MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via *ESMA Website*

European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Response to Public Consultation: Draft technical standards on the Regulation (EU) xxxx/2012 (the "Regulation") of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (the "Consultation Paper")

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to provide comments to ESMA in response to its Consultation Paper. Throughout the drafting process on the Regulation, MFA engaged with EU policy makers in what we hope has been a thoughtful, constructive manner on a number of important issues, most importantly the provisions relating to restrictions on uncovered short sales and credit default swaps. Representatives of MFA attended the Roundtable on the Regulation held on 7 December 2011 and followed up on certain technical issues which were discussed during the Roundtable by a letter to ESMA dated January 10, 2012. We welcome the opportunity to work with ESMA further, as it prepares the final report and technical standards on the Regulation.

MFA would like to take this opportunity to provide comments on a number of matters that we believe will assist ESMA in preparing technical standards that will effectively implement the Regulation in a manner that is efficient and workable for market participants. Although the letter covers several important issues, we would like to highlight the following key points that we raise in the letter:

(1) Given the dynamic nature of the financial markets, the suggested approach of producing an exhaustive list of agreements or arrangements seems overly restrictive, and we recommend that ESMA consider providing market participants with additional flexibility.

(2) The distinction between the Standard Same Day Locate Confirmation and Measures and the Liquid Shares Locate Confirmation and Measures is necessarily artificial, and will be difficult for market participants to implement in practice. We recommend that

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2 trillion invested in absolute return strategies. MFA is headquartered in Washington D.C., with an office in New York.

instead, a locate provider make an assessment of the relative liquidity or illiquidity of shares available to it (to settle an investor's sale) whenever it provides a locate to an investor, and in doing so consider certain relevant criteria, as further discussed below.

Preliminary Comments

Whilst MFA is pleased to be able to contribute to this Consultation Paper, we are concerned by the very short consultation period that has been provided. We understand that to a large extent ESMA has little choice in terms of timing, given that it must submit its advice to the Commission by March 31, 2012. However, we hope that the Commission allows ESMA sufficient time for this important process, particularly given that the Regulation takes the form of an EU regulation and so is immediately and directly applicable in all Member States from November 1, 2012, with no possibility of Member State regulators to interpret or implement the Regulation in a way which fits local circumstances. In this and future consultations, ESMA should be given time to consult with market participants on the issues and seek additional relevant data (*e.g.*, frequency of settlement fails for short sales) supporting ESMA's proposals.

Reponses to ESMA's Questions

Q1: Do you agree with the approach of providing an exhaustive list of types of agreement, arrangement and measure that adequately ensure shares or sovereign debt instruments will be available for settlement and setting out the criteria these should fulfil?

In our view, given the dynamic nature of the financial markets, ESMA's suggested approach of producing an exhaustive list of agreements or arrangements is too restrictive. This is particularly true in relation to Articles 12(1)(c) and 13(1)(c), where the locate arrangements can change over time as the securities lending market continues to evolve and adapt to regulatory change and market forces.

While MFA supports ESMA's expression of the need to retain flexibility to cope with market evolution, we note that Articles 5 to 7 of the draft Implementing Regulation in Annex IV of the Consultation Paper (the "**Draft Implementing Regulation**") do not in fact provide for any such flexibility; Articles 5 to 7 simply provide an exhaustive list.

MFA notes that Article 12(2) of the Regulation does not require ESMA to actually produce an exhaustive list of the relevant types of agreements and arrangements. MFA suggests an approach whereby ESMA could set out the general criteria to be met with a focus on the outcome to be achieved by such agreements/arrangements (that is, adequate cover provisions) rather than grouping such agreements/arrangements into specific eligible categories. ESMA could provide an *indicative* list of types of agreement or arrangement that may meet the criteria.

Q2: Do you agree with the proposed list of agreements and enforceable claims and the criteria they should meet? Are there any other types of agreement or enforceable claims or criteria which should be added?

As noted above, MFA does not consider that the technical standards should provide an exhaustive list of eligible agreements. An indicative list of the types of agreements should be provided for illustrative purposes only. In this regard, we propose that the last category of

agreements in the list should be modified to "other claims or arrangements having the effect of providing a reasonable expectation that the shares or sovereign debt instruments are available for settlement."

If ESMA determines that an exhaustive list is required, ESMA should explicitly include securities lending arrangements and prime brokerage agreements in the list.

As a general matter, MFA agrees with the proposed criteria to be met by the agreements within Article 12(1)(b) of the Regulation. However, MFA believes that a subjective test (*i.e.*, reasonable understanding/belief of the investor) should be introduced with respect to the first four criteria.

Q3: Do you consider that these criteria will entail additional costs as compared to current practices on the market? If so, could you specify the drivers for those additional costs and any indication of their amount?

If an exhaustive list of types of agreement or enforceable claim is required, additional costs may be the result in cases where the agreement in question does not fall clearly within the list of eligible agreements. Such costs may arise in the form of fees for additional arrangements (*e.g.*, back-to-back arrangements which "transform" a non-eligible agreement into one on the eligible list), as well as in legal and other arrangement fees.

Separately, MFA assumes that the criteria referred to in this Question 3 relate solely to agreements to borrow or other enforceable claim having similar effect under Articles 12(1)(b) and 13(1)(b), rather than the locate arrangements referred to in Article 12(1)(c) in particular. We believe that there will potentially be significant additional costs on short sale transactions in relation to Article 12(1)(c) if flexibility is not introduced, as discussed below in relation to Questions 7 to 9 in particular.

Q4: Do you agree with the proposed list of third parties which may be parties to the arrangements or measures and the criteria proposed by ESMA that they should fulfil?

MFA notes that the Regulation does not specifically require that the relevant locate arrangements be entered into with any particular kind of third party. Articles 12(2) and 13(5) of the Regulation require ESMA to draft technical implementing standards to determine the "types of agreements, arrangements and measures" that adequately ensure that the shares/sovereign debt will be available for settlement. As a result, we believe it would be consistent with the Regulation for ESMA to identify in more general terms the types of third parties with whom locate arrangements may be entered, rather than setting out an exhaustive list.

Should ESMA be of the view that it should provide a list of third parties, we would note that the last item ("any other person subject to authorisation...") is problematic. MFA is particularly concerned by the reference in Article 8(g) of the Draft Implementing Regulation to a person "subject to authorisation or registration requirements in accordance with Union Law... or equivalent third country authority." There is no mechanism either in the Regulation or in the Draft Implementing Regulation for determining equivalence and, as ESMA appreciates from the existing discussions on the AIFM Directive, EMIR and MiFID II, there is a great danger that a requirement for third country

equivalence could result in third country firms not being recognised for purposes of Articles 12(1)(c) and 13(1)(c).

MFA members enter into prime brokerage and other arrangements not only with EU-based entities that may provide the locate for the shares or debt securities, but also with third country entities. Given that there is no certainty as to which third country authorities are considered to be "equivalent", this will mean that arrangements under Articles 12(1)(c) and 13(1)(c) may have to be unwound until or unless some equivalence determination is made. It is thus extremely important that the term "equivalent" be deleted from Article 8(g) of the Draft Implementing Regulation.

Separately, MFA is concerned that having an exhaustive list of third parties may exclude perfectly valid arrangements with third parties who may not be on the list. For example, an investor wishing to enter into a short sale transaction in shares may be doing so on the basis of an arrangement where that investor is due to receive shares from a third party which may not be an entity specified on ESMA's list. Similarly, the investor may be receiving the shares from its own affiliate. That transaction should be permissible so long as the relevant investor wishing to enter into a short sale transaction can demonstrate that the locate/reasonable expectation is present.

Q7: Do you agree with the approach proposed by ESMA on the standard/same day/liquid shares locate confirmation arrangements and measures and the criteria that they must fulfil?

Our response to this Question 7 encompasses the issues raised in Questions 7, 8 and 9. We use the terminology in Article 6 of the Draft Implementing Regulation.

As a preliminary note, MFA believes that regulators and policy makers should gather relevant data in order to identify the risks that ESMA's proposals are seeking to address. Amongst other things, we believe that ESMA should obtain (for example from locate providers and other market participants) and publish data on the percentage of settlement fails. Such data will be extremely helpful in calibrating what should be considered a "reasonable expectation" within the meaning of Article 12(1)(c).

MFA believes that (using the terminology in Article 6 of the Draft Implementing Regulation), while the Standard Same Day Locate Confirmation and Measures concept is workable, the distinction that is drawn between the Standard Locate Confirmation and Measures and the Liquid Shares Locate Confirmation and Measures is an artificial one that will lead to a lack of clarity.

In particular, we are concerned with the binary nature of the assessment of whether a share is a "liquid share" and thus whether it falls within the Standard Same Day Locate Confirmation and Measures or the Liquid Shares Locate Confirmation and Measures. In our view, these should be collapsed into what is currently proposed to be the Liquid Shares Locate Confirmation and Measures (but with a different name to remove the reference to Liquid Shares).

The proposed definition of a "liquid share" from MiFID would not be appropriate in the context of locate arrangements. As ESMA is aware, the "liquid shares" concept in MiFID was introduced for the purposes of pre- and post-trade transparency requirements (for example, provisions relating to public disclosure of firm quotes in liquid shares and publication of share turnover statistics). In the context of short sale transactions and the trading of securities in general, however, what may be considered to be "liquid" can change from day to day. So for example a share

that may be "liquid" under the MiFID definition may in fact be extremely illiquid at the time of the short sale transaction due to a merger announcement or other corporate event.

As a practical matter, the approach that a locate provider uses (for example a prime broker in relation to a hedge fund) is fundamentally the same regardless of liquidity of the relevant shares, except that additional procedures are put in place in relation to shares which the locate provider considers to be hard to borrow or extremely hard to borrow. There is no simple line that can be drawn between "liquid" shares and "illiquid" shares; instead, there is a spectrum with "liquid" shares at one end, then hard to borrow shares and finally extremely hard to borrow shares at the other end. A useful indicator of where the share falls in that spectrum is the cost that the locate provider charges the investor for the locate, which reflects the cost of borrowing such shares from other parties in order for the locate provider to satisfy its obligation to the investor. For example, in the case of a liquid/easy to borrow share, it might charge a fee of 1% of share value, hard to borrow shares might draw a fee of 3 to 4%, while extremely hard to borrow shares might attract a fee of 8 to 9%.

In this regard, we believe a locate provider should make the assessment of the relative liquidity or illiquidity of shares available to it (to settle an investor's sale) whenever it provides a locate to an investor. In doing so, the locate provider should have regard to the relevant criteria, which may include but are not limited to the following:

- the cost that the locate provider is charging the investor for the locate (reflecting the cost of borrowing such shares from other parties in order for the locate provider to satisfy its obligation to the investor);

- the daily sources of supply of such shares available to that party, including from external lenders or other providers, or from shares held by that party, including their own internal positions;

- its own reasonable assessment of the stability of the supply being shown;

- requests by other investors for the same shares; and

- a reasonable assessment of the likely execution of sales in the relevant shares by investors to whom locates have been provided.

Where the locate provider confirms that the process it employs in providing a locate includes an assessment of relevant criteria, including but not limited to, those set out above, no further action is necessary and Article 12(1)(c) will be considered to have been satisfied.

Where the locate provider is unable to give the confirmation above, then it should be required specifically to contact the investor and notify that investor that, notwithstanding the fact that the shares are hard to borrow, the locate provider will be able to deliver the shares to the investor when required for settlement either because it has those shares in its inventory or in the event of failure to cover it is able to procure the shares from another third party to cover the short sale to ensure settlement on time. In the case of extremely hard to borrow shares, the investor will have a reasonable expectation as to delivery where the locate provider informs the investor that it (the locate provider) will not allocate those shares to another investor or otherwise deal in those shares.

We would draw a distinction between a locate provider not allocating the relevant shares or otherwise dealing in those shares on the one hand, and the "effective allocation" referred to in paragraph 23 of the Consultation Paper, on the other. We are concerned that the concept of "effective allocation" referred to in the Consultation Paper could have the same practical effect as a pre-borrow arrangement, *i.e.*, a "claim or agreement leading to physical exchanges of the shares" as envisaged by ESMA for Article 12(1)(b). That is, by imposing the "effective allocation" concept in the manner proposed, ESMA would effectively place a standard on the investor in Article 12(1)(c) that is actually covered by Article 12(1)(b). We believe that could not be the intention of the Regulation, since Article 12(1)(c) must mean something different from Article 12(1)(b).

Where a locate provider "reserves to the investor" or "puts on hold" specific shares to the investor, the result is significant additional cost to the investor. It also results in reduced liquidity in those shares since those shares will already have been allocated to a particular investor. In addition, questions arise as to whether title in those shares has transferred to the investor under such an arrangement, which raises tax issues (*e.g.*, for share transfers) and whether the arrangement amounts to rehypothecation of the relevant shares at the time of "reservation" or "putting on hold".

Q9: In relation to the approach suggested for liquid shares, do you consider it appropriate to use the MiFID definition of liquid shares? Do you think ESMA should consider different approaches to determine the reasonable expectation test for liquid and illiquid shares. If not, can you provide indications as to the criteria to consider to define liquid shares or to take into account the liquidity of the shares in these circumstances? Is securities lending activity an additional factor to consider when determining liquidity of a share?

Please see our response to Question 7 above.

Q10: Do you agree with the approach proposed by ESMA on the location confirmation and reasonable expectation arrangements in relation to sovereign debt and that the reasonable expectation test should only apply in the case of intraday short selling of sovereign debt?

MFA broadly agrees with the approach proposed by ESMA in relation to the standard location confirmation. However, we do not read Recital (20) and Article 13(1)(c) as requiring or otherwise implying that the reasonable expectation test should only apply in the case of intraday short selling of sovereign debt. Recital (20) is expressed to be an example of what might amount to a reasonable expectation. As noted in our response to Question 1, it would be preferable for ESMA to provide general criteria to be met, with illustrative examples in relation to such criteria, rather than an exhaustive list of agreements/arrangements.

Q11: Do you agree that there should be one standard format for notifying relevant competent authority for each type of instrument?

Yes, as it will ensure consistency throughout the EU and aid market participants.

Q12: Do you agree that there should be one standard form for public disclosure of information on significant net short position in shares?

Yes.

Q13: Do you agree with the proposed way to identify natural and legal persons, including the contact information details?

We agree with ESMA's approach in that the draft public disclosure form (unlike the form for notifications to competent authorities) should not include contact details.

Q14: Do you agree with the proposed way to notify and disclose the size of the relevant position?

MFA accepts that, in the case of shares, information on the exact percentage of holding and equivalent number of shares would provide competent authorities with useful information as well as an opportunity to conduct checks on the accuracy of calculations. In this regard, MFA broadly agrees with the format of the "net short position" fields in the Notification Form for Net Short Positions annexed to the Draft Regulatory Technical Standards.

However, MFA believes that, for the purposes of public disclosure, the net short position size should be rounded down to one decimal place (rather than two, as suggested in the Consultation Paper). This approach would follow the language and the legislative intent of Article 6 of the Regulation more closely. The thresholds contained in Article 6 are expressed in one decimal point format (*i.e.*, 0.5% and 0.1%) which indicates that the legislative intent was to monitor the variations of 0.1% and not positions in between. ESMA did not identify any public policy reasons in its Consultation Paper as to why public disclosure of position in two decimal point format would be preferable. Accordingly, MFA believes that it would be disproportionate for ESMA to require public disclosure in that format.

Q19: Do you agree that information on the central websites should at least include data as provided in Annex 1[2] of the draft implementing standard presented in appendix to this consultation paper?

Please see our response to Question 14 on the number of decimal places (which we believe should be one rather than two).

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[2] Position holder, name of the issuer, ISIN, net short position size in percentage, position date.

We would be very happy to discuss our comments or any of the issues raised in the Consultation Paper with ESMA. If ESMA has any comments or questions, please do not hesitate to contact Stuart J. Kaswell (SKaswell@managedfunds.org) or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

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