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

March 9, 2012

Via *ESMA Website*

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

Re: EU Short Selling Regulation – Response to Public Consultation on Draft Technical Standards on Possible Delegated Acts

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to provide comments to ESMA in response to its public consultation on draft technical standards on possible delegated acts concerning the Regulation (the "**Regulation**") on short selling and certain aspects of credit default swaps (the "**Consultation Paper**").

Throughout the drafting process on the Regulation, MFA engaged with EU policy makers in what we hope was 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. We welcome the opportunity to work with ESMA further during the Level 2 process and set out our responses to the question raised in the Consultation Paper below.

We would like to reiterate our concern, expressed in our February 10, 2012 letter (responding to ESMA's consultation on the technical standards for the Regulation), that ESMA has not been given sufficient time in which to prepare its advice, and market participants have correspondingly not been given sufficient time to prepare responses. A rushed timetable has a negative effect on the quality of responses from industry. In particular, market participants do not have time in which to generate empirical data to support their suggestions and proposals.

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

[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.

Q1: Do you agree with the proposal concerning Article 2(1)(r) of the Regulation?

MFA believes that the reference to ownership under the respective "civil" or "securities laws" is unclear and may prove too restrictive. In particular, it is not clear what is meant by "civil law" and why, in this context, "securities law" is used as a distinct category of law. MFA would suggest replacing these references with a reference to "law applicable to the sale in the relevant jurisdiction".

Q2: Are there other cases which need to be excluded from the definition of a short sale?

No comment.

Q3: Are there other definitions in Article 2(1), which need further clarification? Please explain which one(s) and why further clarification is required.

MFA notes that the definition of "sovereign issuer" is broad in that it goes beyond a simple reference to each EU Member State. In order to provide clarity to the financial markets, MFA believes that there will need to be a specific list of entities which are considered to be "sovereign issuers" for purposes of the Regulation; such a list could be published, for example, on the ESMA website. In this regard MFA welcomes the statements made by ESMA during the February 29, 2012 hearing on the Consultation Paper that ESMA would be publishing such a list, in accordance with its proposals for the thresholds to be applied for reporting net short positions in sovereign debt issuers.

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

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

Q4: Do you agree with the above proposal? If not, please give reasons.

Please refer to our comments in relation to the holding of convertible bond positions at Question 6 below.

Q5: Do you have any suggestions on possible further criteria to describe the holding of a share or sovereign debt?

No comment.

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

Q6: Do you agree with the above proposal? If not, please give reasons.

In relation to the calculation of long positions in shares for purposes of the net short position calculation, MFA believes that an investor should be permitted to net long positions held in convertible bonds against short positions in the same issuer. Excluding convertible bond positions would mean excluding what is legitimately a long position from the calculation and give an inaccurate result, both to regulators and to the public. Separately, if investors are going to be subject to the disclosure requirements under Articles 5 and 6 of the Regulation on the basis that they are unable to net off long convertible bond positions from their short positions in the same company, that would discourage investors from subscribing to convertible bond issues by such companies. MFA notes that in the prohibitions on short selling imposed by Member States in late 2011 (including France, Spain, Italy and Belgium), convertible bonds were expressly permitted to be included in the calculation of whether a person has a net short position.

MFA notes that the definition of "issued share capital" under the Regulation refers to "the total of ordinary and any preference shares issued by the company <u>but does not include convertible debt securities</u>." We believe that the definition should not be interpreted to mean that long positions held in convertible bonds are to be excluded from the calculation of "long positions" under Article 3(2) of the Regulation. Rather, the definition is simply describing the universe of the issuer's securities that should be aggregated to determine the denominator of the calculation of a person's net short position.

Article 3(2) of the Regulation refers to long positions "relating to" the issued share capital of a company. Convertible bonds are long positions which "relate to" the issued share capital of a company. Article 3(2)(a) refers to the relevant person "holding a share". The Regulation does not define "share" and it is open to ESMA/the Commission to determine that "share" includes convertible bonds. Article 3(7) provides that the Commission may adopt delegated acts specifying cases in which a person is considered to hold a share for purposes of Article 3(2). We urge ESMA to recommend that the Commission determine that convertible bonds may be considered to be "shares" for purposes of Article 3(2).

In the alternative – if convertible bonds are not considered to be "shares" for purposes of Article 3(2) – we believe that convertible bonds could be considered to be instruments under Article 3(2)(b), in that they are issued under "a transaction which creates or relates to a financial instrument other than an instrument referred to in point (a) and the effect or one of the effects of the transaction is to confer a financial advantage on that natural or legal person in the event of an increase in the price or value of the share...". The value of a convertible bond is clearly affected by movements in the price of the related share.

It is extremely important that convertible bonds should at the very least be included in the calculation for purposes of short selling bans (*e.g.*, which might be introduced under Chapter V of the Regulation), whatever approach might be taken in relation to the calculation of net short positions for the purposes of the disclosure requirements under Articles 5 and 6. As noted above, the recognition of convertible bonds in the calculation of net short positions has been recognised in existing Member State short selling bans, including those imposed by France, Belgium, Spain and Italy in the latter half of 2011. MFA urges ESMA to make clear that, in the context of Member State (or ESMA) prohibitions on short selling, convertible bonds can be included in determining whether a person has a short position in an issuer which is a subject of the prohibition.

Q7: Do you agree with setting a quantitative threshold for high correlation? If so, what would be the best correlation co-efficient to use for this purpose ?

Our responses below cover the points raised in Questions 7 to 11.

MFA does not believe that a strict quantitative threshold would be appropriate in all circumstances. In many cases, it will not be possible to demonstrate correlation in quantitative terms.

Due to the short timeframe for the response to this Consultation, we have not been able to run extensive tests of correlation. However, based on the data which is available to us, we believe that it would be impractical (if not virtually impossible) to require market participants who enter into genuine hedges to demonstrate a 90% correlation over a 24 month period (even taking account of ESMA's proposals for buffer periods). We believe that both the requirement to demonstrate correlation of 90% (or other significant percentage figure) and the reference period of 24 months are unworkable in practice, in that compliance with these requirements would be impossible in most cases. One of the key difficulties with the proposed approach is that correlation may fluctuate dramatically over a relatively short period of time in response to a

variety of macroeconomic events (including changes in interest rates), as well as the market's perception of the creditworthiness of the issuer.

By way of illustration, we enclose, as Appendix 1, a chart showing correlation between Spain and *Instituto de Crédito Oficial* ("ICO"). ICO is a State-owned corporate entity attached to the Ministry of Economy and Finance through the Secretariat of State for the Economy. It has the status of the State's Financial Agency of Spain. ICO has the Spanish State's guarantee on debts and other obligations incurred in the netting of funds on the financial markets. This guarantee is explicit, irrevocable, unconditional and direct. (For further details, please refer to http://www.ico.es/web/contenidos/4/1017/index.html). If an investor had a holding in ICO, such investor would consider itself long Spain (as the investor would for all practical purposes be holding debt of a sovereign issuer). As can be seen from the chart, correlation did reach 90% at times but it was also negative at other times. We have also run some initial calculations as to the correlation of 2 year bonds and 5 year bonds issued by individual Member States and found that in certain cases the correlation coefficient was less than 90% even though the issuer was exactly the same.

We urge ESMA to consider an alternative approach to requiring "high correlation" expressed in mathematical terms. One possible approach would be for ESMA to set out a number of tests (some qualitative, others quantitative in nature) each of which (if met) could demonstrate high correlation. For example, high correlation could be demonstrated in either of the following cases:

(a) an automatic assumption of correlation for sovereign issuers within the same Members State; or

(b) average positive correlation over a period of 24 months or longer.

Q8: Do you think it is practicable to measure correlation for sovereign debt with a liquid market price and a long price history on a historical basis using data for the 24 month period before the position in the sovereign debt is taken out? Do you consider that a 24 month reference period is the most appropriate one?

Please see our response to Question 7.

Q9: Do you think it is practicable to measure correlation for assets with no liquid market price or with no sufficiently long price history by using a proxy? What could be a good proxy? What criteria do you think are necessary?

Please see our response to Question 7.

Q10: Do you consider that this Delegated Act needs to provide further specifications on the calculation of whether the high correlation test is met? Do you have any suggestions on what they may contain (e.g. use of a maturity bucket)?

Please see our response to Question 7.

Q11: Do you think that there is a need for a buffer period addressing the issue of temporary fluctuations in the correlation of the sovereign debt (e.g. period of 3 months during which the correlation is less than the standard level (e.g. 90% or 80%) but at least met a prescribed lower threshold (e.g. 75% or 70%)?

Please see our response to Question 7.

Q12: Do you think it is appropriate the "delta adjusted method" for the calculation of short position for shares?

MFA agrees with the approach taken by ESMA that financial instruments should be accounted for on a delta-adjusted basis rather than a notional basis. This more accurately reflects the relevant person's economic exposure to the underlying shares, and is consistent with existing Member State short selling rules.

Q13: Is there any comment you would like to make in relation to the calculation of the position in shares set out in Box 4?

Positions in convertible debt

We refer ESMA to our comments with respect to convertible debt positions at Question 6 above.

Shares held in baskets or indices

MFA is of the view that ESMA should make a distinction in its advice between broad-based indices or baskets of shares (such as Eurostoxx, for example) and narrow-based indices/baskets (*e.g*., sector-specific). Positions in broad-based indices/baskets are typically taken for hedging purposes and not as a directional view on a particular name in the index/basket. In this regard, we do not believe that an investor who has a long or short position in a broad-based index/basket should be considered as having a long or short position *in the underlying shares*. We would argue that positions in broad-based indices do not confer a financial advantage in the event of an increase/decrease of in the value of the underlying shares for the purposes of Article 3(1)(b) and (2)(b). As the value of the index/basket is determined (in broad terms) on the basis of the net asset value of all underlying shares, the value of an index/basket may go up while the underlying share may go down (and vice versa).

MFA is concerned generally with the practical effect of requiring disaggregation of all positions in indices. Unlike existing short selling disclosure rules in Member States, which relate typically to a limited number of companies (typically financial institutions), the disclosure obligation under the Regulation applies in respect of *all* companies admitted to trading on a trading venue in the EU. This means that the reporting burden is exponentially greater than is currently the case under existing regime. This is particularly problematic in relation to broad-based indices.

We note ESMA comments at paragraph 7 of Box 4 which refer to the "weight" of the underlying share in the basket/index and propose that Article 3(3) should be interpreted so that a

position in an index should be considered only if an individual stock represents a significant percentage (say 20%) of the index/basket, or the position holder through its holding in the index/basket holds more than 1% of the relevant stock. This approach is used, for example, by the UK Financial Services Authority (FSA) in its existing rules on disclosure by holders of long positions; the relevant FSA rule includes an anti-avoidance provision, so that a person could not utilize this approach in order to avoid having to make the relevant notification.[2]

We also note that Article 3(3) and ESMA's guidance refer to the position holder having regard to "publicly available information" as to the composition of the index/basket/ETF and that investors should not be required to obtain any real-time information as to such composition from any person. Whilst this is helpful, we believe ESMA should make clear in its advice to the Commission (or in other guidance) that "publicly available information" means information (which is updated in a time frame consistent with the reporting obligation) that can be obtained without payment so that position holders do not have to pay significant fees to index owners/ETF sponsors for data licenses. Otherwise it would be extremely expensive for market participants to include broad based indices in their calculations. As trades on indices are typically used for general hedging purposes, market participants do not currently track the detailed information in relation to underlying stock in an index.

Q14: Is there any additional method of calculation for shares that you would suggest ESMA to consider?

No comment.

Q15: Which in your view is the most appropriate method for the calculation of short position for debt instruments of a sovereign issuer? Are there methods other than the nominal or sensitivity adjusted ones outlined above which you think ESMA should consider?

We urge ESMA to consider recommending the sensitivity adjusted method to calculation of short positions. This method would be consistent with the current market practice for valuation of bonds. MFA believes that this approach would also be consistent with ESMA's technical advice in relation to calculations of exposure under the Alternative Investment Fund Managers Directive.[3] For example, we refer ESMA to Boxes 98 to 100 of that advice.

Trading in sovereign bonds often is not concerned with credit quality, but more focused on macroeconomic factors, such as inflation expectations or the impact of currency values between nations on the prices and yields of sovereign debt. This is more commonly done through an approach called "yield curve" trading where an investor might buy and sell different maturities of the same issuer's debt. To avoid having credit exposure, the investor might

[2] See DTR 5.3.3 G (2)(c) (available at http://fsahandbook.info/FSA/html/handbook/DTR/5/3).
[3] Final Report: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (http://www.esma.europa.eu/system/files/2011_379.pdf)

endeavor to have no net economic exposure or to fully hedge their position with an offsetting short.

MFA is concerned that applying the nominal method would mean that many investors who were hedging an *actual* exposure (adjusted based on maturity, etc.) and so did not have a net short position, could nonetheless find that they have a reportable net short position on 1 November 2012 if they are then forced to calculate under the nominal method. Alternatively, an investor with an actual net short economic position might find they had no reportable position. We think the sensitivity adjusted method will provide more accurate information to regulators and better reflect the actual economic position of investors.

Q16: Is there any comment you would like to make in relation to the calculation of the position in sovereign debt of a sovereign issuer set out in Box 4?

Please refer to our response to Question 13 above with respect to positions held through indices, baskets and ETFs. MFA believes that the same principles should apply equally to sovereign debt positions held through baskets/indices or ETFs.

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

Q17: Do you agree with the approaches described above to cater for specific situations when different entities in a group have long or short positions or for fund management activities related to separate funds? If not, can you state your reasons and provide alternative method(s) of calculation?

As a general matter, MFA believes that the approach proposed by ESMA is extremely complex and is likely to impose a disproportionate compliance burden on fund managers and will provide regulators and the market with confusing information. Our comments and suggestions on the specific proposals are as follows.

Aggregation of positions with respect to fund management activities

MFA agrees that positions held in funds pursuing the same investment strategy with respect to an issuer should be subject to netting/aggregation for the purposes of calculation of net short positions. MFA believes that a similar approach should be adopted to managed portfolios for which the same investment strategy is pursued in relation to a particular issuer as well as funds, as noted in paragraphs 63 and 73 of the Consultation Paper.

However, MFA disagrees that it would be appropriate for fund managers to aggregate and net all positions under their management. MFA considers that this approach may lead to inaccurate and confusing data on open short positions being made available to the regulators and market participants (such as, for example, if positions of funds pursuing different investment strategies in relation to the same issuer are netted against each other). In this respect, MFA considers that it would be more appropriate for the calculation and reporting to be done with respect to the greater of the following: (1) net short positions on a per fund/managed portfolio

basis; (2) net short positions on an aggregated basis for all funds/managed portfolios pursuing the same strategy with respect to a particular issuer under the management of the same "decision maker". We believe that this approach would be consistent with the language of Article 3(7) which requires for the calculation method to take into consideration whether the same or different investment strategies are pursued in relation to a particular issuer. Moreover, we note that this approach is consistent with the recommendations in the CESR report on technical details of the pan-European short selling disclosure regime (May 2010).

Calculation and reporting of net short positions in the context of delegation

MFA's concern is that the proposed framework for calculating and reporting net short positions in the context of delegation of fund management services will be extremely difficult and costly to implement in practice. In the context of delegation of fund management services to an independent third party, it is uncommon for the delegate to provide the fund management company with real-time or end-of-day reporting of positions. Given the short timeframe for short selling notifications/disclosure, it would be difficult to coordinate the reporting of positions by the delegate to the fund management company and is likely to result in both the fund management company and the delegate allocating significant resources to processing and reporting this data which will inevitably result in additional costs being passed on to the investors in the funds.

Further, the requirement to aggregate positions by both the fund management company and the delegate (*i.e.*, the "decision maker") is likely to produce confusing and inaccurate reporting data which will be contrary to the objectives of the short selling disclosure. It would be unusual for a fund management company to retain any control over the investment management decisions in the context of such delegation. As such, it would not be appropriate to require such a fund management company to aggregate positions over which it has no control. Similarly, where management of a single fund is delegated to multiple sub-managers, it would not be appropriate for positions taken by such independent decision makers to be netted and/or aggregated. It is highly unlikely that in the context of multiple sub-managers, all decision makers would be implementing the same investment strategy or acting "in concert" with each other. In fact, delegation to multiple managers is typically undertaken precisely to ensure that a fund can benefit from several different investment strategies. Accordingly, the requirement to net/aggregate positions taken by such independent decision makers would produce an inaccurate picture of open short positions.

In view of the above considerations, we would suggest the following simplifications to the proposed framework:

- include a provision in ESMA's advice similar to that in Article 8(3) of the Transparency Implementing Directive which allows for a single notification to be made with respect to the notification obligations of several parties;

- in the context of delegation, the calculation of net short positions should apply at the level of the decision maker who should calculate (i) the position at the level of each fund under

its management; and (ii) aggregate positions across all funds/managed portfolios under its management pursuing the same strategy with respect to a particular issuer;

- in the context of delegation to more than one "decision maker" with respect to a single fund, each "decision maker" should (i) calculate the positions with respect to the fund's portfolio under its management; and (ii) aggregate positions across all funds/managed portfolios under its management pursuing the same strategy with respect to a particular issuer.

Q18: Which do you consider the better definition of a group for the purpose of this Regulation?

MFA believes that the definition in Alternative 2 is more precise and would be more appropriate for the purposes of the Regulation, as netting and aggregation should be aligned with control over decision-making with respect to net short positions rather than consolidation for accounting purposes.

Many groups choose not to produce consolidated accounts for a variety of reasons or if they do produce consolidated accounts they may choose (or be required by applicable regulation) to exclude certain subsidiaries from the scope of consolidation.

Q19: Are there other situations that should be taken into account?

Please refer to our response to Question 17 above.

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

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

Q20: Do you agree with the general conditions proposed for determining when a sovereign CDS position can be considered covered? Are there any modifications you would propose?

We note that one of the aims of the Regulation is, broadly, to prevent the adverse impacts on stability of sovereign debt markets by prohibiting speculative trading in sovereign CDS (see, for example, Recital 22). As such, we believe that it would be more appropriate to require that investors have a good faith belief that they are hedging an identifiable risk instead of requiring them to demonstrate precise correlation with the underlying exposure. We urge ESMA to consider that, as a general matter, investors who maintain hedged portfolios (*e.g.*, asset managers) may obtain cover for the exposures in their portfolio in a number of different ways. A better approach to establishing correlation might be to look at the amount of protection obtained by the investor relative to the total exposure in that investor's portfolio. Investors should be given flexibility to allow market participants to treat sovereign CDS as covered where they have determined that genuine and evidenced correlation exists.

For many investors, the purpose of a hedge is to provide protection in a crisis (not necessarily on a daily basis) and therefore what is important is the potential correlation if a crisis occurs (conditional correlation). These conditional correlations are hard or impossible to measure on a quantitative basis; instead, the appropriateness of a hedge can be judged on the basis of reasonableness. For example, a holder of a global equity portfolio might buy puts on the Eurostoxx index as a hedge (an inexact match, but likely to be correlated and moreover very liquid, with low transaction costs). Further, a holder of a bond portfolio might buy sovereign CDS as a hedge for the same reasons.

In this regard, MFA would welcome a broader view of correlation, recognizing that correlation can be present in a wide range of circumstances.

Cross-border correlation

MFA does not agree with ESMA's proposal in paragraph 1(c) of Box 6 that a sovereign CDS may be used to hedge any assets or liabilities meeting the correlation test "provided that the obligor of (or counterparty to) such asset/liability is located in the same Member State as the reference sovereign for the CDS." There is nothing in the Regulation which requires that

correlation can only exist within the same Member State. We note in particular that Recital (21) does not mandate intra-Member State correlation. Recital (21) merely states that "[s]uch interests include hedging against" the risk of default of a sovereign issuer; that is, Recital (21) gives examples of correlation; while the examples given in Recital (21) refer to hedging exposure in the same Member State, it is certainly not a requirement that hedging can only be on an intra-Member State basis. In any event, the Recitals do not have the force of law. By the same token, MFA does not agree with ESMA's statement in paragraph 82 of the Explanatory Text that: "Although there could be risks in one Member State which are correlated with the value of the sovereign debt of another Member State, it was the intention of the co-legislators that the geographical scope of the provision should not be drawn too widely."

MFA encourages ESMA to consider that there are many circumstances where exposures in one country are appropriately hedged by buying protection on another country. Significant correlation across Member States is clearly demonstrable, and indeed is acknowledged in the text of paragraph 82 of the Explanatory Text as reproduced above. Please see the chart below, which shows recent correlations between subordinated debt or trust preferred securities for each of RBS, BNP Paribas and Societe Generale against France, Spain and Italy for one year and six months. Notably, correlation between Societe Generale and BNP Paribas bonds and Italy is higher on average than correlation with France, notwithstanding that both Societe Generale and BNP Paribas are French banks. That is, a holder of BNP Paribas subordinated debt might find that his exposure to BNP Paribas is more fully hedged by buying sovereign CDS on Italy rather than France.

	Issuer	**France CDS**	**Spain CDS**	**Italy CDS**	**Itrx Main**	**Itrx Fin Snr**
1yr	RBS G	-0.50425	-0.35841	-0.42859	-0.5214	-0.49475
1yr	RBS 5.5	-0.45957	-0.28069	-0.37364	-0.52447	-0.50838
1yr	BNP 4.875	-0.3926	-0.27044	-0.35071	-0.42015	-0.43974
1yr	Soc Gen 8.75	-0.33152	-0.29722	-0.34254	-0.4155	-0.41982
6m	RBS G	-0.48848	-0.43785	-0.48898	-0.56083	-0.53813
6m	RBS 5.5	-0.49069	-0.30365	-0.42802	-0.52649	-0.53247
6m	BNP 4.875	-0.419	-0.32696	-0.44599	-0.42313	-0.47821
6m	Soc Gen 8.75	-0.36595	-0.36495	-0.41339	-0.44221	-0.46425

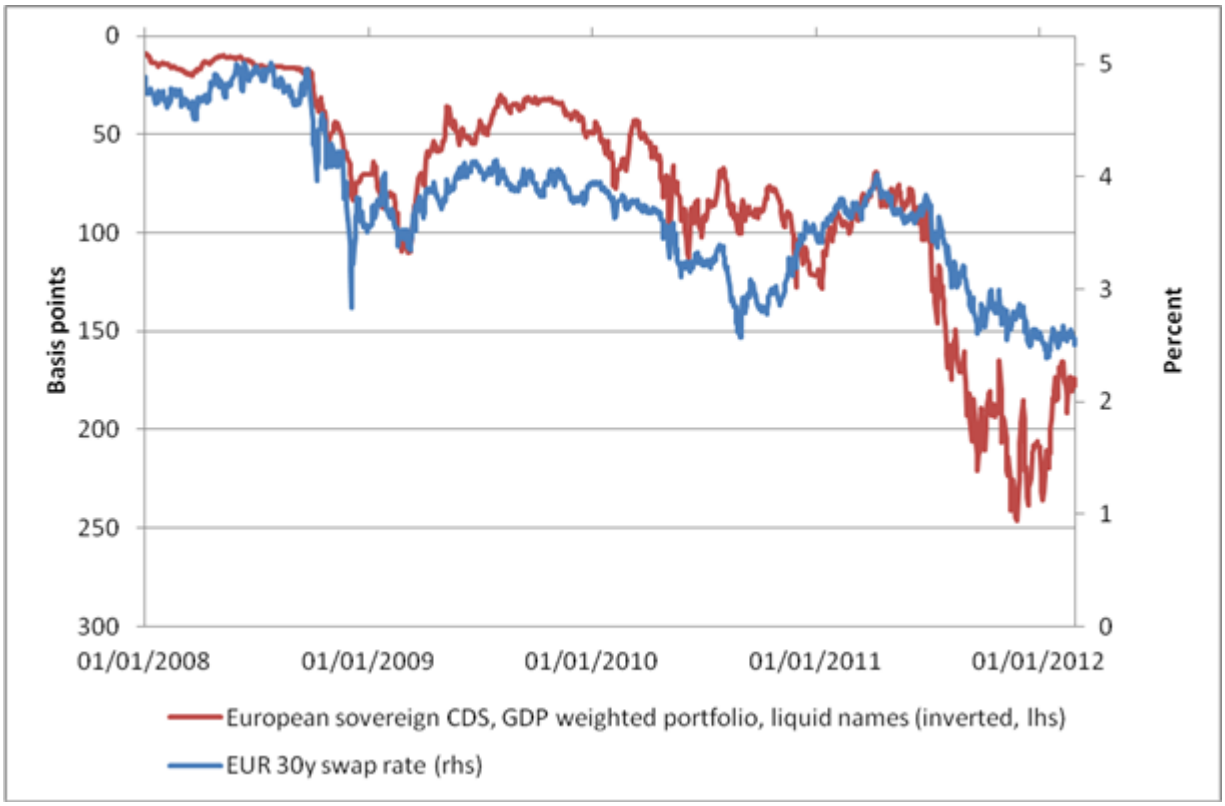
Other examples include: (i) an investor with exposure to German banks might wish to buy protection on Denmark instead of Germany, because CDS on Denmark might provide 90% of the protection, but at 50% of the cost of protection as compared with CDS on Germany; and (ii) an investor who has exposure to a Belgian bank which is known to have a large portfolio of Greek sovereign debt might buy protection on Greece.

MFA notes that EUR swaps and sovereign CDS are an important example of the need to remain flexible on cross-border hedging of sovereign CDS.

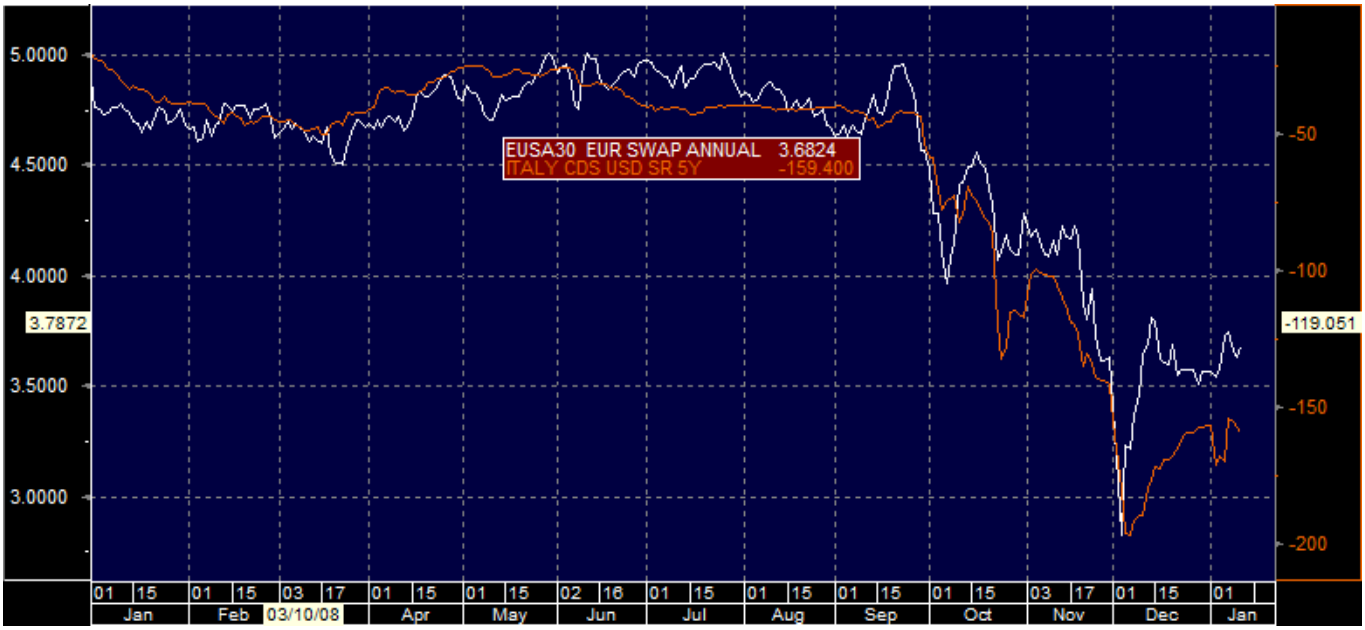
We set out below a representative example of the need to hedge interest rate swap ("IRS") books with sovereign CDS. The following chart shows the tight link between the behavior of the long-end of the EUR IRS curve and the behavior of the sovereign CDS market. By definition, EUR IRS is not linked to any single sovereign. The swap curve embeds both interest rate risk and credit risk of the total membership of the single currency. The following chart demonstrates this link, as there is a prolonged emulation of behavior between the two series, since the beginning of the crisis, even extending before the Lehman bankruptcy.

As a whole, interest rate swaps constitute the largest single P&L risk exposure in the Euro-area fixed income market. In addition, the credit exposure is systemic, not bank name specific. A portfolio of bank name CDS cannot reflect the systemic risk embedded in the IRS curve, while sovereign CDS does exactly that.

It is unreasonable to expect that this elevated exposure cannot be hedged using a portfolio of sovereign CDS. How this is weighted will depend on the emergent systemic risks – it is no help to have protection on Germany if the main systemic risk is elsewhere. Nevertheless, it is possible to construct a useful hedge without resort to peripheral names. The names used below are Austria, Germany, France, Italy & Spain (in other words no CDS from Greece, Ireland and Portugal).



In addition, as evidence of the systemic relationship between the IRS curve and sovereign bonds, we set out below a chart showing the link between 30-year IRS and Italian CDS. This is a particularly sensitive relationship, due to the large amount of outstanding IRS liabilities owned by the Italian state, but serves to demonstrate a more general relationship. The period covered is 1/1/2008 through 1/1/2009 – in other words long before the sovereign debt crisis hit Italy.



MFA notes that Article 4(1) of the Regulation (on sovereign CDS) specifically uses the term "correlated", as compared with "highly correlated" under Articles 3(5) and 13(2) (on sovereign bonds). The Regulation itself contemplates cross-border correlation, even for purposes of "high correlation" under Article 3(5). Article 3(5) provides that the determination of the net short position for sovereign debt includes not only debt issued by a sovereign issuer but also debt issued by any other sovereign issuer, the pricing of which is highly correlated with that of the first sovereign issuer. Consistent with the language of Article 3(5), ESMA specifically contemplates (at paragraph 23 of the Consultation Paper) cross-border correlation for the purposes of calculation of long positions where such high correlation exists. MFA is strongly of the view that, if cross-border correlation is permitted for purposes of a "high correlation" test, it should even more so be permitted where the required standard is only that of "correlation".

Finally, to require the underlying exposure to be in the same Member State as referenced in the CDS would make hedging many transactions in sovereign debt inefficient, as, in most cases, the yield on the sovereign debt and the cost of the CDS would cancel each other. This is likely to lead to fewer asset managers (who maintain hedged portfolios) investing in Member State sovereign debt which would, in turn, lead to a significant drop-off in liquidity of Member State sovereign debt.

Accordingly, MFA respectfully urges ESMA to amend paragraph 1(c) of Box 6 (and the corresponding paragraph 82 of the Explanatory Text) so that cross-border correlation (including

where correlation is demonstrated between a non-EU exposure and an EU sovereign issuer) is permitted.

Statistical correlation

It is not always possible to demonstrate precise correlation on a pure statistical/mathematical or dollar-for-dollar basis. For example, the relevant reference asset held by the protection buyer under the sovereign CDS could be extremely illiquid so that no accurate market price is available. Alternatively, credit protection on a particular sovereign could be bought in anticipation of a correlated risk (*i.e.*, anticipated correlation). To require precise correlation in these circumstances would mean ignoring the fact that correlation between underlying assets varies over time. As such, the protection buyer who is able to demonstrate that he entered into the transaction on the basis of a good faith judgement as to correlation should not be considered to have an uncovered position. In this regard, subject to our response to Question 22 below, MFA supports ESMA's recognition in paragraphs 83 to 86 of the Explanatory Text that a qualitative approach is appropriate.

Tail risk hedging

MFA encourages ESMA to recognize that many investors hedge against tail risk using sovereign CDS. In these circumstances, an asset may not be correlated on a day-to-day basis with a sovereign CDS, but would be expected to have a very high level of correlation if there was a tail risk type event, such as severe market turmoil. Tail risk hedging protects investors and is encouraged by regulators as an important risk mitigating tool. For example, the focus in the systemic risk reports under the AIFM Directive includes requirements to perform scenario analyses that are explicitly designed to highlight tail risks. For tail risk hedging, it may be appropriate to protect investors by using hedges that are not highly correlated in typical trading conditions, but that will become correlated in stressed conditions.

Net exposure

MFA believes that the determination of whether a particular person is "uncovered" in relation to positions in a sovereign CDS should be on a portfolio basis, *i.e.*, on the basis of the net exposure that the person has to the sovereign.

Insurance recharacterisation

It is very important that there should not be a strict requirement for the sovereign CDS protection buyer to hold the exposure it is hedging (*i.e.*, the reference asset) for the life of the CDS. This is important because under certain legal systems (including under English law and New York law, which together govern the majority of CDS contracts), a requirement that a CDS protection buyer always hold the reference obligation could result in that CDS contract being characterized as a contract of insurance.[4] This would result in the protection seller being

[4] For a description of the issue, see *Credit default swaps, guarantees and insurance policies: same effect, different treatment?* by Leonard Ng, Butterworths Journal of International Banking and Financial Law, Dec 2010, p. 664

required to have a license to write insurance – protection sellers in most cases do not have such licenses. In this regard it would be helpful for ESMA to clarify that the reference to "insurable interest" principle in Recital (21) should be taken as merely indicative of the policy behind the rule in Article 14 of the Regulation, rather than an expression of what the rule requires.

Indices

We welcome ESMA's guidance that indirect exposures to sovereign debt issuers held through exposure to indices, funds or special purpose vehicles can be taken into account for hedging purposes as well as ESMA's comments with respect to hedging obligations of a supra-national European body through an basket of sovereign CDS. It would, however, be also helpful for ESMA to confirm that the Regulation does not impose a prohibition on uncovered CDS on sovereign indices (*e.g.*, Markit iTraxx SovX Western Europe Index).

Q21: Do you have any comments or alternative suggestions on the proposed test for correlation? Do you have any estimates of the costs which applying the qualitative test envisaged by ESMA would entail for market participants or the costs which would be associated with the imposition of a quantitative test?

Please refer to our response to Question 20 above.

Q22: Do you consider the proposals for demonstrating correlation provide a workable framework for market participants?

As noted above, we do not believe that ESMA should attempt to define a method or components of measuring correlation (including different tests for "liquid" or "illiquid" CDS under Box 6) and allow market participants to use their own proprietary models for identifying correlation (including any changes in the risk profile). Investors should only be required to demonstrate that they entered into the CDS transaction in good faith having regard to the principles of correlation and proportionality. Competent authorities can then enforce compliance through their periodic inspections and record keeping requirements.

Q23: Are any changes required to the proposals for determining whether a sovereign CDS position is proportionate?

Please refer to our response to Question 20 above.

Q24: Do you think that a position that had become partially uncovered due to fluctuations in the value of the assets or liabilities being hedged and/or the CDS used as the hedge should be allowed only for a certain period of time? If so, what would be an appropriate time limit?

MFA welcomes ESMA's comments with respect to changes in the hedges as a result of market fluctuations. However, MFA does not believe that there should be a time limit on the

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(available at www.sidley.com/credit-default-swaps-guarantees-and-insurance-policies-same-effect-different-treatment-12-01-2010/).

investor's obligation to cover the position or a requirement for such an investor to unwind his position in the event that a hedging position becomes unmatched as a result of market fluctuations. Provided that the investor entered into the sovereign CDS contract in good faith and had the expectation or intention at the time of entering into the contract that he would be holding the reference asset for a reasonable period of time and hence was hedging an exposure, it would be disproportionate to impose an obligation to either cover (within a certain time limit) or unwind the position as a result of events beyond the investor's control. CDS contracts are not typically as liquid as listed securities or sovereign debt, and unwinding them requires negotiations with the counterparty or purchase of a new CDS contract that offsets the first. It will not be as easy and certainly will be more costly to force such an unwind in such an illiquid market.

In addition, we believe that a strict requirement to cover or unwind the position in these circumstances would trigger the insurance recharacterisation issues discussed in our response to Question 20 above.

Further, it would be helpful if ESMA made it clear in its advice that a protection buyer may reallocate a hedge to another asset, at any time, by redesignating what the relevant CDS covers for purposes of Article 4 of the Regulation.

Q25: Do you agree that sovereign CDS positions which are obtained involuntarily as a result of the operations of a CCP clearing sovereign CDS should not fall to be considered as entering into a CDS transaction for the purposes of the Regulation?

We agree with ESMA's proposals. It would be disproportionate to bring these types of positions within the scope of the Regulation.

Q26: Do you consider there are any other illustrative cases of a risk which would be eligible to be hedged by a sovereign CDS position which should be included in the indicative list?

In view of our comments in relation to Question 20 above, MFA would suggest the following additional illustrative cases where the sovereign CDS may be considered to be "covered":

- A holder of bank debt in Portugal should be able to hedge that risk by buying CDS protection on Spain. Equally, if a person has exposure to a U.S. bank which itself has significant exposure to French sovereign debt, that person should be able to hedge his risk in that U.S. bank's exposure by buying CDS protection on France.

- Where a person hedges a portfolio of bonds issued by certain German energy companies by buying CDS protection on Germany, that CDS does not have to be unwound if the bonds in that portfolio are sold but the hedge is now applied to a new portfolio. CDS contracts are not usually highly liquid so requiring a sale or replacement could increase costs greatly.

- An investor owning Italian corporate bonds who is concerned about Italy leaving the eurozone and thus having those bonds potentially being redenominated into Italian lira could buy protection on Italy as a hedge against that redenomination risk. In this case the hedge relates to currency redenomination risk, but the hedge is achieved by buying protection on the relevant sovereign.

- An investor who has an exposure to a bank which is joint venture between a French and Belgian groups may buy protection for up to 100% of the exposure to the bank on each of France and Belgium.

- An investor should be able to hedge a portfolio of EUR interest rate swaps (IRS) using a basket of Eurozone sovereign CDS.

MFA welcomes ESMA's comments at paragraph 81 that there should not be any restrictions as regards the scope of the assets/liabilities which can be hedged provided that they meet the conditions of proportionality and correlation. In this regard, MFA would propose including a general statement in ESMA's advice that it should be sufficient for an investor to be able to demonstrate that its actions are in accordance with a documented investment strategy which contemplates that hedging be carried out, and that the investor entered into the transaction on a good faith basis in relation to the principles of correlation and proportionality set out in ESMA's advice.

III.II. Method of calculating an uncovered position

Q27: Do you agree that the net CDS position is the correct one to use in the calculations?

MFA agrees with this proposal, subject to our comments in relation to cross-border correlation at Question 20 above. That is, we believe that an investor should be able to, for example, deduct any sales of CDS in relation to Italy from CDS purchases in relation to Spain.

Q28: Do you consider that there should be different methods for calculating the value of the positions to be hedged by the sovereign CDS according to whether a static or dynamic hedging strategy is used?

No comment.

Q29: Are there refinements which can be made to the proposed methodology? Are there any standard calculation formulae which can be used when applying risk adjustments which we should include in the draft advice?

No comment.

Q30: Do you agree with the proposed method of treating indirect exposures?

We agree that investors should be able to take into account indirect exposures (such as indices, funds and SPVs) to risks and to CDS in proportion to the extent that such exposure/CDS

is represented in such an index/fund or SPV. We refer ESMA to our comments at Question 13 above in relation to broadly-based indices/baskets and funds.

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

Q31: Do you agree that the relevant notification threshold should be based on a percentage of the total amount of outstanding issued sovereign debt for each sovereign issuer?

We broadly agree with these proposals, subject to our comments in relation to Question 32 below.

In order to provide clarity to the financial markets, MFA believes that ESMA should compile a list of entities which are considered to be "sovereign issuers" for purposes of the Regulation.

Q32: Do you agree with the proposal to convert these percentages into monetary amounts which would be updated quarterly to reflect changes in the issued sovereign debt? If not, what other arrangement would you suggest?

We agree with ESMA's proposal that the percentage thresholds should be converted into monetary amounts and that competent authorities should recalculate and publish this amount on a regular basis. This is consistent, for example, with the approach relating to disclosure of long positions under Directive 2004/109/EC (the Transparency Directive). Issuers are required under Article 15 of that Directive publicly to disclose the total number of voting rights and capital at the end of each calendar month during which an increase or decrease of voting rights or capital has occurred, in order that long position holders can determine if the relevant percentage thresholds for disclosure have been reached or exceeded.

Q33: Do you agree with ESMA's proposal to group sovereign issuers into categories for the purposes of setting the notification thresholds or would you prefer an alternative approach (e.g. a single threshold for all sovereign issuers or setting individual thresholds for each sovereign issuer)? Please state your reasons.

No comment.

Q34: If you support grouping sovereign issuers into categories, do you agree with ESMA's proposal to set the three categories of notification thresholds suggested above? If not, what other grouping would you suggest and why?

No comment.

Q35: Do you consider the proposed initial amounts and the incremental levels as reasonable and optimal? If not, what amounts and incremental levels do you consider as more appropriate and why?

No comment.

Q36: If given the thresholds ESMA has proposed above are implemented, how many notifications do you expect to make in a month to each relevant competent authority?

No comment.

Q37: What level of net short position do you regard as significant for the particular sovereign debt markets?

No comment.

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

Q38: Do you agree with the general proposal suggested by ESMA for setting the parameters and methods for calculating the threshold of liquidity of the issued sovereign debt for suspending restrictions on short sales? If not, please state your reason and explain what could be an appropriate alternative.

No comment.

Q39: In particular, do you agree that a measure in percentiles of the monthly volume traded in the last twelve months is suitable to define a threshold that represents a significant decline relative to the average level of liquidity for the sovereign debt concerned?

No comment.

Q40: In light of your response to the question above, do you think that a threshold of a) the 5th percentile, b) 2nd percentile or c) 1st percentile would best represent a significant decline relative to the average level of liquidity for sovereign debt? Please explain why providing data if possible.

No comment.

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

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

Q41: Do you agree that three categories are necessary? If not please state your reasons.

As a general matter, it is unclear how market participants will be aware of significant falls in prices of OTC instruments. Further, we believe that it will be difficult to implement these thresholds in the absence of consolidated tape which will provide real-time information with respect to all relevant trading venues.

MFA's chief concern with the proposed thresholds is that they are set at such low levels that they are likely to interfere with legitimate market operations. As such, there is a substantial likelihood that the ability of competent authorities to place restrictions on short selling when such thresholds are reached would negatively impact the rest of the market in terms of liquidity and pricing efficiency, thereby harming investors.

Further, as stated in our response to Question 6, we believe that ESMA should make it clear that convertible bonds can be included in the calculation of net short positions in cases where there is a ban on short selling.

Q42: For the more illiquid shares, do you agree that EUR 0.50 is the correct cut off point to use? If not please state you reasons.

No comment.

Q43: Do you agree that 10%, 20% and 30% are the correct percentages to use in relation to the fall in value? If not, what other levels would you propose; please state your reasons.

We believe that a fall of 10% for listed shares would capture too many shares, many of which would be trading down appropriately based on important corporate announcements or investor concerns relating to economic stress for a company or sector. ESMA should consider increasing this threshold to at least 20%.

Q44: Do you agree that an increase in the yield across the yield curve is the appropriate measure to use for sovereign bonds? If not, what other measure would you propose, please state your reasons.

No comment.

Q45: Do you agree that an increase of 5% or more in the yield across the yield curve is the correct percentage to use? If not, please say what alternative threshold you would favour and state your reasons.

If the quantitative thresholds are imposed, these thresholds should be higher in the case of sovereign debt. By way of example, the yield of the UK sovereign bonds maturing March 2013 has increased by more than 5% roughly twice a month over the last year. We estimate that an appropriate threshold might be 10%.

Q46: Do you agree that an increase of 7% or more in the yield is the correct percentage to use for corporate bonds? If not please state your reasons.

No comment.

Q47: Do you agree that an increase of 10% or more in the yield curve is the correct percentage to use for money market instruments? If not please state your reasons.

No comment.

Q48: Do you agree with the proposed ESMA approach to units in collective investment undertakings? If not please state your reasons.

No comment.

Q49: If you consider that a trigger threshold in relation to fall in value in UCITS should be defined, what should be this percentage threshold and why?

No comment.

Q50: Do you agree that 10% or more is the correct percentage to use for ETFs? If not please state your reasons.

MFA does not believe that it is necessary to provide a separate threshold for ETFs for the purposes of Article 23. ETFs and other index products are not generally susceptible to manipulation by short selling and are widely used as risk management tools. These products are based on a portfolio of stocks that seek to provide investment results that correspond generally to the price and yield performance of a specified foreign or domestic stock index. Shares of ETFs and other index products rise and fall based on changes in the net asset value of the component stocks of the particular index and supply and demand; accordingly, it is not necessary to provide a separate threshold for such instruments.

Q51: Do you agree with the proposal of having a differentiated approach depending on whether the concerned derivative has a single financial instrument that is traded on a trading venue and for which a significant fall in value has been specified according to this Delegated Act as underlying? If not, please state your reasons.

No comment.

Q52: Do you agree that a 3/4 ratio of the margin level set by the clearing house per underlying of a derivative is the appropriate level to use for an option, future, swap, forward rate agreement or other derivative instrument, including financial contracts for difference? If not, what alternative would you propose?

No comment.

Q53: What could be an appropriate threshold to define a significant fall in price of a derivative compared to the closing price of the previous day when that derivative does not have a single underlying instrument admitted to trading on a trading venue and is not centrally cleared?

No comment.

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

Q54: Do you agree with the abovementioned proposal for the methods of calculation for various types of financial instrument? Do you have alternative or complementary methods to suggest, in particular in relation to the yield curve calculation method?

No comment.

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

Q55: Do you agree with the proposal for qualitative criteria should be set out?

MFA believes that the above criteria are too subjective, as any of these events may be present in relatively benign market conditions which would not warrant imposing restrictions on short-selling and sovereign CDS transactions. A short selling ban or restriction on CDS transactions would be justified only in the most extreme circumstances. Examples would include a terrorist attack, such as the September 11, 2001 attacks on the US or the assassination of a world leader, such as an EU Head of State. In such events, competent authorities may need to take action because of widespread systems failures or panics. But in our view, even wide swings in markets do not justify emergency bans on trading. We believe that the public is best served by allowing markets to function and reach economic equilibrium.

As a separate matter, we note, for example, that the proposed criteria and factors include "serious financial (monetary, budgetary, financing) instability or uncertainty concerning an EU Member State or of a systemically important financial institution (including banks, asset management, market infrastructure and insurance companies) operating within the EU when this may threaten the orderly functioning and integrity of financial markets or the stability of the financial system in the EU." This example of adverse scenarios is a comprehensive account of the reasons why investors would buy sovereign CDS as protection. ESMA is therefore proposing that the main reason for buying CDS will be subject to potentially capricious regulatory intrusion (which may include an outright ban on sovereign CDS) at exactly the time it was designed to act as a hedge. In our view, this approach contradicts the notion of 'insurable interest' under the Regulation and seriously undermines the purposes of the Regulation.

Q56: Are there any additional criteria or factor that you would suggest adding to the list?

ESMA should make it clear in its advice that competent authorities should give sufficient notice to the market before the implementation of any new restriction. Sudden restrictions or prohibitions have a destabilizing effect on financial markets and MFA is keen for such instability to be avoided. In this regard, MFA supports the approach taken by the Italian CONSOB in relation to restrictions on uncovered short sales of Italian stock, which were announced on 11 November 2011 but which took effect only on 1 December 2011. Similarly, any restriction introduced by ESMA pursuant to Article 28 should be subject to a reasonable notice period in order to reduce market instability.

In addition, as stated in our response to Question 6, we believe that ESMA should make it clear that convertible bonds can be included in the calculation of net short positions in cases where there is a ban on short selling.

Although the provisions on Member State suspensions in Article 14 are beyond the scope of this question, MFA would like to take this opportunity to highlight to ESMA that the language in Article 14 is not entirely clear. In particular, Article 14 provides that a Member State regulator can suspend the restriction where the relevant restriction has a negative impact on "the" (rather than "its") sovereign CDS market. MFA takes this to mean that, in suspending the restriction, Member States can take a view on whether the sovereign CDS market as a whole (globally) is functioning, not only in its own Member State. For example, where a Member State considers that the EU sovereign CDS market generally is not functioning properly, that Member State can permit persons within that Member State to enter into sovereign CDS transactions relating to other sovereign issuers (as well as that Member State itself). It would be helpful if ESMA could clarify this point in its advice.

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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

Richard H. Baker
President and CEO

APPENDIX 1

Correlation between Spain and ICO