afme/ Finance for Europe

ISDA Safe, Efficient Markets

05 October 2012

European Securities and Markets Authority
CS 60747
103 rue de Genelle
75345 Paris Cedex 07
France

Dear Sir/Madam,

ESMA Consultation Paper on Exemption for Market Making Activities and Primary Market Operations under Regulation (EU) 236/2012 of the European Parliament and the Council on Short Selling and certain aspects of Credit Default Swaps

The Association for Financial Markets in Europe ("**AFME**")[1] and the International Swaps and Derivatives Association, Inc. ("**ISDA**")[2] thank the European Securities and Markets Authority ("**ESMA**") for the opportunity to comment on its Consultation Paper (the "**Consultation**") titled "Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps" (the "**Regulation**", "SSR', "Level 1").

The comments in this response reflect the membership of AFME and ISDA which together represent global and European banks and other significant participants in Europe's wholesale financial markets, many of whom serve as market makers to asset managers, insurance companies, pension funds, corporate, end users, sovereign debt management offices as well as other issuers, investors and market participants. AFME, ISDA and its members are keen to be a part of any future ongoing dialogue in relation to this issue and would welcome an opportunity to meet with you and discuss the concerns outlined in this document in more detail.

[1] AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website www.afme.eu.

[2] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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The primary focus of the consultation is on exemptions available under the Regulation for certain market making activities and primary market operations. Market making is at its heart the provision of liquidity and, as such, directly contributes to promote long-term growth in the capital markets. This activity is a vital cog in the efficient and effective running of the markets and more importantly contributes to a reduction in transaction costs for end-user investors, provides enhanced risk management options, and allows improved access to finance. We are concerned that ESMA's guidance on the 'exemption for market making activities and primary market operations' in its current form will prevent legitimate market making activities that nevertheless meet the tests of client servicing and hedging, and therefore have a damaging effect on liquidity and efficiency in the equity, sovereign debt and CDS markets – and also in markets where market makers are reliant on these instruments to hedge their risk positions. An optimal interpretation of the exemption would ensure that the definition facilitates the appropriate functioning, liquidity and accessibility of capital markets as well as responsible and prudent risk management. We support guidance that enables firms and competent authorities alike to firmly identify activities which facilitate client orders and trading requests. The ultimate consequence of reduced liquidity would be higher issuing costs for European companies and Member States, in particular smaller companies and those European Member States whose debt is already less liquid. In particular for sovereign CDS, if the use of CDS for hedging purposes becomes more costly or uncertain then Member States will have to compensate investors for the increased risk, leading to higher funding costs for sovereign and corporate debt.

Our members understand and support the principle that market makers are generally not expected to hold significant short positions other than for brief periods and that at the request of the Competent Authorities they may be asked to demonstrate why their activity falls within the definition of market making. Finally, we would like to note that market makers are not seeking to hide speculative or proprietary trading behind the exemption

We would thus recommend an exemption that is practical to implement in accordance with the Short Selling Regulation Level 1 text, supports the efficient functioning of EU markets, and reflects the needs of market participants who look to market makers to provide liquidity across a range of financial instruments at a reasonable cost.

In Part I below we set forth a number of our key recommendations and concerns. Part II explains certain general observation regarding the Regulation and Part III provides detailed responses to the specific questions asked in the ESMA Consultation Paper.

I. Key Recommendations and Concerns

A. *We recommend an activities-based market making exemption at Level 1 as being consistent with the constructions of the exemption at Level 1 and with existing market practices*

The exemption would apply to trading in any financial instrument where an investment firm is performing any of the quoting, client servicing and hedging activities listed in the exemption. This approach is consistent with existing practice and the CESR Report on Technical Details of the Pan-European Short Selling Disclosure Regime (Report CESR/10-453) and the CESR Report on a Model for a Pan-European Short Selling Regime (Report CESR/10-088). Therefore, most firms have scoped their implementation plans in keeping with this interpretation.

As the definition of market making is critical to effective client facilitation and market liquidity, and also as the concept is heavily related to MiFID 2 and other regulatory proposals globally, we believe that a narrow approach would go beyond the legislative intent as it would, in a practical sense, reduce liquidity and negatively affect the ability to facilitate client requests for trading, ultimately adversely impact the cost of and access to funding for corporates and sovereigns.

An approach which focuses on *specific instruments* only rather than relevant activities is in our view inconsistent with the construction of the exemption in the Regulation (particularly given the clear inclusion of client facilitation activities in the Level 1 definition of "market making activities", which are naturally led by client demand) and does not in our view constitute an effective framework.

We consider that the specific details of an instrument provide no meaningful information to competent authorities to make a determination as to whether a firm is acting in a market making capacity for the purpose of the Regulation. The key determination should focus on the *activities* that a firm is performing in connection with financial instruments.

In order to secure the exemption, firms would need to seek exemptions for a wide universe of financial instruments. Consequently, competent authorities would received exemption notifications for thousands of financial instruments. Further, firms will need to provide updates on a continuous basis, as such competent authorities will continue to be inundated with lists and details of individual instruments from firms on a frequent basis. We believe that it is unwieldy and less effective for competent authorities to manage and review.

Certain financial instruments are created and distributed expeditiously. If the exemption is interpreted on an instrument by instrument basis, compliance would result in a material time lapse of 30 days following creation of the new instrument, during which the market making activities exemption would be temporarily unavailable. This would result in unnecessary market confusion, and suggests that market making activity cannot occur in a particular instrument solely on the basis that it is a new instrument. On the contrary, market making activity is at its most fervent when new instruments (particularly sovereign bonds) have been created/issued.

On this latter point, new financial instruments are created daily. Firms would be compelled to provide daily notifications to their home competent authority in order for such instruments to be covered by the exemption. In the case of an IPO, for instance, the securities may not have an ISIN and/or the transaction may not be publically known 30 days before trading is to start with respect to the security. In addition, it will be nearly impossible for firms to provide an indication of expected daily/weekly volumes for new instruments (which is requested in the ESMA guidance in paragraph 69.b.ix).

We believe that IPOs and new issues and products will suffer from the requirement to give 30 days' notice to use the exemption. This may result in EU markets becoming a less attractive place to list shares and will impact on secondary market liquidity, particularly in the period shortly following the first period of trading where not all market makers will have been able to make the required notification. This will potentially make investors in the primary market less likely to buy.

Furthermore, a specific instrument by instrument approach would be likely to negatively impact liquidity in securities and sovereign CDS that have not been accepted as falling within the scope of the market-making exemption for the relevant financial institution, with the probable outcome of making it more difficult for corporate and sovereign issuers to finance themselves in the capital markets, which we believe not to be the aim of this Regulation.

In this context, it should be noted that the 30 day notification requirement (Article 17(6)) is consistent with an activities-based exemption. It is not consistent with an instrument by instrument approach.

Finally, we note that market makers can be requested by their clients to deal in a wide range of financial instruments at any time. The fact that a market maker may not have traded a particular share or

another financial instrument for a certain period of time should not preclude such market maker from relying on the market making exemption if it is subsequently approached by a client requesting to buy that share or instrument. Moreover, certain instruments are illiquid in nature, and rarely trade and yet market makers would receive client requests to facilitate trading on an sporadic/infrequent basis.

We would like to highlight that there are 863 instruments on the ESMA MiFID database of shares admitted to trading on an EU regulated market with a "Daily Transactions" average of 1 or less, indicating that they trade on average at most once per day. We are concerned how the assessment of “frequent and systematic” in relation to instruments trading once per day would be carried out. In addition there are over 2000 shares with less than 10 trades per day and 72 trading just 0.01 times per day i.e. on average one trade every 100 days. This database only covers shares admitted to trading on regulated markets. SMEs trading on junior markets like AIM (MTFs) will potentially have even fewer transactions.

To give another example, we believe that the ‘frequent and systematic’ trading requirement is not workable in for sovereign CDS either, as liquidity is low and varies over time for these contracts. Average daily trading volume for 1000 most liquid names amounts to approximately three trades per day for each reference entity. For the Kingdom of Spain, one of the most frequently traded sovereign single-name reference entities, the average number of contracts traded per day is 35. Daily trade volumes may vary from fewer than 10 contracts to as many as 125 (DTCC OTC CDS trade repository; 3 month data set of CDS trades from March to June, 2010). An overall result of an approach that focuses on specific instruments will be that firms will no longer be able to provide a full range of prime services to their clients, including certain types of risk transfer. The restrictive definition does not adequately take into account the risk transfer role of market makers, which is an important source of liquidity. This is especially true in the case of illiquid securities, which would become even more illiquid under this approach. In addition, this approach will, contrary to the Regulation’s stated purpose, have the effect of decreasing liquidity and efficiency of the markets.

We are concerned that any measure limiting liquidity on the sovereign CDS market may have adverse effect on the accessibility of sovereign CDS as sovereign debt hedging tools, and therefore cost of sovereign funding. This may be especially important in the context of the geographic restriction on the use of sovereign CSD for cross-county hedging purposes (introduced by the Level 2 Delegated Regulation specifying, inter alia, the definition of covered sovereign CDS for the purpose of the Level 1 Regulation). The effect of the geographic

restriction in the cover requirements for CDS will be to increase interest in some of the less liquid names. However, they will most probably still remain relatively illiquid. If market participants cannot hedge using the more liquid names they need access to the less liquid ones to hedge effectively.

We recommend that "instrument class by instrument class" should be the approach adopted by competent authorities , as this refers to *classes* of instrument (e.g. EU sovereign bonds, EU sovereign CDS, EU equities and derivatives) in which a firm makes a market rather than requiring notification at the individual ISIN, contract or even issuer/reference entity level. Identification of a specific instrument or issuer provides no information to a competent authority upon which to make a determination as to whether a firm is appropriately acting in a market making / client facilitation capacity.

B. <u>A meaningful interpretation of the reference to "*trading venue*" is needed to ensure that the Regulation operates effectively</u>

It appears that significant parts of the draft Guidance are based on the principle that, as a pre-condition to a party being entitled to avail itself of the market-making exemption in respect of a transaction relating to a financial instrument (and in addition to the requirement that it acts in one of the three specified capacities), the party must be a member of a trading venue on which it deals as principal in that instrument. See for instance paragraphs 13, 14, 18, 25, 30 and 41 of the Consultation Paper.

As an initial matter, we believe that this is a misunderstanding of the definition of market-making activities in Article 2(1)(k) of the Regulation and that it (a) hinders the clear purpose of the legislator; and (b) cannot be reconciled with the language of the regulation in other language versions of the text.

Our interpretation of market-making activities is that there is no requirement for a link between the trading venue of which the relevant party is a member and the financial instrument in which it deals. We can reasonably assume that the approach in the ESMA draft Guidance is based on the use of the word "where" in the English language version of the definition in 2(1)(k). ESMA has interpreted this as a geographical reference linking the market and the instrument. But for the reasons set out below, this interpretation cannot be supported. Instead, the word "where" should be interpreted as "in circumstances in which" or "when". Accordingly the pre-conditions should be that (a) the relevant party is a member of **a** trading venue; and (b) that it deals as principal in the relevant

financial instrument, but not that the instrument be dealt in on that venue (or indeed on any venue).

We provide the following to further support our view:

- Other language versions of the Regulation (such as the French, German, Dutch, Polish, Slovakian, Romanian and Spanish versions) would not support the existing ESMA interpretation. These versions do not impose any requirement between the trading venue and the instrument, but instead are consistent with the interpretation which we set out above. They state that the requirement for membership of a trading venue and the requirement to deal as principal in the financial instrument, are unconnected tests. The ESMA reading conflicts with non-English versions of the Regulation, requiring further consideration to provide guidance to regulators on the market-making exemption.

- A considerable amount of activity where liquidity is provided (that is within the scope of the Regulation) occurs away from trading venues. In order to ensure that the Regulation operates effectively, the reference to a 'trading venue' must not be interpreted so that trading outside such a venue is automatically regarded as activity not covered by the exemption. For instance, debt of certain sovereigns, certain sovereign CDS and most derivatives, are generally not available to trade on regulated markets or MTFs. Based on Recital 26, we do not consider that scoping instruments traded only OTC outside of the exemption was the intention of legislators in drafting these provisions.

- Our members make markets in related instruments, such as for instance OTC equity derivatives. These instruments are used by institutional clients to hedge their portfolios and manage their risk. The fact that the instrument is OTC allows it to be customised according to the specific needs and requirements of the client. For example, an institutional investor may have issued a product to its client base, in order to hedge this offering effectively, the institutional investor may wish to enter into a customised derivative. For market makers in 'related' OTC equity derivatives, it is essential that they can hedge their positions (that are created as a result of their market making activity) using the underlying instrument (which would be cash equities in relation to this example). Whilst the ESMA guidance is not clear with regard to 'related' instruments, there is a concern amongst our membership that firms using shares, sovereign debt, or sovereign CDS to hedge positions arising from making markets in 'related' instruments would be unable

to utilise the market making exemption - unless the related instrument is admitted to trading on a regulated market or MTF. We are unclear as to the rationale behind such a proposal. Inevitably, liquidity will be reduced in related instruments and the increase in hedging costs will in turn increase transaction costs for clients as well reduce the accessibility of capital markets for corporate and sovereigns.

Overall, we understand that the market making exemption seeks to enable market makers to continue offering liquidity in OTC products and clients using these instruments, to address customised funding and hedging needs, and effectively mitigate other business-related risks. Moreover, the market making exemption has been included in the Regulation to ensure meaningful transparency by avoiding double counting with the clients' orders. In our view, neither of these objectives will be furthered under the current reference to trading venue.

C. The market making exemption must be comprehensive enough to encompass necessary and reasonable *hedging activities* arising from market making and/or client facilitation activities

The market making activities exemption must be comprehensive, so as to permit the necessary and reasonable hedging activities arising from market making and/or client facilitation activities. In this context, we strongly believe that the following activities should be included:

- Proxy hedging as an important means of mitigating risks while market making on, for instance, less liquid corporate bonds markets.

- Market making and hedging in derivatives, underlyings and indices.

- Anticipation of client orders, CVA hedging and portfolio hedging.

- Instances where clients may need agency firms or desks to step in to guarantee pricing or offer pricing where they would not ordinarily do so (for example trading system outages meaning orders are not completed and clients request redress which effectively requires firms to take on risk of particular trades on the spot).

- Hedging with indices where the market makers could have a short position in shares or sovereigns as a result of the index constituents.

The exemptions in the Regulation are crucial to the efficient and orderly functioning of markets. Market makers provide liquidity which involves taking some amount of direct risk for short periods. They must manage the inventories of positions they take as principal in order to mitigate those risks. If this is done effectively, it allows them to accommodate clients' trades quickly and at favourable prices. Restrictions on the ability of market makers to manage risk discourages them from taking on risk, reducing the ability of investors to manage their own risk in a timely and cost-effective manner.

In order to facilitate a customer who wants to sell a financial instrument the market maker must acquire the financial instrument as principal for short periods of time. In order to hedge the risk associated with the acquisition of the financial instrument, the market maker may elect to sell the financial instrument. Such hedging can take place before the trade with the client or after (called "anticipatory market making").

Gradually accumulating a short position in anticipation of a large sale by a client (rather than selling after the fact) is often the best strategy for maintaining an orderly market and providing the best prices to clients as well as reducing potential impact on the volatility of the market. We set out below some examples:

> *Example 1: large block positions require market makers to manage inventory*
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> *Larger dealers are often the only sources of liquidity for block positions, which UCITS funds and pension funds buy or sell to meet redemptions and payment obligations or to rebalance their portfolios in response to changing market conditions. Market makers may have relationships with both buyers and sellers in the relevant positions as well as the expertise and incentive to provide supply and demand to both sides without disrupting the market. Market makers today build and manage inventories on an ongoing basis before customers commit to a block trade. If they are only able to do this in response to a customer trade, customers will suffer from increased execution time, along with worse pricing and higher price volatility.*
>
> *Executing a block trade also requires market makers to prudently manage their inventory to reflect prevailing market liquidity, avoid disrupting the market and protect the customer's trading strategies. If market makers are uncertain about the permissibility of accumulating and disposing of these blocks in a gradual manner, they will provide less favourable size and pricing terms to customers or may even decline to execute certain trades at all.*

If investors cannot sell block positions to market makers, they will need to unwind the positions on their own. This means that they will either hold the positions for longer than they would like, or alternatively that they will dispose of the positions quickly, resulting in lower prices and a lesser amount of proceeds. Either directly or indirectly, this will drive investment costs higher and returns lower, eroding investment.

Example 2: market makers in sovereign debt may need to buy CDS protection ahead of trading large bond positions with clients

Market Makers may be asked by a client (or may anticipate a client's request) to purchase a significant bond position it holds. The market maker may only be able to agree to the risk of such a trade if it can purchase CDS protection over the relevant sovereign beforehand – this is especially likely to be the case where the relevant bond market itself is illiquid (and so the market maker will need to unwind its physical position over time) but the CDS market for the sovereign in question is sufficiently liquid.

The likely impact on limiting market makers' ability to manage their risk in this way is a loss of liquidity in the bond markets (particularly in the debt of economically weaker Member States), causing widening spreads and therefore an increase in the cost of investing in EU sovereign debt. Compounded by concerns large investors may develop with respect to building significant bond holdings (because of difficulties in selling such a position to a market maker easily), limiting the scope of the exemption may impede certain Member States' capital raising efforts.

Example 3: market makers undertaking client order to carry out index rebalancing

In situations where clients of a market-maker are attempting to match a specific point-in-time benchmark, such as an index rebalance where the closing price of the day's primary market defines the weighting of shares in a particular index, the market-maker may build a position in the shares in question around that benchmark. This serves the purpose of minimizing any adverse price movement or liquidity spikes that might occur had the broker been unable to engage in this activity, and the client would be forced to execute all of their order at the benchmark price. The likely impact of restricting the market-maker's activity will be a concentration of orders during the time at which the benchmark is being set. With limited subsequent liquidity being provided by other market participants around that benchmark, significant price movements would occur at that time, which bear little reference to

the financial fundamentals of the company itself, and more to do with a very short term imbalance of supply and demand for the shares in question.

The definition of market-making activities in the Regulation includes trading by a firm as part of its usual business to fulfil orders initiated by clients, or in response to clients' requests to trade, and also trading to hedge positions arising from the fulfilment of such tasks. The definition does not require that such hedging activity take place after the trade with the client. In other words, the taking of a short position in a financial instrument in order to mitigate risks arising from client facilitation is within the scope of the definition. Further, we believe that such activity is within the hedging limb of the definition even where the firm is not posting two-way quotes to the market in accordance with the first limb of the definition.

The definition in the Regulation was initially proposed by the Committee of European Securities Regulators in two reports which are intended to be read together: the CESR Report on Technical Details of the Pan-European Short Selling Disclosure Regime (Report CESR/10-453) and the CESR Report on a Model for a Pan-European Short Selling Regime (Report CESR/10-088). CESR Report 10-088 discusses anticipatory market making and includes the following paragraph:

> *"The exemption would only cover market makers when, in the particular circumstances of each transaction, they are genuinely acting in the capacity of a market maker. They are afforded a certain level of flexibility in anticipating sales as long as this activity is genuine market making in line with their existing general levels of business. Consequently, CESR would not expect firms to hold significant short positions, other than for brief periods. Proprietary trading, where a firm is acting more as an investor or trader rather than liquidity provider, would not fall within the scope of market-making and would not be exempt."*

We strongly believe that this is an unequivocal statement that short sales in anticipation of sales by clients are within the scope of the definition of market-making activities proposed by CESR and adopted in the Regulation. We supported the definition on the basis of that statement and we are confident that ESMA will want to ensure that its guidance is consistent with the position taken by CESR.

We are convinced that permitting anticipatory market making will not result in firms running significant speculative short positions for significant periods of time. The Regulation clarifies that market makers are not expected to hold significant short positions other than

for brief periods. If a firm accumulates a significant short position in anticipation of a client trade that does not materialise then the firm will be expected to unwind that position at its own risk.

Morever, any anticipatory market making that a market maker does will be required to comply with the Market Abuse Directive and applicable restrictions on front-running so that clients are not disadvantaged.
Finally, internationally it is recognised that anticipatory trading is a legitimate part of market making. It is important that in global markets definitions of market-making activity are consistent both with each other and with the manner in which market making is conducted in practice.

D. The Regulation as currently envisioned would have a negative on competition

We are strongly concerned that the proposed Guidelines will also have a negative effect on competition, especially smaller broker firms. If firms were required to provide locate notices under Article 12 or 13 of the Regulation this would increase costs and therefore cause a fundamental shift in the accessibility to capital markets that these broker firms can offer to their clients, especially in less liquid small and medium mid cap markets. Moreover, higher costs would drive some firms out of the market and many of the remaining firms would be reduced to making markets in fewer financial instruments. This would have a negative effect on competition and would concentrate the market around fewer and larger firms, thereby increasing systemic risk as well.

We also note that not every broker or prime services firm is a member of a trading venue, which is particularly true with respect to smaller brokers and firms. Restrictions that will reduce the number of brokers or other firms that are permitted to make markets would disproportionately affect smaller brokers and firms and would cause another negative drag on competition.

In addition, unless the Commission has notified on third country equivalent regimes, competition will be decreased as non-EU entities will not be permitted to apply and make use of the market making exemption status.

E. Further clarity is needed with regard to third country equivalence under the Regulation

Article 17(8) requires third country entities seeking to apply the Article 17(1) market making exemption on the basis of their membership of a third country market, to notify the relevant EU competent authority accordingly. However, the definition of "market making activities", along with Article 17(2) of the Regulation, contemplate a declaration by the Commission that a particular third country has an equivalent legal and supervisory framework for its markets. It would appear, therefore, that competent authorities receiving notifications from entities that are members of a market in a third country (but which are not members of a "trading venue" in the EU) of their intention to use the market making exemption would be required to take steps to prohibit the use of the exemption if a third country entity is domiciled in a jurisdiction which has not been declared equivalent by the Commission.

To date, we are not aware that the Commission has made any such equivalency declarations. This may be a significant issue for certain of our members who are carrying out legitimate market making activities, which would otherwise benefit from the exemptions under the Regulation. Firms have been proceeding on the assumption that the Commission would declare equivalency for relevant third countries in advance so that market making notifications (which must be made at least 30 days ahead of any intention to use the exemption) could be made in time for compliance with the 1st November effective date. With the effective date only a few weeks away, non-EEA firms (including those that are a member of a third country market but not a member of an EU trading venue) have missed the opportunity to make their notifications. (See generally Part I.A. above). It is therefore essential that non-EEA firms are advised of third country equivalence as soon as possible so as to minimise any further impact.

Clearly the Regulation intends certain exemptions to be made in relation to legitimate market making activities, including where those activities are carried out by entities that are a member of a third country market but not a member of an EU trading venue.

However, if equivalency declarations are not made by the Commission in relation to appropriate third countries in time to allow for exemption notifications, there may be a significant impact for third country market makers, their clients, and for the relevant markets. Firstly, as regards the position reporting aspects of the Regulation, market makers should be separating their market making positions from their proprietary positions when calculating long and short positions, if third country market makers cannot notify their intention to use the exemption, they will be forced to amalgamate their

proprietary and market-making positions for the purposes of notification and disclosure. Secondly, as regards CDS-trading, those third country entities may be unable to make use of legitimate hedging strategies in order to minimise risk arising from their market making activities (which would otherwise be permissible under Article 2(1)(k)(iii) of the Regulation).

Uncertainty in this area may impact the ability of firms to offer certain market making services, which in turn may impact the ability of their clients to access the markets, and have a negative effect on liquidity.

F. Further clarity is needed with respect to which specific entities will be considered *sovereign issuers* under the Regulation, and with respect to the calculating and reporting *cash net short positions in sovereign debt*

Regarding the requirement for reporting and disclosing position levels with respect to sovereign debt, we would welcome a prompt publication of the list of sovereign issuers and corresponding outstanding issued debt levels by ESMA that are covered by the Regulation, Article 2(1)(d) (including granular information per government department, agency, special purpose vehicle, international financial institution and region covered). These are, inter alia, critical components for the industry to be able to build and adapt IT reporting systems. Given the short time period before the application date of the Regulation, it will be extremely challenging to be ready to comply with the reporting requirements on time. The later the list is published, the more difficult the preparation for 1 November reporting becomes.

Concerning individual firms' cash sovereign debt positions, we strongly believe that it is critical and extremely urgent to clarify what amount market participants are required to calculate and report. In particular, we would welcome a clarification whether it would be a 'nominal amount,' as ESMA recommended and two European Commission (EC) Regulations seem to require to be reported,[3] or a 'nominal duration adjusted amount', as one of the 5.07.2012 EC Delegated Regulations (DR) seems to require to be calculated.[4]

We believe that it is crucial that the chosen method is applied consistently for calculating (both nominator and denominator) and reporting to ensure comparable and meaningful information across

[3] Annex II of the EC Delegated Regulation of 29.6.2012 requests equivalent nominal amount regarding the format of notification for net short position by market participants. Annex II of the EC Implementing Regulation of 29.6.2012 requests equivalent nominal amount in notifications for net short positions to be provided to ESMA by Competent Authorities.

[4] Annex II, Part 2, Article 11, Sub 1 states that any cash position shall be taken into account using their nominal value duration adjusted. Annex II, Part 2, Article 11, Sub 7, states that 'the net short position shall be calculated by netting nominal delta adjusted equivalent long and short positions'.

the EU for the benefit of appropriate transparency for regulators and market participants.

The most expedient approach, both for the nominator and denominator of the sovereign debt reporting threshold, would be to use the nominal amount. It would be the approach that is the simplest and easiest to implement by 1 November, as based on the ESMA advice and initial market participants' preparations for the SSR implementation (IT systems creation).[5]

If 'duration' is used, it will be extremely challenging to design, build and test an appropriate IT reporting system in the matter of weeks (1 November 2012 application date of the SSR). We would be concerned about the potential consequences on the ability of firms and their clients to report and therefore participate in the sovereign debt market.

We understand that Macaulay duration is one of the calculation methods currently contemplated by ESMA. Please note that ISDA and AFME members agree that Macaulay Duration coefficients are readily available for most nominal (bullet or fixed-coupon) government bonds, but not for other instruments such as inflation-linked bonds, floaters, etc. In other words, Macaulay duration can only be determined for instruments with fixed cash flows. Therefore, it would probably not be suitable to calculate duration for floating rate instruments.

Moreover, Macaulay duration does not appear to be used in practice by market participants and would therefore be more burdensome to implement in a short period of time than certain currently commonly applied methods. We strongly believe that a calculation method that takes into account price sensitivity would be appropriate for both the derivatives element and cash sovereign debt instruments. This would not only be suitable for both types of instrument but would also allow for consistency of position calculation across cash and derivatives. Moreover, such a method would provide information on a short term downward pressure on prices, which is the type of data we assume Regulators are seeking. We note that ESMA have contemplated some of these methods already in its technical advice mentioned above.

We appreciate that the 'duration' calculation method is not defined in the final Delegated Regulations. Therefore, we would welcome an appropriate public consultation period on this technical matter. It appears to be important also because of the global impact of the

[5] ESMA's Technical Advice on possible delegated acts of the short-selling and certain aspects of CDS, 20/04/2012, p.19, par. 13,

http://www.esma.europa.eu/content/ESMAs-Technical-Advice-possible-delegated-acts-short-selling-and-certain-aspects-CDS

reporting rules on various types of corporate and sovereign debt investors, including long term position holders.

II. General Observations

A. Guidelines' consistency with Short Selling Regulations Level 1

The draft Guidelines on which ESMA is consulting appear to significantly restrict the exemption agreed by co-legislators during the Level 1 negotiations. The proposals contained in the consultation document are interpreted so narrowly that it has the effect of limiting the scope of the Level 1 provisions. We believe, that this inconsistent with the 'ESMA Regulation' 1095/2010, which indicates that ESMA guidelines should be prepared:

> *with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law.*

The draft Guidelines not only narrow the Level 1 text, but redrafts and adds further restrictions and responsibilities to the text we consider not intended or required under Level 1.

Certain provisions would, if complied with, result in a restructuring of the relevant markets and of the firms' business models (in addition to what is already in process with respect to what was agreed in Level 1). Ultimately a very restrictive application of the market-making exemption will have detrimental impacts on markets' liquidity and efficiency.

The strictly limited availability of the market-making exemption outlined in ESMA consultation paper seems to depart from the Short Selling Regulation (SSR) primary legislation and the co-legislators' intent. The crucial importance and usefulness of market making activities for EU markets is clearly and explicitly highlighted in Recital 26 of the SSR L1 text: "Market making activities play a crucial role in providing liquidity to markets within the Union and market makers need to take short positions to perform that role. Imposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the Union markets. It is therefore appropriate to exempt natural or legal persons involved in such activities from requirements which could impair their ability to perform such a function and therefore adversely affect the Union markets." The formulation of the market-making related provisions of the final SSR Level 1 text is fully consistent with the co-legislators willingness to preserve the key role

fulfilled by market-making activities and sets accordingly a clear special exemption for these activities.

Moreover, ESMA's proposed restrictive approach of the market-making exemption would not reflect the conclusions of the cost-benefit analysis used by ESMA to develop its proposals for the exemption of market-making activities and certain primary market operations. Indeed, Annex II "Cost-benefit analysis" of ESMA consultation document is exclusively referring to the European Commission's impact assessment carried out when adopting its proposal for the SSR in September 2010.[6]

In this impact assessment, the Commission explicitly recognizes and highlights the crucial role played by market-making activities in providing liquidity to the market. In this respect, the liquidity provided by market-making activity is further recognized by the Commission as "<u>critical to the efficient functioning of markets</u>" [see notably page 62 of EC Impact Assessment]. Finally, the Commission's impact assessment clearly demonstrates that to impose SSR requirements (locate and disclosure obligations and ban on uncovered sovereign CDS) on market-makers would significantly impair their ability to provide liquidity to the market and further states that this would have a "<u>significant detrimental effect on markets</u>".

Considering the above, we believe that the market-making exemption has not been introduced in the SSR Level 1 with a narrow application perspective as currently contemplated in ESMA consultation document.

As regards the restrictive scope of the market making exemption which would exclude certain market making activities (such as anticipatory client demand trading), such approach seems inconsistent with the intent of the SSR Level 1 text. Indeed, Recital 26 explicitly provides that "*The exemption should apply to the different types of market-making activity but* not to proprietary trading*.*" This recital, which is further supported by the Commission's Impact Assessment to which ESMA is referring in its consultation document, suggests that the co-legislators' intent was not to establish a narrow "market-making exemption". In this respect**,** the exemption on a per instrument basis proposed by ESMA would introduce unnecessary complexity in the exemption notification procedure without clear benefits. The Commission's Impact Assessment as well as the SSR Level 1 text consider the "activities" performed by market makers. Moreover, the detailed/granular information on the financial instruments effectively covered by the market-making exemption could be requested at any time by national regulators.

[6] ***[http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_impact_assessment_en.pdf]***

As regards the requirement that "*the instrument which is the subject of the notification should be admitted to trading or traded on that venue or market of which that person is a member*" [page 8, paragraph 25 of the ESMA consultation paper], we understand that this requirement is based on the definition of "market making activities" of the English version of the SSR L1 text.

> *'market making activities' means the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC, which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2)* ***<u>where</u>*** *it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities (…).*

It seems that the meaning/interpretation provided to the adverb "where" used in the above definition is causing some legal uncertainty and confusion.

Looking at the definition of "market-making activities" provided in other languages, it appears that the English meaning of "where" in this definition would not introduce a "locational requirement" establishing a link between the market and the financial instrument, but would rather mean "when/if" and would thus introduce a second separate criteria that national regulators will consider to grant the market-making exemption, i.e. the notifying market-maker "*deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities".*
In French: the term "**et**" meaning **"and**" is used
In German: the term "**wenn**" meaning "**when**" is used
In Spanish: the term "**si**" meaning "**if"** is used
In Italian: the term "**quando**" meaning "**when**" is used
In Polish: the term "w **przypadku gdy**" meaning "**in the case where**" is used

B. <u>Timing</u>

We are concerned that a piece of draft ESMA guidance, with such far-reaching and significant (potential) implications has been published subsequent to the first date on which firms are able to notify Competent Authorities of their market making/Primary Dealing exemption and, and only a month and a half before the entry into force of the actual Regulation (1 November 2012). We believe that this approach is inconsistent with Article 16 of Regulation 1095/2010, which states that:

> *The Authority shall, where appropriate, conduct open public consultations regarding the guidelines and recommendations and analyse the related potential costs and benefits. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.*

The exemption for market making activities is a fundamental provision of the Short Selling Regulation, and its final form will have a significant impact both on individual firms and the wider market. The short amount of time available between the deadline for responses to Consultation and the Regulation's entry into force will make it very difficult for ESMA to properly "analyse the related potential costs and benefits".

In light of this, we have important concerns with respect to the length of time firms have to comply with/implement the Regulation. It will be extremely challenging for firms to be in a position to comply with the substance of any further market making definition/guidance until they have been finalised (following consultation and due process) and firms are afforded a sufficient period of time to implement any new guidelines. An appropriate lead time is essential because the definition may have a fundamental impact on: the structure of the market; firms' ability to respond to client requests; and IT systems that may need to be re-designed. Of course, the implementation timing problem will be exacerbated if the final guidelines differ from the CESR Report.

We understand that the deadline for entry into force is outside ESMA's control and appreciate the Authority's considerable workload, both on the Short Selling Regulation and other legislative dossiers. However, there must be an appreciation from policy makers and supervisors that recent developments with regard to the market making/primary dealing exemption have created challenges in terms of implementation, and undoubtedly increased their compliance risk. Looking forward, we repeat our call to the co-legislators to ensure that Level 1 Regulations provide ESMA with adequate time to prepare Level 2 standards and Guidelines.

III. Responses to Consultation Questions

Q1: Do you agree with the above approach regarding the definition and scope of the exemption for market making activities?

We do not agree with the proposed approach.

We recommend an activities-based market making exemption at Level 1 as being consistent with the constructions of the exemption at Level 1 and with existing market practices.
The primary focus of the consultation is on exemptions available under the Regulation for certain market making activities and primary market operations. Market making is at its heart the provision of liquidity and, as such, directly contributes to promote long-term growth in the capital markets. This activity is a vital cog in the efficient and effective running of the markets and more importantly contributes to a reduction in transaction costs for end-user investors, provides enhanced risk management options, and allows improved access to finance. We are concerned that ESMA's guidance on the 'exemption for market making activities and primary market operations' in its current form will prevent legitimate market making activities that nevertheless meet the tests of client servicing and hedging, and therefore have a damaging effect on liquidity and efficiency in the equity, sovereign debt and CDS markets – and also in markets where market makers are reliant on these instruments to hedge their risk positions. An optimal interpretation of the exemption would ensure that the definition facilitates the appropriate functioning, liquidity and accessibility of capital markets as well as responsible and prudent risk management. We support guidance that enables firms and competent authorities alike to firmly identify activities which facilitate client orders and trading requests. The ultimate consequence of reduced liquidity would be higher issuing costs for European companies and Member States, in particular smaller companies and those European Member States whose debt is already less liquid. In particular for sovereign CDS, if the use of CDS for hedging purposes becomes more costly or uncertain then Member States will have to compensate investors for the increased risk, leading to higher funding costs for sovereign and corporate debt.

As the definition of market making is critical to effective client facilitation and market liquidity, and also as the concept is heavily related to MiFID 2 and other regulatory proposals globally, we believe that a narrow approach would go beyond the legislative intent as it would, in a practical sense, reduce liquidity and negatively affect the ability to facilitate client requests for trading, ultimately adversely impact the cost of and access to funding for corporates and sovereigns.

An approach which focuses on *specific instruments* only rather than relevant activities is in our view inconsistent with the construction of the exemption in the Regulation (particularly given the clear inclusion of client facilitation activities in the Level 1 definition of "market making activities", which are naturally led by client demand) and does not in our view constitute an effective framework

A meaningful interpretation of the reference to "*trading venue*" is needed to ensure that the Regulation operates effectively.
It appears that significant parts of the draft Guidance are based on the principle that, as a pre-condition to a party being entitled to avail itself of the market-making exemption in respect of a transaction relating to a financial instrument (and in addition to the requirement that it acts in one of the three specified capacities), the party must be a member of a trading venue on which it deals as principal in that instrument. See for instance paragraphs 13, 14, 18, 25, 30 and 41 of the Consultation Paper.

As an initial matter, we believe that this is a misunderstanding of the definition of market-making activities in Article 2(1)(k) of the Regulation and that it (a) hinders the clear purpose of the legislator; and (b) cannot be reconciled with the language of the regulation in other language versions of the text.

A considerable amount of activity where liquidity is provided (that is within the scope of the Regulation) occurs away from trading venues. In order to ensure that the Regulation operates effectively, the reference to a 'trading venue' must not be interpreted so that trading outside such a venue is automatically regarded as activity not covered by the exemption. For instance, debt of certain sovereigns, certain sovereign CDS and most derivatives, are generally not available to trade on regulated markets or MTFs. Based on Recital 26, we do not consider that scoping instruments traded only OTC outside of the exemption was the intention of legislators in drafting these provisions.

Overall, we understand that the market making exemption seeks to enable market makers to continue offering liquidity in OTC products and clients using these instruments, to address customised funding and hedging needs, and effectively mitigate other business-related risks. Moreover, the market making exemption has been included in the Regulation to ensure meaningful transparency by avoiding double counting with the clients' orders. In our view, neither of these objectives will be furthered under the current reference to trading venue.

The market making exemption must be comprehensive enough to encompass necessary and reasonable *hedging activities* arising from market making and/or client facilitation activities.
The exemptions in the Regulation are crucial to the efficient and orderly functioning of markets. Market makers provide liquidity which involves taking some amount of direct risk for short periods. They must manage the inventories of positions they take as principal in order to mitigate those risks. If this is done effectively, it allows them to accommodate clients' trades quickly and at favourable prices.
Restrictions on the ability of market makers to manage risk discourages them from taking on risk, reducing the ability of investors to manage their own risk in a timely and cost-effective manner.

In order to facilitate a customer who wants to sell a financial instrument the market maker must acquire the financial instrument as principal for short periods of time. In order to hedge the risk associated with the acquisition of the financial instrument, the market maker may elect to sell the financial instrument. Such hedging can take place before the trade with the client or after (called "anticipatory market making").

Q2: Do you agree that when determining the RCA for notification purposes the third country entity should assess the turnover in relation to its market making activities as defined in Article 2(1)(k) of the Regulation?

We do not agree with the proposed approach.

Article 17(8) requires third country entities seeking to apply the Article 17(1) market making exemption on the basis of their membership of a third country market, to notify the relevant EU competent authority accordingly. However, the definition of "market making activities", along with Article 17(2) of the Regulation, contemplate a declaration by the Commission that a particular third country has an equivalent legal and supervisory framework for its markets. It would appear, therefore, that competent authorities receiving notifications from entities that are members of a market in a third country (but which are not members of a "trading venue" in the EU) of their intention to use the market making exemption would be required to take steps to prohibit the use of the exemption if a third country entity is domiciled in a jurisdiction which has not been declared equivalent by the Commission.

To date, we are not aware that the Commission has made any such equivalency declarations. This may be a significant issue for certain of our members who are carrying out legitimate market making

activities, which would otherwise benefit from the exemptions under the Regulation. Firms have been proceeding on the assumption that the Commission would declare equivalency for relevant third countries in advance so that market making notifications (which must be made at least 30 days ahead of any intention to use the exemption) could be made in time for compliance with the 1st November effective date. With the effective date only a few weeks away, non-EEA firms (including those that are a member of a third country market but not a member of an EU trading venue) have missed the opportunity to make their notifications. (See generally Part I.A. above). It is therefore essential that non-EEA firms are advised of third country equivalence as soon as possible so as to minimise any further impact.

Clearly the Regulation intends certain exemptions to be made in relation to legitimate market making activities, including where those activities are carried out by entities that are a member of a third country market but not a member of an EU trading venue. Uncertainty in this area may impact the ability of firms to offer certain market making services, which in turn may impact the ability of their clients to access the markets, and have a negative effect on liquidity.

Q3: Do you agree with general principles applicable to persons intending to make use of the exemption under Article 17(1) of the Regulation?

We do not agree with the proposed approach. The Level 1 text makes no reference to general principles that a firm must meet in order to benefit from the market maker exemption. We therefore consider that any such general principles go beyond the Level 1 text and should be omitted from the final guidance.

If in proposing the general principles ESMA's intention is to ensure that market maker firms only rely on the exemption in appropriate circumstances and are able to demonstrate the appropriateness of such reliance, then the guidance should make this clear and the general principles should be restricted to principles which are necessary for this purpose and not covered elsewhere in the exemption criteria.

Parts I.B and I.D above set out our views on the requirement in the first proposed principle. We note that this principle repeats a proposed threshold condition for eligibility for the exemption and thus is unnecessary.

The second principle can apply only to firms which are registered market makers on a regulated market; the principle should make clear that this is the case. We note that the principle is unnecessary on that

basis that, if a firm did not comply with the rules and requirements of a trading venue on which it is a market maker, its contract with the trading venue would likely be terminated such that the firm would no longer be a market maker on that venue.

We understand that the remaining four principles seek to ensure that a firm which relies on the market maker exemption is able to demonstrate the appropriate use of the exemption, in particular by being able to identify, promptly upon request by a Competent Authority, trades that arose as a result of market making activity and to evidence the client activity to which any such trade relates. The principles should make this clear; as currently drafted they (and the third principle in particular) could be interpreted to mean that a firm would have to establish entirely separate teams and systems for its market making activities and its other activities, which would be disproportionate and would not result in any significant risk mitigation or other benefit.

To further explain our concerns with a strict interpretation of the third principle, if a firm receives a client order related to a number of securities, some of which the firm has the exemption for and some for which it does not, the firm would be required to assign different personnel to execute the order and otherwise treat the securities differently -- despite providing the same services for the same client, and related to the same securities. It is unclear how "separate arrangements" would work in this situation and even if it were clear, there would be little benefit from such a requirement.

Moreover, the requirement that firms have in place "separate arrangements" would seem based on the flawed assumption that all firms engage in market making activity and proprietary trading. It does not consider a situation whereby a firm engages only in market making activity. We further point out that issues around proprietary trading in firms are being addressed in other European and national regulations.

Q4: D*o you agree with principles applicable to persons carrying out market making activities in accordance with Article 2(1)(k)(i) of the Regulation?*

We do not agree with the proposed approach. The Level 1 text makes no reference to general principles that a firm must meet in order to benefit from the market maker exemption. We therefore consider that any such general principles go beyond the Level 1 text and should be omitted from the final guidance.

As a general matter, we note that these principles, while they appear to be applicable to shares, are written such that they would apply to all relevant financial instruments. We request that ESMA clarifies the applicability of these principles.

In addition, these principles could go beyond the thresholds included in agreements with applicable exchanges. The Regulation cannot have been intended to override the obligations that a market maker has with respect to an exchange of which it is a member.

In your view which of the two options in paragraph 44 should apply to quotes entered when carrying out market making activities?

We do not agree with either approach for the reasons set forth above.

Do you see another alternative to the two options pro-posed? Please, provide explanations.

We have no comment at this stage.

Q5: Do you agree with the principles applicable to persons carrying out market making activities in accordance with Article 2(1)(k)(ii) of the Regulation?

We do not agree with the proposed approach. The Level 1 text makes no reference to general principles that a firm must meet in order to benefit from the market maker exemption. We therefore consider that any such general principles go beyond the Level 1 text and should be omitted from the final guidance. In particular, ESMA has interpreted the definition of market making activity as firms needing to perform all of the criteria in Article 2(1)(k) in order to be classed as a market-maker and make use of the market-making exemption.

We have several concerns to these principles, including:

The emphasis on whether a person already deals "on a frequent and systematic basis" is a concept related to Systematic Internalisers. The concept of systematic internalisation was one introduced as part of the Markets in Financial Instruments Directive (MiFID). The SI definition does indeed require that activity is performed on an organised, frequent and systematic basis. However, this definition should be viewed in the wider context of the SI regime. It is an equities-exclusive concept, the main goal of which was to achieve a 'fair deal' for the small scale retail investor who wanted to trade cash equities. The regime was also limited to 'liquid stocks' and trades

'below standard market size'. Criteria such as these should not be applied for market making activities generally and in particular, they should not be applied for market making activities in non-equities, which by their nature, are less homogenous, trade in larger size, and are generally less liquid than equities.

This requirement would also have a detrimental effect on liquidity. For instance, there are securities and other financial instruments (including new issuances and contracts) that trade quite infrequently and therefore no market participant would be able to demonstrate that it has dealt in that relevant security on a frequent and systematic basis. In addition, a primary dealer, when it receives a client request to transact in a certain security, may decline to do so if it is not sure that the Regulation will permit secondary dealers to make a market in that security if the dealer cannot establish that it has dealt in the security on a frequent and systematic basis.

This requirement is also inconsistent with the usual client servicing business practices and contractual obligations of market makers. Prime Service providers generally have a contractual obligation to respond to client requests, including one-time ad-hoc requests. Such providers need flexibility to offer all of the Prime Services that it has agreed to offer in its relevant client or market making agreements. This requirement would greatly restrict this flexibility in many cases.

We understand ESMA's interpretation to be that if a firm is trading in a financial instrument on an ad hoc or irregular basis, such trading cannot be considered part of the firm's usual market making business, and therefore should fall outside of the exemption. These activities in our view can be part of the core business of firms in providing liquidity to the markets. Products that are tailored to meet client demands (OTC financial instruments, structured medium term notes, dedicated UCITS, etc.) do not trade frequently but form a vital part of a market maker's function of servicing clients and providing access to capital markets.

Finally, the requirement will also have a negative effect on competition. While a large market making firm, being very active in the market, would likely be able to satisfy the requirement with respect to a great number of securities, a small or medium-sized firm would have a more difficult time demonstrating that it has traded in securities on a frequent and systematic basis. This would have a negative effect on smaller firms' ability to remain competitive in the marketplace and concentrate the market around a smaller number of large firms, with some clients put in a position where they would be unable to deal in certain securities through their usual broker. This

could also have an impact on the ability of small and medium-sized companies to raise capital in the EU.

Q6: Do you agree with the qualifying criteria for the comparable size of orders?

We do not agree with the qualifying criteria for comparable size of orders. It is not clear why these qualifying criteria are necessary. There is no inherent reason to suppose that small orders would "undermine the orderly functioning of the markets." It could equally be said that fulfilment of orders in varying sizes across a range of market makers would allow a broader range of participants on a venue. Individual exchanges are best placed to determine what are appropriate quoting requirements for their instruments and investor base.

In particular, it should be noted that excluding smaller than average size orders from the assessment would discourage market makers from filling smaller orders and hinder, for example, an existing venue from extending its customer base downwards from institutional to retail investors. In addition, we would note that these criteria seem to be mostly relevant to equities.

Q7: Do you agree with the qualifying criteria for competitive price of orders?

We do not agree because these criteria, particularly paragraph 52, are a significant departure from Level 1.

Q8: Which option do you favour?

As noted above the criteria are a significant departure from Level 1 and should not be included in the Guidelines. We do not favour either option.

We consider that this relates to shares and seek clarity how this applies to sovereign debt and CDS and other OTC financial instruments.

Q9: Do you agree with the qualifying criteria for ongoing presence on the market?

As an initial point, we note that paragraph 54 of the consultation acknowledges that "the Regulation does not appear to require an uninterrupted presence" and then explicitly requires that the market maker should conduct "qualifying activities each day that the market is open". This paragraph is internally inconsistent and is another instance where the consultation goes beyond Level 1, which does not exclude financial products that are solely traded OTC from the scope of the market making exemption. The consultation itself, in paragraph 35, explicitly takes into account that "sovereign debt is largely traded OTC" and therefore the proposed framework is not consistent with OTC traded securities and derivatives.

In addition, the concept of "trading time" in paragraph 55 is not defined and this lack of clarity would lead to uncertainty as to whether a party is actually complying with the Regulation.

Finally, it should be kept in mind that firms must comply with the rules of the exchanges of which they are members. It would be a significant burden or are impractical when applied in addition to the exchange rules, or even potentially contradictory.

Do you think different criteria should apply when conducting market making activities in sovereign debt?

Yes, we do think different criteria should apply. Paragraph 35 explicitly takes into account that "sovereign debt is largely traded OTC", whereas the proposed framework seems to be targeted towards securities traded on a venue.

Q10: Do you agree with the ESMA approach towards assessment of notification of intent to make use of the exemption?

We do not agree with this approach, but any approach towards assessment of notification should be proportionate and should not be overly burdensome. We also note that this approach would not be appropriate for OTC products – see also the response to questions 7, 8 & 9 above.

Q11: Would you agree that frequency and systemic basis of the activities exempted under Article 2(1)(k)(ii) capacity should be assessed against the same qualifying criteria as applicable to systemic internalisers under Article 21(1) of the Commission Regulation (EU) No 1287/2006?

We do not agree with the proposed approach.

As the definition of market making is critical to effective client facilitation and market liquidity, and as the concept is heavily related to other regulatory proposals globally, we believe that a narrow approach would go beyond the legislative intent as many related provisions would, in a practical sense, reduce liquidity and negatively affect the ability to facilitate client requests for trading, ultimately adversely impact the cost of and access to funding for corporates and sovereigns.

The market-making exemption would apply to trading in any financial instrument where an investment firm is performing any of the quoting, client servicing and hedging activities listed in the exemption. This approach is consistent with existing practice and the CESR Report on Technical Details of the Pan-European Short Selling Disclosure Regime (Report CESR/10-453) and the CESR Report on a Model for a Pan-European Short Selling Regime (Report CESR/10-088). Therefore, most firms have scoped their implementation plans in keeping with this interpretation.

As regards the restrictive scope of the market making exemption which would excludes certain market making activities (such as anticipatory client demand trading), such approach seems not consistent with the intent of the SSR Level 1 text. Indeed, Recital 26 explicitly provides that "*The exemption should apply to the different types of market-making activity but* not to proprietary trading*.*" This recital, which is further supported by the EC Impact Assessment to which ESMA is referring in its consultation document, suggests that the co-legislators' intent was not to establish a narrow "market-making exemption".

In addition, please refer to our answer for question 5.

Q12: In your opinion, what would be the most appropriate qualifying criteria in terms of percentage to assess scale of activity eligible for exemption under Article 2(1)(k)(ii) capacity in comparison to overall proprietary trading? 21

We have no comment at this stage other than to point out that proprietary trading is not covered by the Regulation and therefore we do not understand why it is necessary for these purposes to quantify the volume of proprietary trading. This implies that any activity that is not considered market making may automatically be viewed as proprietary trading, with which we strongly disagree; we also note that it is not always the case that a firm that undertakes market making activity also undertakes proprietary trading activity.

We do not believe that the purpose of the Short Selling Regulation was to regulate or control proprietary trading.

Q13: Do you agree that the above information needs to be provided in the notification form?

No we do not agree that the above information needs to be provided in the notification form.
As a general matter, these requirements go beyond Level 1. In addition, if a party is engaged in legitimate market making activities or responding to a bona fide client request, we do not understand why expected volume is relevant. If this requirement results in a restriction on the ability of parties to undertake these actions it would have a significant effect on liquidity and stability in the relevant markets.

Should historical data be also provided with the notification form?

No. Please see the response to question 5 above.

Q14: Do you agree with 6 months after application of the Guidelines period for revising and assessing notifications made before entry into force of the Guidelines? Please explain.

We do not agree with the proposed approach. General information on the market maker applying to make use of the exemption in respect of the activities that they undertake and how they make use of the exemption status are appropriate to be requested from firms. However, we do object to some key elements that are proposed that market makers would need to provide - section 69 (b) (vi) and (ix) of the ESMA consultation paper.

In addition, it is unclear how firms should proceed during the 6 month period following the publication of revised Guidelines. The ESMA guidelines address the situation for competent authorities but firms also need clarity as to which set of guidelines they must comply with pending reviews of the notification by the relevant competent authority, ESMA should address this bearing in mind that firms need time to adapt their systems in order to be able to comply with the requirements that apply to them.

Q15: Do you agree that a list of market makers and authorised primary dealers published on the ESMA website according to Article 17(13) should at least include the above in-formation?

We do not agree with the proposed approach. Such a list would be quite voluminous and difficult to maintain for ESMA and national Competent Authorities. There might also be challenges with publicly disclosing such information in certain contexts, for example during an IPO process or otherwise in connection with the issuance of new shares. Any notification process must take into account reasonable restrictions on information disclosure that are part of firms' normal business practices.

We do not see who would make use and benefit from such a list – ESMA would need to maintain this list in 'real-time' for any benefit to be evident.

What additional information should be included? Please justify.

We have no comment at this stage.

We remain fully at your disposal for further engagement and correspondence.

Yours faithfully

AFME

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