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ESMA consultation paper on short selling (ESMA/2012/30)

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees and in this case the response has been prepared by a working party of the CLLS Company Law Committee comprising senior and specialist corporate lawyers.

We welcome the opportunity to respond to ESMA consultation paper ESMA/2012/30.

Question 1

We feel that the list is helpful and fulsome, but do not agree that an exhaustive list is appropriate. As with any exhaustive list, there is a danger that certain types of agreement which should be included are omitted or that further developments are not covered. In any event, there is a catch-all suggested at draft Article 5(1)(f) of the draft implementing regulation (the "Implementing Regulation") which would cover what is needed in generic terms (as indeed would draft Article 12.1(b) of the November 2011 compromise draft of the Regulation itself, without any elaboration by ESMA). If a list is to be used, we suggest that it is a non-exhaustive list of examples only.

Question 2

See above in respect of exhaustive/non-exhaustive lists. We make the following points in the event that a list of some sort is used.

In respect of draft Article 5(c), we note that Article 2 of the underlying Regulation (the Regulation on short selling and certain aspects of credit default swaps adopted 15 November 2011) (the "Underlying Regulation") specifically excludes securities lending from the definition of short selling. We suggest that (c) also covers securities lending in a similar manner and in respect of both repurchase agreements and securities

lending explains that this refers to the right of the investor under those agreements to receive back the shares.

We query what draft Article 5(1)(d) of the Implementing Regulation "standing agreements or rolling facilities" is meant to cover. Is it intended to cover prime brokerage agreements? We consider the uncertainty surrounding such terminology to be another reason for avoidance of exhaustive lists.

In relation to draft Article 5(1)(e), you could specifically refer to subscription warrants and provisional allotment letters as being examples of "agreements relating to subscription rights".

Question 3

We do not comment on any additional costs that may be entailed as that is a matter for trade bodies, who are better placed to respond on behalf of market participants. However, we note that the consultation paper was issued on 24 January 2012 and requires a response by 13 February 2012. We regret that this is a very short timeframe for market participants and their trade bodies to adequately consider the paper and react.. We share the objective of harmonising pan-European disclosure and procedural requirements in this area, so consider it unfortunate that the paper is unlikely to have received sufficient scrutiny in that timeframe. We also note that, as a result of the expedited timetable, there is no impact assessment, the absence of which again may make it harder for relevant bodies to establish views on the consultation..

Question 4

Please can you include credit institutions and insurers (each EU and third country) in the list of third parties who can lend.

We question the conclusions reached in paragraph 19 of the consultation paper. We do not think that a trading desk entering into a sale and then entering into a covering transaction with its own lending desk within the same legal entity should be treated as a short sale for these purposes. The legal entity concerned has not made any short sale on an aggregate basis, because it (as opposed to the relevant trading desk) owns the share that is sold. Even if you do not agree with our analysis, the Underlying Regulation does not mention that a third party has to be independent in a legal sense i.e. a separate legal entity. Following your analysis, an arrangement made with a separate legal entity within the bank's group structure would be acceptable which seems a somewhat artificial and surprising distinction. We also think that your comment cuts across the Chinese wall structures established by banks to deal with conflicts and other issues and implies that Chinese walls are not effective.

Draft article 8(g) of the Implementing Regulation permits third party equivalence i.e. the third party may be "any other person subject to authorisation or registration requirements" where that person is authorised or registered with "an equivalent third country authority" "which participates in the management of the borrowing or purchasing or the relevant securities..." However, the same equivalence point has not been applied to the third parties set out at 8(a) to (f). This means that a bank not authorised in the EU but only authorised in, for example, the United States could not be an appropriate third party unless it can meet the test set out in 8(g).

Question 5

No comment.

Question 6

Please see our comments in answer to question 4 above.

Question 7

Subject to our answers below to questions 8 and 9, we agree generally with the approach proposed by ESMA but make the following suggestions.

It would be helpful if the arrangements and measures required could be set out in a way which is more immediately accessible to market participants, both in ESMA's response to consultation, and in the text of the implementing technical standards. In particular, in the draft Implementing Regulation, the interaction between Article 6(1)(a), 6(1)(b) and 6(1)(c) is not obvious. Our understanding of the requirements can be summarised as follows:

1. Short position is in illiquid shares, not intraday. Requirement: locate and put on hold.

2. Short position is intraday (whether in illiquid or liquid shares) and this is indicated by the investor. Requirement: locate and obtain confirm from a third party that the share is easy to borrow or acquire. There is no need to put the share on hold.

3. Short position is in liquid shares, not intraday. Requirement: locate and obtain confirmation that the share is easy to borrow or acquire. There is no need to put the share on hold.

We are concerned about the requirement on stock lenders to make confirmations about their ability to lend "taking into account...market conditions" (references in Article 6(1)(a), (b) and (c)), particularly when there is considerable volatility in equity markets. It is not clear what extent of due diligence is required of lenders, what degree of confidence they should be expected to have, and over what period. We suggest that ESMA should explore the practicalities with key market participants.

We believe that the requirement on the investor in Article 6(1)(b)(iii) should be to carry out periodic reconciliations (including intra-day) to satisfy itself that the amount of the short sale is covered by purchases. A requirement for "continuous monitoring" is impractical.

It would also be helpful to state expressly in Article 6(2) that it is not necessary that each and every locate confirmation includes the statements and confirmations from the third party contemplated by Article 6 *in full and in long-hand*, and that it would be permissible to provide in a framework contract that the use by the third party of agreed codes, designations or abbreviations (provided they are in durable medium) will signify which statements are made and which confirmations are given.

Question 8

We do not have any views on this issue and suggest that you consult market practitioners.

Question 9

Again, we suggest that you consult with market practitioners to ascertain whether using the MiFID definition of "liquid shares" is the correct one.

Question 10

No response.

Question 11

We agree that there should be one standard format for notifying the relevant competent authority for each type of instrument.

We note that, broadly speaking, the form set out in Annex 1 to the Implementing Regulation follows the format adopted in the United Kingdom by the UK Financial Services Authority. We are aware that further draft technical standards will be published in relation to the position of investment managers and we draw your attention to footnote 2 of the UK form which explains how the form should be filled in by discretionary and non-discretionary investment managers. We suggest that the guidance set out in footnote 2 is followed by ESMA when explaining how the EU form should be filled in.

Question 12

We agree that there should be one standard form of public disclosure of information on significant net short position in shares.

Question 13

We agree with the proposed way to identify natural and legal persons.

Question 14

We agree with the proposed way to notify and disclose the size of the relevant position.

Question 15

We do not have any comments on the proposed way to identify the issuer. We think that the use of the ISIN code is sensible.

Question 16

We agree with the proposal to use the ISO 8601 2004 standard for specifying the date.

Question 17

We agree that this additional information should be provided.

Questions 18 and 19

We do not have any views on this issue and suggest that you consult market practitioners.

Question 20

We cannot currently foresee any other situation that might merit an update of the list of exempted shares within the two year effectiveness period, however, we note that the market is changing rapidly and future circumstances may arise such that the list needs to be updated more quickly.

In terms of the procedure for review of the list within the two years and the circumstances set out in draft Article 13 of the Implementing Regulation, we note that the list of triggering events in rather limited. We suggest that there is a process for either an issuer or a market participant to ask its competent authority to include its shares on the list of exempted shares or to remove the shares from the list. For example, an issuer's shares may not be included in the initial list if the issuer does an IPO in the initial two year period.

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