duration.

11. Nearly all respondents refrained from submitting comments or suggestions on the need to provide further specifications on the calculation of whether the high correlation test is met. However, there was a wide support for the introduction of a buffer period (e.g. 3 months) to address the issue of temporary fluctuations in the correlation of the sovereign debt during which the correlation is less than the standard level of high correlation but at least met a prescribed lower threshold. Only a few respondents suggested to set that lower threshold at no more than 50% (even 30%).

ESMA's response: ESMA introduced a 3 months buffer period during which a lower correlation level would be acceptable. That lower level is set at 20% below the level set out for high correlation.

Box 4 - Specification of the method of calculation of net short positions (Article 3(7)(b))

For shares

12. The vast majority of respondents agreed with ESMA in supporting the delta adjusted model for calculation of short positions in shares. There was broad recognition of the fact that this method has been already in use for some time in some jurisdictions within the EU.
13. A few respondents commented about the fact that investors would not be able to take notice of changes in the total issued share capital and suggested alternative proposals.

14. One respondent requested clarification on the meaning of “publicly available information” provided in the draft advice and in article 3(3) of the Regulation as to the composition of the index, ETF or basket meant information that can be obtained without payment.
15. There were a few requests to align the method of calculation for derivatives with the UCIT regulation, in particular with the methodology for standard derivatives set out in CESR Guidelines (CESR/10-788).

ESMA’s response: In light of the responses received, ESMA considered there was no need to modify the advice.

However, with respect to the information on the issued share capital, ESMA considers that trading venues, data providers and sometimes competent authorities would normally publish in their web pages data about the total shared capital admitted to trading, including information about the effective date on which new shares are admitted to trading.

On the implication of “publicly available information”, ESMA understands that this information should be obtained free of charge.

As to the alignment of the method of calculation for derivatives, ESMA would like to point out that the function of the Short Selling Regulation is a different one. While the key purpose of the CESR guidelines was to provide UCITS with detailed methodologies in order to foster a level playing field among Member States in the area of risk measurement and the calculation of global exposure, this delegated act only tries to provide a method as simple as possible so that market participants, natural and legal persons, can somehow calculate easily short positions in shares deemed significant and important for monitoring and supervisory purposes.

For sovereign debt of a sovereign issuer

16. The majority of respondents agreed that for sovereign debt the best method of calculation was, on the grounds of its simplicity, the so called “nominal method”. There was, however, some support for the “sensitivity method” as well. Three respondents suggested an alternative mark-to market risk or mark-to market model to be considered. There were also references asking ESMA to align the method of calculation proposed in this DA with the advice ESMA produced on systemic risk reporting for AIFMD in respect to reporting requirements for sovereign bonds.

ESMA’s Response: ESMA would like to stress again the different purpose and scope sought in this advice.

17. A couple of respondents queried the reason for converting all nominal positions in Euros.

ESMA’s responses: ESMA acknowledges that a sovereign issuer might issue debt in other currencies as Euros but would like to mention that notification thresholds for every sovereign issuer will be published in Euros to ensure a unified presentation of the information.

18. Others respondents pointed out that that it is not accurate to specify in the advice that the actual net short position expressed in percentage of as Article 7(2) of the Regulation requires notification thresholds in sovereign debt to be set up in (monetary) amounts.

ESMA’s response: In light of these comments, ESMA has modified the text of its advice.

Box 5 - Method of calculating positions when different entities in a group have long or short positions or for fund management activities related to separate funds

19. The vast majority of the respondents expressed strong concerns on the three layer approach for calculating and reporting of net short positions within groups and for fund management activities as proposed in the Consultation Paper. It was generally considered as too complex, not practical and difficult to implement while creating high administrative burden and risks of mistakes and wrong reports.
20. In particular, the concept of decision maker was widely criticised and considered as not appropriate for several reasons:
 - not consistent with the Regulation itself as it would introduce an intermediate level below the legal entity;
 - practically difficult and too subjective in identifying decision makers in relation to the specific and various investment processes of different organisations (in particular, considering the risk of instability over time);
 - high administrative burden and costly to set up and maintain.
21. The alternative methods suggested by respondents varied greatly. With respect to calculation at group level, some supported a simple aggregation at group level of all the positions of the legal entities constituting that group whereas other advocated for the calculation to be performed only at individual legal entity level within the group. For fund management activities, some argued that the calculation should take place only at funds level while other considered that aggregation across funds only should be applicable.
22. It should be noted that a minority of those who supported the decision maker concept provided though that it should be the only level at which net short positions are calculated.
23. For the sake of clarification, some respondents indicated that fund management and portfolio management should be treated in a similar way. One respondent claimed that it should be possible to aggregate positions of discretionary and non-discretionary managed portfolios.
24. The fact that ESMA had addressed cases of delegation of funds management was welcome by the respondents. However, they questioned the approach whereby the net short positions of the funds the management which has been delegated to another entity should be aggregated at the level of that entity (i.e. considered as the decision maker) while the management entity that has delegated their management should also include them in the netting off of the net long and short positions of the funds under its responsibility.

ESMA's response: In light of the feedback received, ESMA has reviewed considerably its approach with the objective to limit the complexity and to avoid (as much as possible) double counting of positions that are notified or disclosed as well as double reporting.

Therefore, the concept of decision maker has been abandoned and a clear and specific method is defined and should apply for fund management and portfolio management activities, even in the case they are performed within a group.

Furthermore, for the purpose of the Regulation, fund management activities have been clearly defined in such a way as to encompass also portfolio under management and it was also clarified that only discretionary management is concerned by the advice, so non-discretionary portfolios where the management entity is following the instructions of the client are excluded and the related positions would be considered as positions of that client. Though the net short positions are calculated for each managed portfolio and fund regardless of its form (legal/non-legal entity), reporting, and disclosure where relevant, is done by the management entity when its position (resulting from the aggregation of the net short positions of the funds it manages and the portfolios under its management) reaches or crosses any relevant threshold.

With respect to method relating to groups, the calculation should be performed both at the level of the legal entities constituting the group and at group level (aggregation of the net positions of individual entities) but the advice specifies how reporting should occur so as to have only one report notified, and disclosed where relevant, depending on who --an individual entity or the group-- has crossed a threshold.

25. In relation to the definition of a group for the purpose of this Regulation, the vast majority of the respondents supported the alignment with the Transparency directive which sets out in Article 2(1)(f) a definition of controlled entities rather than the alternative definition suggested in the Consultation Paper based on an accounting approach.

ESMA's response: In light of the responses received, ESMA introduced in its technical advice reference to the definition of the Transparency directive for the legal entities constituting a group.

Box 6 – Cases in which a sovereign CDS transaction is considered to be hedging against a default risk or a risk in the decline of the value of assets or liabilities correlated with the value of the referenced sovereign debt

26. Generally, the vast majority of respondents broadly agreed with ESMA proposals for a qualitative and non-prescriptive approach in determining whether a sovereign CDS position would be covered. It was commented that this was necessary given the wide scope of exposures which, according to the Regulation, could be hedged using sovereign CDS. However, particular concerns were expressed on three main issues:

- the proposed restriction that an exposure being hedged by a sovereign CDS had to be located in the same Member State referenced in the CDS;
- the wording which ESMA proposed in its qualitative correlation test;
- the emphasis in ESMA's proposals on measuring correlation on a historic basis.

27. Nearly all respondents who commented the general conditions proposed for determining when a sovereign CDS position can be considered covered were strongly opposed to the proposed requirement that the obligor or counterparty of any exposure which was being hedged using a sovereign CDS should be located in the same Member State as referenced in the CDS. They considered that this restriction was not justified by the Regulation itself and that the imposition of a ban on the cross-border use of sovereign CDS positions would prevent market participants from undertaking legitimate risk management activities and using the most suitable hedges for the exposure in question. A number of actual or generic examples were cited of where the use of a sovereign CDS posi-

tion referenced to a different Member State would be more appropriate. It was noted that prohibiting the use of sovereign CDS for cross-border hedging would be inconsistent with Basel III and Article 375 of the Capital Requirements Regulation which imposed no such geographical restriction. It was argued that the restriction would have a negative impact on the real economy and constitute a barrier to the Single Market. Certain respondents considered that it should be legitimate to use a sovereign CDS to hedge exposures outside the European Union provided that the correlation test was met.

ESMA's response: ESMA noted in its Consultation Paper that, according to its understanding, it was the intention of the co-legislators not to draw geographical scope of the provision too widely. However, based on the comments received, ESMA considers that its original proposal might have been too narrowly drawn and believes that there are some cases where there are legitimate reasons for allowing the use of sovereign CDS for cross-border hedging purposes within the European Union. Moreover, the Regulation and the proposals for the delegated act under Article 4(2) already contain sufficient safeguards against the speculative, abusive or destabilising use of sovereign CDS positions without the need to impose a blanket prohibition on cross-border hedging through sovereign CDS. ESMA has therefore decided to amend its approach on this issue and recommends in its final technical advice that, providing the other tests are met, a sovereign CDS position could be used to hedge an exposure within the European Economic Area in certain cases, mostly taken from the responses from the public consultation.

However, ESMA remains of the opinion that to use such a position to hedge an exposure outside the EEA –should be considered as an uncovered sovereign CDS position.

28. There was unanimous support from those who commented for ESMA's proposal for a qualitative rather than a quantitative test for correlation. It was considered that a quantitative approach would be inappropriate and unworkable, given the very wide range of exposures which the Regulation contemplated that a sovereign CDS position could be used to hedge.
29. However, many respondents considered that the definition proposed by ESMA that there should be "...a consistent significant positive correlation between the value of the asset/liability being hedged and the value of the referenced sovereign debt" would mean going beyond the condition set down in the Regulation itself and be tantamount to imposing a test of high correlation. These respondents stated that ESMA should either leave the term 'correlated' undefined or at least modify its proposed definition so that the test remained in conformity with what was set out in the Regulation.
30. There were also a few more technical comments regarding the accuracy or consistency of the terminology which ESMA was using in its draft advice.

ESMA's response: In the light of the comments received, ESMA remains with a qualitative test of correlation in its final technical advice but modifies the wording of the test. It was not ESMA's intention to impose a test of high correlation through the delegated act as this obviously would not be consistent with the wording of the Regulation itself. However, ESMA considers that leaving the term 'correlated' completely undefined would leave market participants and competent authorities without any common frame of reference and that indicating at least some factors for what is expected would be helpful. ESMA's view is that the proposed revised formulation does not imply that high correlation is required.

ESMA has made some minor changes to the text of its proposals to employ more consistent use of terminology in the draft advice on the delegated act and explanatory text.

31. While there was some support for ESMA's proposal to demonstrate correlation using historic data and the employment of proxies, the general view was that this framework was too narrow to cover the hedging of risks where the approach needed to be forward looking. It was noted that the past was not necessarily a guide to the future. Hence, although it was accepted that the use of historic data could be one way to show correlation, respondents thought there were other legitimate approaches and that ESMA's advice should not be prescriptive in this area. A number of factors and examples were quoted which would provide confidence of a qualitative correlation between the exposure and the sovereign and it was recommended that the advice on the delegated act should reflect these. It was also noted that, where historic data were used, it might be appropriate to use data from a period other than the most recent 12 months if the circumstances warranted it. Finally, it was proposed by some respondents that the test should be one of whether the market participant had entered into the sovereign CDS transaction in good faith.
32. On a separate but related issue, a number of respondents commented that the key point was that the correlation test should be met at the point of entry into the sovereign CDS transaction.

ESMA's response: ESMA recognises that hedging risks entails looking to the future and that historic data may not always be relevant or available. Therefore, ESMA has modified its advice to take account of other ways in which correlation can be demonstrated, considering relationships between exposures and sovereigns which would provide confidence of correlation. ESMA also accepts that where historic data is used there should be flexibility in the timeframe chosen, provided there is good reason for not selecting the most recent 12 months. It is for the party entering into the CDS position to be able to justify to the competent authority that the correlation test has been met but ESMA considers that a general 'in good faith' test for correlation would be too broad and subjective.

As regards timing, ESMA notes that its advice makes clear that the test is to be met at the time the sovereign CDS position is entered into.

33. Respondents were mostly supportive of ESMA's proposals to determine whether a sovereign CDS position is proportionate. They considered the proposal to generally provide sufficient flexibility for legitimate hedging. It was commented that it was important that the delegated act recognised that proportionality of hedges should take into account the need for anticipation of potential changes in the size of the exposure in the future. Respondents also noted that where assets or liabilities were liquidated before the expiry of the CDS position, it should be possible to substitute other exposures provided these met the correlation tests.

ESMA's response: ESMA has made a number of modifications to its proposals in the final advice to fine-tune the provisions concerning proportionality. However, the substance of the approach remains the same. ESMA agrees that dynamic hedging strategies do need to take into account potential changes in the size of exposures going forward and ESMA's advice on proportionality and calculating positions does recognise that this is both legitimate and necessary with this type of exposure. ESMA's advice also recognises that if exposures are liquidated or redeemed during the lifetime of the sovereign CDS position, they can be replaced by equivalents for which the CDS position would provide the hedge.

34. While some respondents suggested that there should be time limits (of varying periods), the majority of those who expressed a view considered that no time limit should be placed when a position that becomes partially uncovered due to fluctuations in the value of assets/liabilities being hedged and/or of the CDS used as the hedge. There were concerns that forcing market participants to divest a CDS position in these circumstances could expose them to risks when market conditions subsequently change and that introducing such a requirement could significantly increase volatility in sovereign CDS markets. It was also considered unjustified to require position holders to be disadvantaged as a result of events outside their control.

ESMA's response: ESMA agrees that it would not be appropriate to impose a limit on the period during which a CDS sovereign position could be disproportionate to the value of the exposure it was hedging when this was due only to market fluctuations and without any active change of position by the CDS purchaser. ESMA's final advice therefore does not include such a time limit.

35. All respondents who commented on involuntary sovereign CDS positions resulting from the operations of a CCP clearing sovereign CDS transactions agreed with ESMA's view that the obtaining of sovereign CDS positions in such circumstances should not be treated as uncovered CDS. There were some suggestions for additions to the Explanatory Text to deal with further situations in which a member of a CCP could obtain a sovereign CDS position as a result of the operations of the CCP. It was also noted that it might not be feasible or sensible to liquidate immediately any positions obtained. There was also a suggestion that if an exposure came to an end before the expiry of the sovereign CDS position through no action by the position holder (e.g. if a loan was pre-paid), this should also be treated as an involuntary uncovered position.

ESMA's response: ESMA has made some changes to the explanatory text to take account of the additional circumstances suggested in relation to the activities of CCPs clearing sovereign CDS. However, ESMA considers that a distinction is to be drawn between those circumstances and the other cases where the hedging purpose of the sovereign CDS position comes to an end earlier than expected (albeit not through any actions of the CDS position holder themselves). The latter cases should not fall to be treated as involuntary uncovered CDS positions. As previously noted, it is open to position holders to substitute other exposures for which the CDS position would be a hedge provided that the specified tests are met.

36. When answering to the question on the need to include other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position in the indicative list proposed in the Consultation Paper, several respondents provided some additional suggestions to support their argument that there should be no geographical scope limitation. There were also comments that it should be made clearer that the list of cases was non-exhaustive.

ESMA's response: ESMA did not consider that the list needed to be substantially extended since its function is illustrative only, although some amendments have been made. However, it is now clearly stated that the list is non-exhaustive.

Box 7 - Method of calculation of an uncovered sovereign CDS position

37. There was general agreement that, in calculating sovereign CDS positions, the reference point should be the net rather than the gross position. There was also support for the proposal 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. It was considered that ES-

MA's proposals provided sufficient flexibility to use the calculation methodology suitable for the type of exposure being hedged. Some respondents suggested possible refinements to the methodology but others noted that there are no market standard calculation formulae.

38. There was a greater difference of view in respect of ESMA's proposals concerning treatment of indirect exposures. The majority of those who commented supported ESMA's view that indirect exposures should be taken into account in proportion to the extent the reference exposure or CDS is represented in the index, fund or other mechanism. However, some respondents questioned whether this would work in the case of index positions, arguing that there could be an identifiable correlation between the risk arising from the inclusion of a Member State within a portfolio and the value of the sovereign debt even if it was not possible to track that correlation into the portfolio as whole.

ESMA's response: ESMA has not modified its technical advice in this area since most of the proposals were supported by respondents. On the question of indirect exposures, ESMA was not clear that the alternative proposed was a better way of treating these and notes that in any event, its revised advice concerning evidencing correlation would provide more flexibility and less exclusive reliance on data than the consultation proposals.

Box 8 - Specification of the amounts and incremental levels of notification thresholds referred to in Article 7(2) for net short positions relating to the issued sovereign debt of a sovereign issuer (Article 7(3))

39. The vast majority of respondents to the consultation agreed with the proposal that the relevant notification threshold should be based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer.
40. Two of the respondents suggested setting corresponding monetary amounts and then additional incremental levels rather than calculating the threshold based on a percentage of the total outstanding issued sovereign debt. Another respondent considered more appropriate applying one monetary amount to all sovereign debt issuers without setting different thresholds for each Member State.
41. A couple of respondents asked for clarification in respect of the denominator to be used in the calculation of the threshold.

ESMA's response: ESMA would like to underline that, according to the Regulation, the reporting threshold (expressed in monetary amounts) with respect to each sovereign debt issuer will be published on ESMA web site. This monetary amount is, however, derived and fixed on the basis of the conversion (rounding up to the nearest million Euros) of the percentage threshold applied to the outstanding sovereign debt of the sovereign issuer. The rationale for using this approach is given in the explanatory text. Among others, using a percentage threshold caters for the differing sizes of issued debt in the various sovereign issuers. Furthermore, it is the percentage of the outstanding issued sovereign debt that is relevant in terms of potential volatility.

Setting a threshold purely in terms of a monetary amount, unrelated to the outstanding sovereign debt, could mean that the threshold becomes either too high or too low as the case may be in the light of developments in the size of individual sovereign debt markets. Such a result would not be in line with the intention of the Regulation to enable authorities to identify and monitor those net short positions likely to have some impact on the sovereign debt of each sovereign issuer and which might contribute to creating systemic risks or potential market abuse.

Considering the general support expressed by the respondents for this proposal, ESMA did not modify the advice concerning the setting of notification thresholds based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer.

ESMA would also like to clarify that, in line with the definition of Article 2 of the Regulation the total amount of the outstanding issued sovereign debt of a sovereign issuer that is a Member State includes debt issued by that Member State as well as debt issued by a government department, an agency, or a special purpose vehicle of that Member State. Debt guaranteed by a sovereign issuer is not included in the definition of the issued sovereign debt.

42. There was general support to the approach proposed by ESMA to convert these percentages thresholds into monetary amounts and to proceed with quarterly updates to reflect changes in the issued sovereign debt.

ESMA's response: In light of this general support, ESMA did not modify the advice.

43. In general respondents to the consultation agreed with the proposal of grouping sovereign issuers into categories for the purposes of setting the notification thresholds. None of the respondents expressed support for the option of using a single percentage threshold for all sovereign issuers.
44. There were, however, some respondents that favoured the use of individual percentage thresholds for each sovereign issuer stating that this approach would not add to complexity or uncertainty; one of them arguing that a diversified approach would be more appropriate considering the characteristics of the respective markets, for instance in terms of liquidity.
45. One respondent suggested using another approach which would include liquidity directly in the determination of the percentage that is used to calculate the monetary thresholds. In addition, there was general support from the respondents for the suggested categories of notification thresholds.

ESMA's response: ESMA has considered the reasons provided by those respondents that were in favour of setting individual thresholds for each sovereign issuer. While ESMA recognizes the positive aspects of such an approach, it also acknowledges the complexities entailed for both market participants and competent authorities of having to cope with a multiplicity of divergent percentages when setting the monetary thresholds. As explained in the Consultation Paper, such an approach would also run counter to the harmonising intent of the Regulation. ESMA maintains the concept of grouping of the sovereign issuers into a limited number of categories. Some of the respondents considered the proposed initial amounts and the incremental levels as reasonable. Quite a few of the respondents did not comment on this question. Two of the respondents expressed the view that the proposed initial thresholds were too low while one of the respondents reiterated the position that the thresholds should directly consider average liquidity.

46. However, respondents were not able to provide figures about expected notifications to be made in a month to each relevant competent authority on the basis of the thresholds proposed in the Consultation Paper.

ESMA's response: In devising the proposed initial amounts and the incremental levels ESMA considered all the currently available information on the respective sovereign debt markets of the sovereign issuers. Currently this information consists of the size of the sovereign debt of each sovereign issuer and the liquidity of the sovereign debt markets in terms of a liquid futures market for

sovereign debt. ESMA and the competent authorities have thus defined the initial and incremental threshold levels based on these parameters and the data available regarding the sovereign debt markets of sovereign issuers. However, in order to simplify the regime it has reduced the number of categories to only two: those issuers below € 500 billion of outstanding debt (with a threshold that will be defined based as 0.1% of the outstanding debt), and, those issuers with more than € 500 bln or with a related liquid futures bond market (where the threshold will be defined as 0.5% of the outstanding debt). The suggested levels are deemed to be significant enough to be meaningful for the national regulators/competent authorities.

Complete data information on all the criteria to be taken into account when setting the thresholds, as stipulated in the Regulation, is not available. There is, for instance, no available information on the average size of positions held by market participants relating to the sovereign debt of sovereign issuers. Data on liquidity in terms of turnover is not complete either as much of the trade in sovereign bonds takes place OTC.

ESMA acknowledges, therefore, that there is ground for reviewing the appropriateness of the notification threshold in 2013 as foreseen under Article 45 in the Regulation in light of the results from the application of the short selling regime.

Box 9 - Specification of the parameters and methods for calculating the threshold of liquidity referred to in Article 13(3) in relation to the issued sovereign debt for suspending restrictions on short sales of sovereign debt (article 13 (4))

47. Among the few responses received, less than a half supported the proposals, namely the adoption of the 5th percentile criterion to identify a significant decline of liquidity for sovereign debt and a reference period of 12 months whereas the other respondents claimed to have no comment.

ESMA's response: In light of the feedback received, ESMA did not modify its advice on the matter.

Box 10 - Specification of what constitutes a significant fall in value for financial instruments other than liquid shares and draft regulatory standard on the method for calculating the fall (Article 23)

Illiquid shares

48. The majority of respondents agreed with ESMA's proposals for three categories of illiquid shares and supported the € 0.50 cut off point between categories b and c.
49. Regarding the percentage fall in price for triggering consideration of whether to temporarily suspend short selling in non-liquid stocks a majority of respondents indicated that the thresholds were too low.

ESMA's response: Having considered the responses to the public consultation, and the additional data provided on both UK and German markets, ESMA has decided to increase the percentage fall for a share where the price is less than € 0.50 (or the equivalent in the local currency) from 30% to 40%.

Sovereign bonds

50. The large majority of respondents agreed that for sovereign bonds the best measure to trigger action by a competent authority should relate to an increase in the yield across the yield curve for the sovereign issuer during a single trading day. The majority of respondents believe that an increase of 5% or more in the yield across the yield curve is too low. Some respondents to the consultation suggested that in addition to percentage moves in yields there should also be a threshold of an absolute change in yields.

ESMA's response: Additional data was received from debt management agencies and taking that into account together with the views of the respondents, ESMA has decided that an increase of 7% or more in the yield across the yield curve would be an appropriate trigger for the competent authority of the home Member State for the venue to consider whether it is appropriate to take any action.

Corporate bonds

51. The majority of respondents believe that an increase of 7% or more in the yield of a corporate bond is too low to trigger action by a competent authority. Some respondents to the consultation suggested that in addition to percentage moves in yields there should also be a threshold of an absolute change in yields.

ESMA's response: Taking into account the views of the respondents, ESMA has decided that an increase of 10% or more in the yield would be an appropriate trigger for the competent authority of the home Member State for the venue to consider whether it is appropriate to take any action. An increase of 10% or more in the yield is considered to be outside the normal range of volatility while representing a significant fall in the price.

Money-market instruments

52. The few responses commenting on this point questioned the approach proposed in the Consultation Paper of using the yield curve to measure a significant fall in the value of money market instruments.

ESMA's response: Having considered these responses, ESMA has decided that for money-market instruments the competent authority of the home Member State for the venue will consider whether it is appropriate to take any action when there is a decrease in price of 1.5% of a money-market instrument during a single trading day. ESMA considers that this is a better measure of a fall in value of a money-market instrument than that proposed in the Consultation Paper.

Units in collective investment undertakings

53. The feedback from the consultation was supportive of the approach of having no threshold for a significant fall in value of the unit price of a listed UCITS.

ESMA's response: In light of the feedback received, ESMA did not modify the advice in relation to units in collective investment undertakings.

Exchange Traded Funds (ETFs)

54. Some respondents believe that it is not necessary to have a threshold for ETFs while others respondents favour having a threshold as ETFs are basically equivalent to liquid shares.

ESMA's response: Having considered the responses to the public consultation, ESMA did not modify the advice in relation to ETFs.

Options, futures, swaps, forward rate agreements and other derivative instruments including financial contracts for difference

55. Some respondents do not believe that there is any need for specific measures for derivatives, as it is only necessary to take measures in relation to the underlying financial instrument.
56. Many respondents questioned ESMA's approach to derivative instruments that do not have a sole underlying financial instrument that is traded on a trading venue. The respondents rejected the approach to rely on margins that are required by central clearing counterparties (CCP) on those products that are centrally cleared, as derivative instruments may be cleared by more than one CCP and different margin rates may apply.
57. Some respondents pointed to the importance of ensuring that trading limits or triggers are relevant to the price and liquidity of the instrument in question.
58. In relation to commodity derivatives a number of respondents pointed out that for some in the physical market, short selling on commodity futures markets is an essential part of trading activity.
59. Respondents to the Consultation Paper pointed out that no single threshold would be appropriate for all derivatives.
60. Two respondents suggested broadly differentiating derivatives which do not have a single financial instrument as an underlying into two categories:
- Derivatives with an index as underlying
 - Derivatives with a basket of underlying or an underlying which is not traded on a trading venue

ESMA's response: Having considered the responses, ESMA did not modify the advice where the derivative instrument has a sole underlying financial instrument that is traded on a trading venue and for which a significant fall in value is specified. A significant fall in value in that derivative instrument occurs when the underlying financial instrument has reached its fall in value.

ESMA has not had time to fully assess the particular proposal suggested in relation to derivatives which do not have a single financial instrument as underlying. Due to the multiplicity and complexity of derivatives in this category, it has not been possible, in the limited time available, for ESMA to devise any feasible or meaningful workable thresholds.

Box 11 - Specification of criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments and threats arise (Article 30)

61. Many respondents to the Consultation Paper decided not to provide comments on the question on whether they agree with the qualitative criteria proposed by ESMA. Nevertheless, most of the respondents who provided remarks generally agreed with the need for the competent authorities to have reasonable discretion to address the threats referred to in the document.
62. Some respondents, though, felt that the wording proposed was somehow imprecise, that some circumstances were difficult to determine and considered a list of qualitative criteria to be insufficient. However, many agreed on the difficulty of quantifying concepts or situations like “market confidence” or “functioning or integrity of financial markets”.
63. A few respondents specifically questioned the imprecision of the concept “unsubstantiated rumours” arguing that this was difficult to determine.
64. A few respondents expressed their concern about Competent Authorities imposing discretionary restrictions on short selling and sovereign CDS transactions.
65. There were no suggestions of additional new criteria of factors to be added to the list.

ESMA’s response: Having considered the responses to the public consultation, ESMA has decided not to make any change in its technical advice on criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments arise. In addition, ESMA would like to recall that the power to impose discretionary restrictions is stemming directly from the level 1 text.

On the Regulatory Technical Standard on the specification of the method of calculation of the 10 % fall for liquid shares and of the fall in value (Article 23(8))

66. A few respondents explicitly agreed with the proposed technical standard whereas the other respondents refrained from submitting comments. One respondent however stressed the need to have a proper communication (clear, unambiguous and in a standardised format) on the measures that may be decided by a regulator if a significant fall of the value of a financial instrument occurs.

ESMA’s response: Even though there was no specific request for changes expressed in the feedback to the consultation, ESMA has modified the technical standard so as to adapt it to the new approach put forward in the technical advice of what is significant fall in value in relation to derivatives financial instrument.

ESMA would like to recall that, in accordance with Article 23(1) of the Regulation, a competent authority has the possibility, though not the obligation, to intervene in case of a significant fall in the price of a financial instrument. In addition, ESMA considers that it is neither in the Commission’s request to ESMA for technical advice on a delegated act concerning the determination of significant falls nor on the mandate to submit a technical standard on the method of calculation such significant fall to prescribe any communication requirements. It should also be noted that Article 23 already described the various steps to be followed in the decision making process.

Annex III

Cost-benefit analysis on draft technical standards on Article 23 of the Regulation (EU) NO 236/2012 on short selling and certain aspects of credit default swaps

Summary of the Analysis

The overarching benefit of the TS related to calculating significant price falls is of creating an orderly and transparent mechanism for assessing the need to intervene or not – market participants can assess the price changes themselves if they wish to confirm the Competent Authorities' calculations.

The consequent harmonization of regulatory action avoids the discouragement of firms from participating fully in the market.

The tailoring of the calculation methodology to individual asset classes (or to segments within asset classes) should aid flexibility.

There will be associated one-off and on-going monitoring costs for the Competent Authorities, but we are not able to disaggregate this from the incremental costs implied by the Regulation itself.

The summary tables below provide an overview of our estimates.

Table 1: Potential Costs of the Technical Standards

Provision	Cost driver	Nature of cost	Bearer of cost	Lower bound	Upper bound
<i>Price falls</i>	Monitoring of price falls in different asset classes	One-off and on-going	Competent Authorities	Not quantified (cannot disaggregate from Regulation)	Not quantified (cannot disaggregate from Regulation)

Table 2: Potential Benefits of the Technical Standards

Provision	Benefit driver	Nature of benefit	Beneficiary	Lower bound	Upper bound
<i>Price falls</i>	Defined approach tailored to asset classes promotes flexibility and certainty	On-going	Industry	Not quantified	Not quantified

Context and the Counterfactual

1. The aim of this study is to assess the expected costs and benefits of ESMA's proposed technical standards relating to the method for calculating the price falls that would trigger a decision by the Competent authority on whether to intervene (or not) in accordance with Article 23 of the Regulation of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (the Regulation).
2. The context and the baseline scenario for our analysis are the same as the ones used for the cost-benefit analysis conducted for the ESMA draft technical standards on agreements, arrangements and measures to ensure settlement, the information provision and the determination of principal trading venue (Ref: ESMA/2012/2228)¹⁶.
3. The incremental impacts of the proposed technical standards (as set out in the Public Consultation¹⁷) will be assessed against this baseline.

Mechanisms of Economic Effect and Cost-benefit Analysis on the method of calculation of the fall for liquid shares and other financial instruments

Introduction

4. ESMA pursues sound evidence and robust cost-benefit analysis on draft technical standards relating to the Regulation on short selling and certain aspects of credit default swaps (CDS).
5. The technical standards relate the method for calculating a significant price fall in non-liquid financial instruments and a 10 per cent fall in liquid shares (Article 23(8) of the draft Regulation). Below we present our analysis of the mechanisms of economic effect for both the costs and the benefits.
6. The methods of calculation proposed in the standards concern various instruments, namely shares, sovereign and corporate bonds, other non-derivative instruments and derivatives instruments.
7. However, the extent to which significant price falls would be triggered and the subsequent identification of the cases that may result in a regulatory intervention is beyond the scope of these technical standards. The levels of the relevant thresholds will be defined in the delegated acts to be adopted by the Commission¹⁸ whereas the identification of falls triggering intervention will only be established post-implementation of the Regulation and may be specific to the Competent Authority and to overall market conditions.

Potential costs

8. The main costs would be for the regulators to establish a system for calculating and monitoring the price falls, as defined in the technical standards.

¹⁶ See Section 1 of Appendix II of the Final Report - Draft technical standards on the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (ESMA/2012/228)

¹⁷ Available at: <http://www.esma.europa.eu/system/files/2012-98.pdf>

¹⁸ Except for liquid shares, The 10 per cent price fall trigger is already set out in the Regulation.

9. Some data are more accessible and transparent than others. An equity price fall and the yield curve of a sovereign or yield of a corporate bond are relatively straightforward to monitor — indeed, the relevant data can be accessed from data providers. We assume that all of the Competent Authorities will have access to at least one such terminal, i.e. there will be no need to purchase additional data feeds on this account.
10. Where there is a single underlying and the underlying is a share, corporate bond or sovereign then the price of the underlying is the key determinant: it follows that the comments in the previous paragraph apply here. It is important to note that this means that thresholds tailored to individual derivatives do not need to be set, nor is an “average” threshold set that might either poorly reflect the nature of many derivatives (both setting off false alarms and missing significant falls) or even result in the skewing of future derivative design.
11. Some additional headcount would obviously be necessary at the Competent Authorities to establish a system of alerts, monitor price falls (and subsequently to investigate these). However this system cost and the additional headcount is implied — at least in part — by the Regulation itself rather than by the technical standard defining the method of calculation. To the extent that ESMA has designed the calculations around ready-made data sets and with a sensible reference point in terms of defining “significant” price changes (where asked to) it appears reasonable to conclude that a disaggregation of this uplift in headcount would be very heavily weighted towards the Regulation itself (which has already been subject to cost-benefit analysis).

Potential benefits

12. The overarching benefit is of creating an orderly and transparent mechanism for assessing the need to intervene or not — market participants can assess the price changes themselves if they wish to confirm the Competent Authorities’ calculations. Since the standard proposed maximizes objective determination of regulatory action, this avoids the discouragement of firms from participating fully in the market.
13. The technical standard excludes price falls associated with specific company actions. We would expect the natural starting point in any assessment of a price fall to assess the impact of such corporate actions: in consequence, the practical benefit of this exclusion may be rather limited in terms of saved time and expense. Again, the main benefit is probably of regulatory certainty.

Annex IV

Draft Regulatory Technical Standards

COMMISSION DELEGATED REGULATION (EU) No .../..

supplementing 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 with regard to the method of calculation of the fall in value for liquid shares and other financial instruments

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to 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 swaps¹, and in particular Article 23(8) thereof,

Whereas:

- (1) The method of calculation of the significant fall in value of financial instruments contained in Section C of Annex I of Directive 2004/39/EC of the European Parliament and Council on markets in financial instruments should be adapted to the various ways in which that fall is reflected depending on the type of financial instrument concerned. That method can take the form of an actual fall in price of the financial instrument, of an increase in the yield of a corporate or in the yield across the yield curve for sovereign issuers.
- (2) This Regulation is based on the draft regulatory technical standards submitted by ESMA to the Commission.

¹ OJ L 86, 24.3.2012, p. 1



ESMA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010.

HAS ADOPTED THIS REGULATION:

Article 1

Subject Matter

This Regulation defines the method of calculation of the 10 % fall in value for liquid shares and of the fall in value specified by the Commission pursuant to Article 23(5) and (7) of Regulation (EU) No 236/2012.

Article 2

Method of calculation of the fall in value for shares

- 1) For a share traded on a trading venue, the fall in value shall be calculated from the official closing price of the previous trading day at that trading venue defined according to the applicable rules of that trading venue.
- 2) The method of calculation shall exclude any downward movement of a price resulting exclusively from a split or any a corporate action or similar measures adopted by the issuer on its issued share capital which can result in an adjustment of the price by the relevant trading venue.

Article 3

Method of calculation of the fall in value for other non-derivative financial instruments

- 1) A significant fall in value for financial instruments other than shares and not falling into the categories of derivatives listed in points (4) to (10) of Section C of Annex 1 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments² shall be calculated according to the method in paragraphs 2, 3 and 4.
- 2) For a financial instrument for which the significant fall in value referred to in Article 23(7) of Regulation (EU) No 236/2012 is measured in relation to a price on the relevant trading venue, that fall shall be calculated from the official closing price at the relevant trading venue defined according to the applicable rules of that trading venue.

2 OJ L 145, 30.4.2004, p. 1.



- 3) For a financial debt instrument issued by a sovereign issuer for which the significant fall in value referred to in Article 23(7) of Regulation (EU) No 236/2012 is measured in relation to a yield curve, that fall shall be calculated as an increase across the yield curve in comparison with the yield curve of the sovereign issuer at the close of trading of the previous trading day, as calculated based on data available for the issuer on that trading venue.
- 4) For a financial instrument for which the significant fall in value referred to in Article 23(7) of Regulation (EU) No 236/2012 is measured in relation to a variation of the yield, that fall shall be calculated as an increase of the current yield as compared to the yield of that instrument at the close of trading of the previous trading day, as calculated based on data available for that instrument on that trading venue.

Article 4

Method of calculation of significant fall in value for derivatives

A significant fall in value for financial instruments falling under the categories of derivatives listed in points (4) to (10) of section C of Annex 1 of Directive 2004/39/EC and which have a sole underlying financial instrument that is traded on a trading venue and for which a significant fall in value has been specified in accordance with Article 2 or Article 3, shall be calculated by reference to the significant fall in value of the underlying financial instrument.

Article 5

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

It shall apply from 1 November 2012.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission

The President

On behalf of the President



[Position]

Annex V: Tables on outstanding sovereign debt

Total Debt Outstanding end of 2010	Alternative percentage thresholds						
	Euro	0,025%	0,050%	0,100%	0,250%	0,500%	1,000%
Estonia	0	0	0	0	0	0	0
Latvia	1 932 000 000	483 000	966 000	1 932 000	4 830 000	9 660 000	19 320 000
Bulgaria	3 647 000 000	911 750	1 823 500	3 647 000	9 117 500	18 235 000	36 470 000
Malta	3 989 000 000	997 250	1 994 500	3 989 000	9 972 500	19 945 000	39 890 000
Luxembourg	4 000 000 000	1 000 000	2 000 000	4 000 000	10 000 000	20 000 000	40 000 000
Cyprus	7 833 000 000	1 958 250	3 916 500	7 833 000	19 582 500	39 165 000	78 330 000
Lithuania	8 721 000 000	2 180 250	4 360 500	8 721 000	21 802 500	43 605 000	87 210 000
Slovenia	11 741 000 000	2 935 250	5 870 500	11 741 000	29 352 500	58 705 000	117 410 000
Romania	18 012 000 000	4 503 000	9 006 000	18 012 000	45 030 000	90 060 000	180 120 000
Slovakia	25 749 000 000	6 437 250	12 874 500	25 749 000	64 372 500	128 745 000	257 490 000
Czech Republic	53 634 000 000	13 408 500	26 817 000	53 634 000	134 085 000	268 170 000	536 340 000
Hungary	71 896 000 000	17 974 000	35 948 000	71 896 000	179 740 000	359 480 000	718 960 000
Finland	75 152 000 000	18 788 000	37 576 000	75 152 000	187 880 000	375 760 000	751 520 000
Denmark	92 647 000 000	23 161 750	46 323 500	92 647 000	231 617 500	463 235 000	926 470 000
Ireland	93 498 000 000	23 374 500	46 749 000	93 498 000	233 745 000	467 490 000	934 980 000
Sweden	128 000 000 000	32 000 000	64 000 000	128 000 000	320 000 000	640 000 000	1 280 000 000
Portugal	151 775 000 000	37 943 750	75 887 500	151 775 000	379 437 500	758 875 000	1 517 750 000
Austria	162 956 000 000	40 739 000	81 478 000	162 956 000	407 390 000	814 780 000	1 629 560 000
Poland	167 273 000 000	41 818 250	83 636 500	167 273 000	418 182 500	836 365 000	1 672 730 000
Greece	286 455 000 000	71 613 750	143 227 500	286 455 000	716 137 500	1 432 275 000	2 864 550 000
Netherlands	306 470 000 000	76 617 500	153 235 000	306 470 000	766 175 000	1 532 350 000	3 064 700 000
Belgium	341 192 000 000	85 298 000	170 596 000	341 192 000	852 980 000	1 705 960 000	3 411 920 000
Spain	540 639 000 000	135 159 750	270 319 500	540 639 000	1 351 597 500	2 703 195 000	5 406 390 000
Germany	1 065 252 000 000	266 313 000	532 626 000	1 065 252 000	2 663 130 000	5 326 260 000	10 652 520 000
France	1 228 971 000 000	307 242 750	614 485 500	1 228 971 000	3 072 427 500	6 144 855 000	12 289 710 000
United Kingdom	1 257 308 000 000	314 327 000	628 654 000	1 257 308 000	3 143 270 000	6 286 540 000	12 573 080 000
Italy	1 526 334 000 000	381 583 500	763 167 000	1 526 334 000	3 815 835 000	7 631 670 000	15 263 340 000

Source: Responses from members of the EFC - Sub-Committee on EU Government Bonds and Bills Markets (2011)

As of 31 December 2011

German federal states	Total Debt Outstanding (in €)	0.010%	0.025%	0.050%	0.100%	0.250%	0.500%
Berlin, State of	38,049,300,000	3,804,930	9,512,325	19,024,650	38,049,300	95,123,250	190,246,500
Hessen, State of (Hesse, State of)	27,618,000,000	2,761,800	6,904,500	13,809,000	27,618,000	69,045,000	138,090,000
Hamburg, State of (Freie und Hansestadt Hamburg)	8,015,300,000	801,530	2,003,825	4,007,650	8,015,300	20,038,250	40,076,500
Rheinland-Pfalz, State of	19,016,100,000	1,901,610	4,754,025	9,508,050	19,016,100	47,540,250	95,080,500
Baden-Wuerttemberg, State of	16,309,000,000	1,630,900	4,077,250	8,154,500	16,309,000	40,772,500	81,545,000
Saarland, State of	3,783,300,000	378,330	945,825	1,891,650	3,783,300	9,458,250	18,916,500
Schleswig-Holstein, State of	12,630,000,000	1,263,000	3,157,500	6,315,000	12,630,000	31,575,000	63,150,000
Thuringen, State of	4,041,700,000	404,170	1,010,425	2,020,850	4,041,700	10,104,250	20,208,500
North Rhine-Westphalia, State of (Nordrhein-Westfalen)	76,794,400,000	7,679,440	19,198,600	38,397,200	76,794,400	191,986,000	383,972,000
Bavaria, State of (Bayern)	10,164,800,000	1,016,480	2,541,200	5,082,400	10,164,800	25,412,000	50,824,000
Brandenburg, State of	11,360,600,000	1,136,060	2,840,150	5,680,300	11,360,600	28,401,500	56,803,000
Lower Saxony, State of (Niedersachsen)	31,370,000,000	3,137,000	7,842,500	15,685,000	31,370,000	78,425,000	156,850,000
Bremen, State of	10,584,000,000	1,058,400	2,646,000	5,292,000	10,584,000	26,460,000	52,920,000
Saxony, State of (Sachsen-Freistaat)	769,200,000	76,920	192,300	384,600	769,200	1,923,000	3,846,000
Saxony-Anhalt, State of (Sachsen-Anhalt)	10,268,000,000	1,026,800	2,567,000	5,134,000	10,268,000	25,670,000	51,340,000
Mecklenburg-Vorpommern	4,384,500,000	438,450	1,096,125	2,192,250	4,384,500	10,961,250	21,922,500
Sum of all federal states	285,158,200,000	28,515,820	71,289,550	142,579,100	285,158,200	712,895,500	1,425,791,000

As of 18 April 2012

- EFSF²¹: Up to now issues amount to € 72,5 Billion (€ 54.5 billion for long term and € 18 billion for short term)
- EIB : issued debt amounts to approximately € 948 billion (USD 1242 billion)

²¹ Guarantee commitments of € 780 billion but lending capacity of € 440 billion.