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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the evaluation of the Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps

(Text with EEA relevance)

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1. INTRODUCTION

This report to the European Parliament and the Council (hereinafter: "**Report**") provides for the evaluation of the Regulation on short selling and certain aspects of credit default swaps (EU) No 236/2012 (hereafter: "**SSR**"). The European Commission is required under Article 45 SSR to report to the European Parliament and the Council on the appropriateness and impact of certain provisions of the SSR. This report covers the points listed in Article 45 SSR.

This Report was prepared in light of discussions with the competent authorities and ESMA. On 22 October 2012 the Commission formally mandated ESMA to carry out a quantitative analysis of the available short selling data and a consultation of competent authorities and market participants. On the basis of this work, ESMA issued its technical advice on the evaluation of the SSR on 3 June 2013 (hereinafter: "**ESMA's Report**").[1]

2. APPROPRIATENESS OF THE NOTIFICATION AND DISCLOSURE PROCEDURES

2.1. Notification and public disclosure of significant net short positions in shares

According to ESMA's findings, between 1 November 2012 and 28 February 2013, there were 12,603 notifications reported to competent authorities on 970 different shares in 18 Member States. Notably, 74% of these notifications were within the 0.2% and 0.5% thresholds; the other 26% stood above 0.5% and were therefore disclosed to the public. During that period only a few holders shorted a large number of shares, with 75% of holders shorting seven different shares or less. Short position holdings were quite concentrated, as ten entities held more than 28% of all the positions reported in the period (ESMA's Report, § 17 and 19).

ESMA considers that the current thresholds of the SSR are well-suited to generate both meaningful information for competent authorities and the market as well as a proportionate compliance burden on investors. ESMA considers that the current reporting thresholds and incremental levels for shares are appropriate and should remain unchanged (ESMA's Report, § 31 and 32).

The Commission concurs with ESMA's conclusion that the notification and public disclosure thresholds of significant net positions in shares appear to be well-calibrated and appropriate and sees, at this stage, no compelling evidence for the need to change them or the current methodology for calculating the net short positions in shares.

[1] Final Report. ESMA's technical advice on the evaluation of the Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps. ESMA/2013/614.

2.2. Reporting of significant net short positions in sovereign debt and notification of uncovered positions in sovereign CDS

Between 1 November 2012 and 28 February 2013, ESMA has established that only a small number of notifications (148) were made to competent authorities on 13 sovereign entities in 11 Member States. There were 26 holders that reported 39 short positions, on which 109 modifications occurred during the period (ESMA's Report, § 50 and 51).

ESMA considers that the very low number of notifications received on sovereign debt, compared to the number of notifications received on shares, might mean that the threshold was set too high, or could be attributed to the use of a duration adjusted method for this reporting. ESMA considers the nominal method more appropriate than the duration adjusted method for calculating net short positions in sovereign debt. ESMA suggests that, should the duration adjusted approach be maintained, then the initial thresholds would need to be revised accordingly. ESMA also suggests moving to an annual review instead of the current quarterly review (ESMA's Report, § 52 and 57-59).

The Commission takes note of the relatively low level of short selling notifications in sovereign debt compared to the number of notifications received on shares, as well as the pros and cons of both the duration adjusted and nominal methods. However, given the limited period of time since the application of the SSR and the consequent lack of data, the Commission sees, at this stage, no compelling evidence justifying revisions of the SSR framework in this area.

3. IMPACT OF INDIVIDUAL DISCLOSURE REQUIREMENTS

ESMA reports that 224 holders publicly disclosed 1090 short positions on 427 shares, with the bulk of disclosures from the UK, followed by France and Sweden. Among the 3,508 notifications made public by these 224 holders, 90% were from holders domiciled in the UK or the US, and the ten biggest holders accounted for 37.5% of those published notifications (ESMA's Report, p. 60-62).

Competent authorities considered the individual reporting thresholds to be appropriate, but they received mixed views from market participants. ESMA also comments that market participants may tend to avoid crossing the notification threshold so as to remain under the 0.5% thresholds to avoid disclosing information on short selling activities. (ESMA's Report, p§ 22 and 29).

In terms of the general impact of the Regulation, ESMA notes that overall there was a slight decline in the volatility of EU stocks compared to US stocks. There were mixed effects on liquidity and price discovery seems to have decreased compared to the period before the entry into force of the Regulation. However, ESMA cautions that the analysis should be interpreted with due care given the short time span, the empirical limits and the difficulty in identifying the specific effects of the Regulation (ESMA's Report, §10-11).

As noted in section 2.1, ESMA's Report does not recommend any changes to the disclosure thresholds. The Commission agrees with ESMA that no changes in the individual disclosure requirements are required.

4. APPROPRIATENESS OF DIRECT, CENTRALISED REPORTING TO ESMA

The majority of competent authorities would prefer not to introduce a centralised reporting mechanism and prefer to maintain current arrangements (ESMA's Report, § 64). They argue that a centralised EU-wide reporting mechanism could potentially make national monitoring

and enforcement more difficult and less effective. In contrast, a minority of competent authorities and some market participants support and acknowledge the benefits of a centralised reporting mechanism (ESMA's Report, § 62 and 64). ESMA recommends no change to the SSR and its implementing texts in relation to the reporting mechanism (ESMA's Report, § 66).

In light of the above, the Commission considers that the current system of reporting at national level is functioning well and that direct centralised reporting does not appear, at this stage, to offer substantial benefits.

5. RESTRICTIONS AND REQUIREMENTS ON THE UNCOVERED SHORT SELLING IN SHARES, SOVEREIGN DEBT AND SOVEREIGN CDS

5.1. Restrictions on uncovered short selling of shares and sovereign debt

ESMA evaluated the operation of the restrictions on uncovered short selling by assessing the impact on securities lending and the number of settlement fails. ESMA reports that activity in securities lending markets has been lower since the entry into force of the SSR, though it has recovered since January 2013. However, ESMA points out that regulatory data on securities lending is non-existent, so this analysis may not be comprehensive enough.

The restrictions would be expected to reduce settlement fails. Indeed, ESMA reports that settlement fails seem to have decreased since the entry into force of the Regulation, evidenced by fewer settlement fails on European equities based on volumes and value, whereby average settlement fails fell respectively by 0.5 and 1 percentage points (ESMA's Report, § 77). ESMA concludes that the application of the SSR was followed by an increase in settlement discipline (ESMA's Report, p. 21-23. See also section 5.3).

Given the above empirical evidence, ESMA suggests that no substantial changes in this area are warranted at this stage. However, ESMA proposes some changes to Articles 12 and 13 SSR to enable short sellers to obtain the confirmations necessary to undertake a short sale from parties within the same legal entity provided that those parties meet the necessary conditions, and some refinements in the Commission Implementing Regulation (EU) No 827/2012 (ESMA's Report, § 83-85).

The Commission concurs with ESMA's conclusions that no major revisions of the SSR framework in this area are required at this stage.

5.2. Restrictions and requirements pertaining to uncovered sovereign CDS transactions

By measuring the effect of the uncovered CDS ban on sovereign borrowing conditions by CDS spreads and sovereign bond yields, ESMA has observed a slight decrease in Member States' sovereign CDS spreads after the introduction of the prohibition on uncovered sovereign CDS transactions. The effect of the ban was found to result in a reduction of around 26 basis points in the CDS spread (ESMA's Report, § 100). ESMA concluded that as a whole, the entry into application of the SSR did not seem to have had a compelling impact on the activity in the sovereign CDS market, with the exception of sovereign CDS indices, for which a sharp decline was observed. ESMA points out that there seems to have been no noticeable adverse effects on EU sovereign debt markets. However, there has been a decline in activity for sovereign CDS in a few Member States and sovereign CDS indices (ESMA's Report, § 112).

Overall, ESMA does not see compelling evidence warranting major changes in the SSR provisions dealing with sovereign CDS at this stage, noting that it may be too early to draw firm conclusions (ESMA's Report; § 112).

The Commission is of the view that there was only a very short period of experience of the effect of the SSR on which to base these conclusions. Given the above, the Commission considers that the restrictions and requirements on uncovered sovereign CDS transactions remain appropriate.

5.3. Settlement discipline including buy-in procedures

Market participants reported a general improvement in settlement discipline in shares since the entry into application of the SSR, Overall, the number of buy-ins and buy-in attempts across the Union has increased by 35% since the application of the SSR. However this increase could largely be attributed to one particular Member State.

ESMA considers that the settlement discipline requirements, notably the buy-in procedures, could be more appropriately addressed in a single, horizontal piece of legislation (ESMA's Report, § 88-91). In particular, ESMA is of the view that the forthcoming Regulation on central securities depositories (CSD)[2] provides a more efficient tool to set out a more detailed regime and to ensure a level-playing field in the application of the buy-in and settlement penalties procedures.

The Commission agrees that the settlement discipline requirements, notably the buy-in procedures, could be more appropriately dealt with in the forthcoming Regulation on CSD, provided that a more comprehensive horizontal approach is achieved.

5.4. Other aspects related to the operation of restrictions

Based on the feedback from the market participants and competent authorities on the improvements in settlement performance, ESMA considers that the introduction of the restrictions on uncovered short selling had a noticeable impact in reducing the incidence of settlement failures in share transactions. Regarding the impact of the "locate rule", ESMA's analysis of data on securities lending during 2012 and the first part of 2013 shows that activity in securities lending markets has been lower since the entry into application of the SSR, though it has recovered since January 2013.

Overall, ESMA takes the view that no substantial changes to the requirements in this area are warranted at this stage. However, ESMA proposes making some minor changes in the details of Articles 12 and 13 SSR (such as allowing internal lending desks rather than third parties) to provide locates and revisiting the definition of liquid shares for the purpose of locate arrangements at a later stage (ESMA's Report, § 83).

The Commission agrees with ESMA's conclusion that the operation of the restrictions and requirements related to the transparency of net short positions and uncovered short sales do not at this stage suggest any evidence of major deficiencies or malfunctionning of the SSR in this area.

6. FUNCTIONING OF THE MARKET MAKING EXEMPTION UNDER THE SSR

The application of the market making exemption under the SSR is linked to the operation of obligations contained in Chapters II and III of the SSR and therefore to the evaluation carried

[2] The Commission's proposal (COM(2012) 73 final) for a Regulation on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC of 7 March 2012 is currently under consideration by the European Parliament and the Council.

out in this Report. ESMA Guidelines on market making exemption have been applied since April 2013.

ESMA reports that the majority of competent authorities considered that the exemption would allow liquidity provision without permitting circumvention, however some thought it could lead to a decline of liquidity provision. Market participants expressed concerns that the limited scope of the exemption restricted their ability to offer OTC market making in instruments such as interest rate swaps and non-listed derivatives (ESMA's Report, § 140- 144).

Competent authorities generally considered the procedure for notifications of intent to use the exemption to be appropriate, although a number were concerned about a heavy workload. Market participants considered that the requirement to notify on an instrument by instrument basis was cumbersome and impracticable. Concerns were also expressed about the risks of an uneven playing field as a result of different authorities processing notifications for exemptions at different speeds (ESMA's Report, § 145-146).

ESMA proposes to change the text of the SSR and re-consider the scope of the market making exemption, as well as making certain changes in either technical standards or delegated acts (ESMA's Report, § 149). In particular, ESMA recommends revisiting the scope of, and the conditions for, the exemption while still respecting the underlying purpose and rationale of the SSR (ESMA's Report, § 152-156). The Commission considers, however, that the concerns expressed in ESMA's Report on the scope of, and the conditions for, the market making exemption can only be meaningfully assessed once an appropriate period of time has elapsed since the entry into force of the SSR so sufficient experience in applying the SSR can support any proposal for revision.

Furthermore, according to ESMA Guidelines compliance table, published on 19 June 2013, regarding the exemption for market making activities and primary market operations under the SSR (ESMA/2013/765), the competent authorities of five Member States have explained their non-compliance with aspects of the Guidelines by referring to their divergent views on a number of issues, such as the scope of the covered instruments and the conditions for granting the market maker exemption. [3]

The Commission cautions that the non-compliance with the ESMA Guidelines by some competent authorities is bound to create a situation whereby the SSR is applied in a divergent manner, resulting in an unlevel playing field across the Union. In addition, different criteria applied to the reassessment of previously granted market maker exemptions can also lead to a divergent application of that exemption. These divergences may consequently distort competition and diminish the effectiveness of the SSR framework.

The Commission considers that a consistent application of the SSR framework and, in particular, of the market making exemption in all Member States is crucial in ensuring a level playing field and consistency of market practices across the Union. The creation of an unlevel playing field in the Union could undermine the main objective of the Regulation, *i.e.* ensuring the proper functioning of the internal market for financial services, and ensuring a high level of consumer and investor protection.

Against this background, the Commission sees, at this stage, no compelling evidence for revisions of the SSR framework in this area. Where the Commission establishes that the SSR, and in particular the market making exemption, is applied in a manner which is in breach of the SSR, the Commission will take appropriate follow-up measures.

[3] On 16 June 2013, ESMA published a table of compliance table with ESMA's Market Making Guidelines (ESMA/2013/765).

7. INTERVENTION POWERS UNDER THE SSR

According to Article 23 SSR, the competent authorities have the right to take certain emergency measures in the event of a significant price fall in a financial instrument. So far this power to temporarily restrict short selling or otherwise limit transactions in a financial instrument has been exercised by two Member States only (Italy and Portugal). According to the feedback of some market participants, the bans created confusion and uncertainty for participants and led to an immediate impact on liquidity and price efficiency. Furthermore, the measure caused investigative costs for market participants to seek the information due to differences in the content, in timing of the releases during the trading day in the concerned countries and due to lack of clarity about the scope of instruments (ESMA's Report; § 190).

It has come to the attention of the Commission that in cases where a competent authority imposed a temporary "significant price fall" short selling ban on certain shares, similar bans on the same shares were not imposed by competent authorities of other Member States in which those shares were also traded, or they adopted divergent measures. This resulted in the ban being in force in some Member States and not being applied in other Member States. In certain other cases, even different competent authorities within one Member State have acted differently in deciding whether or not to impose a short selling ban applied by a Member State.

ESMA suggests that for the Article 23 measures to be workable, less complex and less resource intensive, the competent authorities of the most relevant market in terms of liquidity for a particular instrument should be allowed to exercise their judgment as to if and when a temporary measure to ban short selling or limit trading in a particular instrument is necessary, without having to implement a mechanism based on thresholds for significant falls in price (ESMA's Report, § 209).

The Commission is of the view that the SSR provides competent authorities with an effective and complete framework of rules to apply short selling bans in a consistent and efficient manner. Competent authorities should therefore ensure that a consistent approach is taken and their powers are effectively used in a way that avoids potential inconsistent applications of short selling bans, thus contributing to the achievement of the objectives sought by the SSR. For these purposes, competent authorities must ensure that the procedure set out in Article 26(4) SSR is fully observed, enabling ESMA to inform all other relevant competent authorities of a banning measure taken in accordance with Article 23 SSR. The observance of this procedure should also enable competent authorities to assess whether measures taken by other competent authorities are consistent to each other.

Regarding the appropriateness of thresholds specified in Article 23 SSR and Article 23 of the Commission Delegated Regulation (EU) No 918/2012, ESMA considers that not all current thresholds set to identify a significant fall in prices for all categories of instruments should be maintained and that some thresholds should be changed or removed (ESMA's Report, § 210-211). According to ESMA, the thresholds for corporate and sovereign bonds should be reconsidered or removed, and no thresholds are necessary for listed UCITS (other than ETFs) or for commodity derivatives (ESMA's Report, § 211).

Given the limited experience with the application of these thresholds, the Commission does not deem it necessary to revise them or to reconsider thresholds for significant price falls for UCITS and commodity derivatives.

With respect to emergency measures in case of adverse events or developments which constitute a serious threat to financial stability or market confidence under Articles 18, 19, 20

and 21 SSR, ESMA is of the view that the provisions of the SSR are generally necessary and appropriate. The Commission concurs.

8. CONCLUSIONS

The Commission considers that, based on the limited data available so far, it can be said that the SSR has had a positive impact in terms of greater transparency of short sales and reduced settlement failures, and a relatively mixed economic impact. There is no compelling evidence of a substantial negative impact of the SSR in terms of reduced liquidity of sovereign CDS. ESMA's Report does not suggest any major negative economic impacts of the SSR which, in the Commission's view, would warrant a revision of the SSR in the short term. Overall, the empirical evidence available shows that the SSR has had some beneficial effects on volatility, mixed effects on liquidity and led to a slight decrease in price discovery.

As ESMA itself notes, the conclusions in its Report should be taken with caution given the short time available for evaluation since the SSR entered into application and the consequent lack of data. The competent authorities and the market participants acknowledge that this short time scale and limited data backed assessment make it difficult to draw precise conclusions as to whether the SSR's goals of improving the conditions of market functioning and ensuring a high level of investor protections have been achieved (ESMA's Report, § 12-13). In addition, the Market Making Guidelines adopted by ESMA have only been applicable since April 2013.

Although ESMA has made some recommendations for adjustments to the SSR, notably concerning the locate rule, market making exemption and the power of competent authorities to impose short term bans, ESMA has advised the Commission to revisit the assessment of the SSR and its implementing texts at a later stage, once more data and greater experience will be available. ESMA has also drawn the Commission's attention to the cost implications that changes in the legislative framework so soon after its entry into application might have on investors and on competent authorities. Finally, the overall quantitative analysis of the effects of the SSR presented in ESMA's Report is subject to certain qualifications that have substantial effect on the way in which the impact of the SSR is to be interpreted. In particular, the methods used by ESMA in its technical assessment of the SSR are subject to model risk and empirical limits.[4] According to ESMA, there is also a risk that the analysis captures nevertheless certain external factors that may distort the findings outlined therein.

The Commission is therefore of the view that it is too early, based on available evidence, to draw firm conclusions on the operation of the SSR framework which would warrant a revision of the legislation at this stage.[5] The Commission will, therefore, continue monitoring the application of the SSR. In order to ensure a smooth functioning of the short selling legal framework, the Commission considers that a new evaluation of the appropriateness and impact of the SSR, similar in scope to that specified in Article 45 SSR, could be carried out based on more empirical data and evidence and once the competent authorities have accumulated sufficient regulatory experience of applying the SSR. Such an evaluation could be concluded by 2016, *i.e.* three years after the entry into application of the SSR. Such an analysis of the effects and impact of the SSR should be based on the input of ESMA, the analysis of available data and the feedback of competent authorities and market participants.

[4] This qualification was also emphasised in ESMA's Report, § 8.

[5] In this context, it is important to note the pending case before the Court of Justice of the European Union in case C-270/12 in which the United Kingdom sought the annulment of Article 28 of the SSR.