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By e-mail submission to: markt-consultations@ec.europa.eu

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Dear Maria

European Commission Public Consultation on Short Selling (June 2010)

Thank you for the opportunity to provide comments on the Commission's proposals relating to short selling. We have set out below our views in relation to: the scope of the regime; disclosure obligations; uncovered short sales; exemptions; and emergency powers. We have provided in the Annex to this letter our responses to the question posed by the Commission in the Consultation Paper.

By way of background, BATS Trading Limited¹ ("BATS Europe") is based in the UK and is authorised and regulated by the UK Financial Services Authority ("FSA") as the operator of a Multilateral Trading Facility ("MTF").² BATS Europe operates an Integrated Book (for displayed orders and non-displayed Large in Scale orders), a Dark Book (for non-displayed orders that match at an externally generated reference price) and an Order Routing Facility so that orders which are not filled on the BATS Europe order books may be routed to other execution venues.

We agree that short selling plays an important role in financial markets, including – as noted by the Commission in the Consultation Paper – with respect to contributing to the efficiency of the price formation process, increasing liquidity, and facilitating hedging and other risk management activities. We, therefore, strongly believe **it is important to ensure that any short selling regime does not hinder the ability of market participants to legitimately sell short financial instruments.**

¹ BATS Trading Limited is a fully owned subsidiary of BATS Global Markets Inc. Owners of BATS Global Markets Inc include affiliates of Citigroup, Credit Suisse, Deutsche Bank, GETCO, JPMorgan, Lime Brokerage, Morgan Stanley, Merrill Lynch and Wedbush.

² BATS Europe launched its market for the trading of pan-European equity securities on 31st October 2008 and regularly matches more than 10% of the notional value traded in FTSE 100 securities and 5-7% of other major European indices.



We understand that short selling is believed increase the potential risk of: market abuse (an attempt to move a price to a different level); transparency deficiencies or information asymmetry; disorderly markets (the disorderly change in a price); and settlement failure.

We are supportive of the Commission’s proposal to increase the information that regulators have to monitor short sale activity through the provision of private disclosures on end of day short positions. We are not aware of evidence that demonstrates particular and fundamental risks associated with short selling. The provision of this data to regulators should provide further information on the legitimacy of concerns related to short selling.

It is important that any risks related to short selling are clearly enumerated and that the measures proposed are aimed at addressing those specific risks. In addition, the benefits of any additional measures should outweigh any costs; both the costs of compliance and the potential impact on the market if additional regulation discourages legitimate short selling activity.

We are concerned that some of the measures proposed by the Commission may have the effect of discouraging legitimate short selling activity. For example, the proposed “borrow” condition for uncovered short sales. Should the Commission proceed with this proposal, we would urge the Commission to ensure that the wording of the condition is not so narrowly drawn as to hinder legitimate short selling activity. Similarly, whilst we strongly support the inclusion of a market maker exemption – both with respect to the disclosure requirement and uncovered short sales condition – we are concerned that the definition as currently drafted may not capture the firms intended, excluding a proportion of firms who at present provide significant liquidity to the market, and that it may not create sufficient legal certainty.

Scope of the regime

We welcome the Commission’s approach of aiming to ensure that there is consistency between European Member States. It is important that this includes clearly defined terms, and consistent obligations, implementation, monitoring and enforcement. Such consistency should help to reduce the complexities and costs associated with compliance with multiple differing regimes, and will better reflect the pan-European nature of trading since the implementation of MiFID.

Whilst we believe there are benefits in consistent obligations across all financial instruments, in practice we believe that the different characteristics of the instruments themselves and the way in which they are traded (type of liquidity, level of transparency, etc), cleared and settled will necessarily require different obligations. For example, we consider that it will be necessary to differentiate between corporate and sovereign entities, and financial instruments related to those entities.



Disclosure obligations

The private and public disclosure obligations seek to address different risks. The private disclosure to the regulator should aid regulators in the early identification of significant increases in short selling activity and any potentially abusive behaviour. We agree that this obligation should lie with the holder of the short position, whether a regulated firm or not. We believe that the suggestion of an end of day calculation with next day reporting is a sensible measure, which seeks to strike the balance between over- and under-reporting and should help to reduce additional compliance and data costs associated with real-time intraday short position reporting.

Whilst not the subject of any specific proposals, we would note that we are strongly opposed to a short sale flagging requirement on individual orders. Such a regime for individual orders would impose significant costs on market participants and would not address any clear market failure. The costs associated with real-time flagging of all orders would be considerable, in particular if the overall short selling regime aims to capture net economic interest. In addition, there are logical complexities when orders are in flight, for example, the marking of simultaneous buy and sell orders. We believe that such information would be less useful than an end of day net short disclosure. With respect to public disclosure, flagging would generate a significant amount of additional information which may be potentially misleading and could increase volatility, for example, the flagging of short sales which are covered by the end of the day. It is important that any new requirements do not have the unintended consequence of amplifying the potential risks that they are seeking to address.

Clearly it is important that regulators have appropriate tools to be able to monitor the disclosures to identify patterns and potential issues. In addition, given the pan-European nature of trading, it is important that regulators have mechanisms in place to efficiently and effectively share information. In the absence of these, the proposed disclosure regime could impose significant costs on firms with little overall benefit to the market.

With respect to the proposed public disclosure requirement, we understand that this would primarily address concerns about transparency deficiencies or information asymmetry. In particular, that information relating to the level of short selling in a financial instrument contains pricing information that would be useful to other market participants and aid the overall efficiency of the price formation process. To this extent, we consider that public disclosures should be made on an anonymous basis, preferably in aggregate form. We do not consider that requiring disclosure of individual short positions (that is the short position of an individual firm) would efficiently address any of the potential risks identified in relation to short selling.

There has been suggestion, for example, in the UK FSA's Discussion Paper on short selling³, that an individual public disclosure requirement can act as a deterrent to those considering taking large short

³ DP09/1: http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf



positions. Whilst we appreciate this concern during periods of extreme stress in the market, we would be concerned if such public disclosure discourages legitimate short selling activity. We would note that the stock borrowing market is a bilateral and relationship-based market. An individual public disclosure requirement could be disruptive to the pricing available to individuals when borrowing stock, which coupled with a hard “locate”/“borrow” condition for uncovered short sales, could have the unintended consequence of increasing the price of borrowing stock and hampering legitimate short selling, to the detriment of liquidity and efficient price formation.

It is important to balance the benefits that additional disclosure could bring against the potential negative consequences. **We believe the public disclosure of short sale positions on an anonymised aggregated basis is a more proportionate approach than the disclosure of the identities and short positions of individual holders.** Ideally, subject to appropriate information sharing arrangements between regulators, this information would be aggregated on a pan-European basis and published by, for example, the Competent Authority of the most relevant market in terms of liquidity.

Uncovered short sales

In the Consultation Paper, the Commission notes that it appears that sometimes uncovered short selling can increase the risk of settlement failure and result in increased price volatility. We are not convinced that there is evidence that demonstrates the need for additional conditions relating to uncovered short sales. For example, the current low settlement failure rate and lack of evidence to suggest that uncovered short selling has resulted in increased price volatility.

We would note that the structure of the European market, to the extent that orders are only marked as buy or sell, does not lend itself to gathering this type of data. Therefore, where there has been a failure to settle there is no immediate mechanism to determine whether this is as a result of uncovered short selling. That is not to say that we support a flagging regime for individual orders; we would strongly oppose such a regime, which as noted above would introduce a significant level of complexity, impose considerable costs on market participants and would not address any clear market failure.

With respect to the “borrow” requirement, we would suggest that the language should be widened to: “has borrowed the share, has entered into an agreement to borrow the share or has evidence of other arrangements which ensure that it will have a reasonable expectation of being able to borrow the share at the time of settlement”. **We could be concerned if the current narrow wording has unintended consequences on the costs of stock borrowing and therefore hinder the ability of market participants to enter into legitimate short sales.**

We believe that an effective settlement regime is a more important factor in generally ensuring efficient and timely settlement, including a short settlement cycle (e.g. T+3), financial penalties for failure to settle, and buy-in procedures at the trading platform, CCP or CSD level, as appropriate. Although it is important to have regard to the differences between markets, there are clear benefits to clarity and



consistency of settlement regimes across Europe. However, we do not think that any work in this area should be solely conducted in relation to short selling activity but could be considered in relation to the MiFID obligations on organised markets, the Commission's proposals for requirements for CCPs and through the work being conducted by CPSS-IOSCO.

In order to guard against disorderly price changes, we believe the additional information provided by the public disclosure of (aggregate and anonymised) short sales positions as well as existing mechanisms, or limit-up/limit-down mechanisms, provide reasonable safeguards. We do not consider that regulators should have additional powers to, for example, ban short selling if prices move by a specific percentage.

Exemptions

It is imperative that there are appropriate exemptions in place to ensure that any obligations relating to short selling do not have an adverse impact. In particular, **we believe that firms regularly providing liquidity to the market should be exempt from at least the public reporting requirement and the conditions related to uncovered short sales (i.e. the "borrow" condition).**

The Commission has suggested that the exemption should be in the terms recommended by CESR in its *Report on Technical details of the pan-European short selling disclosure regime* (May 2010)⁴; that is:

An investment firm (or equivalent third-country entity) or a local [*the notion of local refers to the exemptions provided by article 2(1)(d) and (l) in connection with articles 42(3) and 14(4) of MiFID*] that is a member of a regulated market or MTF (or equivalent third-country market), that deals as principal in the relevant share and/or relevant derivatives (whether OTC or exchange-traded), in either both of the following capacities:

- (i) By posting firm, simultaneous two-way quotations of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;
- (ii) As part of its usual business, to fulfil orders initiated by clients or in response to clients' requests to trade, and to hedge positions arising out of those dealings.

However, the Commission's proposal states that "local" means "a firm referred to in article 2(1)(l)" of MiFID, and does not include article 2(1)(d) exempt firms. **We strongly believe that article 2(1)(d) exempt firms should be able to qualify for the market maker exemption.** Whilst such firms are not formally registered as market makers, a number of these firms are members of RMs and/or MTFs and act in a way that is functionally the same as market makers by regularly providing liquidity in a principal capacity. In this regard, as with market makers, they are directionally neutral and do not typically hold short positions other than for brief periods.

⁴ CESR/10-453.



We believe that excluding such firms from the exemption would not help achieve the aims of the disclosure requirement and uncovered short sales condition. Such firms provide a significant amount of liquidity to the market and **we would be concerned about the unintended consequences, including on the level of liquidity and efficiency of the price formation process, if such firms were not included in the exemption.**

As a broader point, we would note **it is important that the exemption creates legal certainty.** The wording suggested relating to, for example, comparable size and competitive prices will have different meaning depending on the financial instruments being traded, the nature of the market and the associated risk.

To more accurately capture the firms that we believe the exemption is intended to cover, we would suggest a definition in terms of: an investment firm or local [which means an article 2(1)(d) or article 2(1)(l) exempt firm] which is a member of an RM or MTF and which deals as principal, which as part of its usual business regularly and on an ongoing basis provides liquidity by posting firm quotes at relevant prices or fulfils orders initiated by clients or in response to clients' requests to trade and to hedge positions arising out of those dealings.

In its Report, CESR suggests that those firms wishing to make use of the market maker exemption should make a prior notification to the relevant CESR member(s) of their intention to do so. CESR also suggests that the CESR member receiving the notification may decline to allow a party to make use of the exemption. It is important to ensure that this mechanism is subject to objective criteria to ensure fair and consistent treatment between Member States. We would also suggest that the market participant seeking to use the exemption should only need to notify its home Competent Authority (in the case of authorised firms) or the most relevant Competent Authority (in the case of exempt firms), and that regulators should share this information (cf. the passport regime).

Emergency powers

Where regulators identify specific issues as a result of the private disclosures made to them or otherwise, we agree that they should have powers to intervene where necessary to ensure continued market confidence and financial stability. However, we believe it is essential that these powers are narrowly drawn (emergency situations) and that they are subject to clear and objective criteria to provide greater certainty over the circumstances in which they will be used and to ensure consistency between Member States.

We agree that Competent Authorities should provide advance notification to the other Competent Authorities and ESMA when they intend to use their emergency powers. We agree that the notification should include details of the proposed measures, the financial instrument coverage, the reasons for the measures, the evidence supporting those reasons and the date on which the measures are intended to take effect and end. We also agree that such information should be made public and easily accessible to



all market participants. In addition to the contents of the notification suggested by the Commission, **we consider it is important that the notification should provide clarity on any cross-border implications.** By their nature, emergency measures will likely be imposed within a very short timeframe. In order to ensure that the measures are implemented smoothly, it is important that market participants understand the scope of the measures and their application, including any cross-border implications. In particular, it is important to ensure that any issues related to uncoordinated, unilaterally imposed conditions are resolved.

We would be happy to discuss our response further or provide such additional information or data as the Commission may require.

Yours sincerely

Anna Westbury
Head of Compliance and Regulatory Affairs
BATS Europe

BATS ... Making Markets Better



Annex

1. *Which financial instruments give rise to risks of short selling and what is the evidence of those risks?*
2. *What is your preferred option regarding the scope of instruments to which measures should be applied?*

Clearly there are benefits in a single harmonised regime. However, it will be important to take into account the different characteristics of the financial instruments covered. For example, whether they are standardised, the level of transparency, whether they are exchange-traded, whether they are centrally cleared, the settlement cycle, etc. Therefore, we think it likely that different groups of financial instruments will require different requirements. We would differentiate between financial instruments related to corporate and sovereign entities. We would be concerned if requirements were imposed on a limited number of classes of financial instruments in such a way as to make them less attractive to investors.

3. *In what circumstances should measures apply to transactions carried on outside the European Union?*

We consider that the requirements should ideally apply to transactions carried on outside the European Union to avoid the risk of regulatory arbitrage.

4. *What is your preferred option in relation to the scope of financial instruments to which the transparency requirements should apply?*
5. *Under Option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?*
6. *Under Option B do you agree with the proposals for notification to regulators and the markets of significant net short positions in EU shares?*
7. *In relation to Option B do you agree with the proposals for notification to regulators of net short positions in EU sovereign debt (including through the use of CDS)? In addition to notification to regulators should there be public disclosure of significant short positions?*

As noted above, we believe there are benefits to a harmonised regime. However, we consider that the different characteristics will require tailored regime. We also consider that it would be useful to conduct further work on the effect of public disclosure.

8. *Do you agree with the methods of notification and disclosure suggested?*

We believe that the suggestion of an end of day calculation with next day reporting is a sensible measure, which seeks to strike the balance between over- and under-reporting and should help to reduce additional compliance and data costs associated with real-time intraday short position reporting.



Clearly it is important that regulators have appropriate tools to be able to monitor the disclosures to identify patterns and potential issues. In addition, given the pan-European nature of trading, it is important that regulators have mechanisms in place to efficiently and effectively share information. In the absence of these, the proposed disclosure regime could impose significant costs on firms with little overall benefit to the market.

9. If transparency is required for short positions relating to sovereign bonds, should there be an exemption for primary market activities or market making activities?

No comment.

10. What is the likely costs and impact of the different options on the functioning of financial markets?

It is important that the benefits of any additional regulation outweigh the costs; both the costs of compliance and the potential impact on the market (in terms of liquidity and price formation) if additional regulation discourages legitimate short selling activity.

The costs of compliance with the disclosure obligation will be dependent on the scope of the obligation and where responsibility for reporting lies. We will be interested in the responses of firms to the Commission on the likely costs of compliance with the reporting obligations, including with respect to any complexities associated with the calculation methodology.

- 11. What are the risks of uncovered short selling and what is the evidence of those risks?*
- 12. Is there evidence of risks of uncovered short sales for financial instruments other than shares (e.g. bonds or sovereign bonds), which would justify extending the requirements to these instruments?*
- 13. Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions could be put in place? If so please indicate which ones? Do you agree that arrangements other than formal agreements to borrow should be permitted if they ensure the shares are available for borrowing at settlement? If so, why?*
- 14. Do you consider that the risks of uncovered short selling are such that they should be subject to an upfront ban/permanent restrictions? If so, why?*
- 15. Do you agree with the proposal requiring buy in procedures for settlement failures due to short sales? If so, what is an appropriate base period that could be specified before buy in procedures are triggered (e.g. T + 4)?*

We believe that an effective settlement regime is a more important factor in generally ensuring efficient and timely settlement, including a short settlement cycle (e.g. T+3), financial penalties for failure to settle, and buy-in procedures at the trading platform, CCP or CSD level, as appropriate. Although it is important to have regard to the differences between markets, there are clear benefits to clarity and consistency of settlement regimes across Europe. However, we do not think that any work in this area should be solely conducted in relation to short selling activity but could be considered in relation to the



MiFID obligations on organised markets, the Commission's proposals for requirements for CCPs and through the work being conducted by CPSS-IOSCO.

We are not convinced there is evidence that demonstrates the need for additional conditions relating to uncovered short sales. For example, the current low settlement failure rate and lack of evidence to suggest that uncovered short selling has resulted in increased price volatility.

We would note that the structure of the European market, to the extent that orders are only marked as buy or sell, does not lend itself to gathering this type of data. Therefore, where there has been a failure to settle there is no immediate mechanism to determine whether this is as a result of uncovered short selling. That is not to say that we support a flagging regime for individual orders; we would strongly oppose such a regime, which would introduce a significant level of complexity, impose considerable costs on market participants and would not address any clear market failure.

We do not consider that the benefits of a ban on uncovered short selling would outweigh the costs. We would be concerned if additional measures were introduced that discourage legitimate short selling activity, to the detriment of liquidity and price formation, and do not address any identified risk.

16. Do you consider that there should be permanent limitations or a ban on entering into naked credit default swaps relating to EU sovereign issuers? If so, please explain why, including if possible any evidence relating to the use of naked CDS.

No comment.

17. Do you consider that in addition to the measures described above there should be marking of orders for shares that are short sales?

No. A flagging regime for individual orders would impose significant costs on market participants and would not address any clear market failure. The costs associated with real-time flagging of all orders would be considerable, in particular if the overall short selling regime aims to capture net economic interest. In addition, there are logical complexities when orders are in flight, for example, the marking of simultaneous buy and sell orders. We believe that such information would be less useful than an end of day net short disclosure. With respect to public disclosure, flagging would generate a significant amount of additional information which may be potentially misleading and could increase volatility, for example, the flagging of short sales which are covered by the end of the day. It is important that any new requirements do not have the unintended consequence of amplifying the potential risks that they are seeking to address.



18. *What is the likely costs and impact of the different options on the functioning of financial markets?*

As noted in our response to questions 11-14, we would be concerned if additional measures were introduced that discourage legitimate short selling activity, to the detriment of liquidity and efficient price formation, and do not address any identified risk.

19. *Do you agree with the proposed exemption for market making activities? Which requirements should it apply to?*

20. *Do we need any exemption where the principal market for a share is outside the European Union? Are any other special rules needed with regard to operators or markets outside the European Union?*

21. *What would be the effects on the functioning of markets of applying or not applying the above exemptions?*

We agree that there should be an exemption from at least the public reporting requirement and the condition related to uncovered short sales (i.e. the “borrow” condition).

We note that the Commission’s proposal states that “local” means “a firm referred to in article 2(1)(l)” of MiFID, and does not include article 2(1)(d) exempt firms (unlike the CESR report). We strongly believe that article 2(1)(d) exempt firms should be able to qualify for the market maker exemption. Whilst such firms are not formally registered as market makers, a number of these firms are members of RMs and/or MTFs and act in a way that is functionally the same as market makers by regularly providing two-way liquidity in a principal capacity. In this regard, as with market makers, they are directionally neutral and do not typically hold short positions other than for brief periods.

We believe that excluding such firms from the exemption would not help achieve the aims of the disclosure requirement and uncovered short sales condition. Such firms provide a significant amount of liquidity to the market and we would be concerned about the unintended consequences, including on the level of liquidity and efficiency of the price formation process, if such firms were not included in the exemption.

As a broader point, we would note it is important that the exemption creates legal certainty. The wording suggested relating to, for example, comparable size and competitive prices will have different meaning depending on the financial instruments being traded, the nature of the market and the associated risk.

To more accurately capture the firms that we believe the exemption is intended to cover, we would suggest a definition in terms of: an investment firm or local [*which means an article 2(1)(d) or article 2(1)(l) exempt firm*] which is a member of an RM or MTF and which deals as principal, which as part of its usual business regularly and on an ongoing basis provides liquidity by posting firm quotes at relevant prices or fulfils orders initiated by clients or in response to clients’ requests to trade and to hedge positions arising out of those dealings.



With respect to the notification regime, we consider it is important to ensure that the mechanism by which a firm is not granted the exemption is subject to objective criteria to ensure fair and consistent treatment between Member States. We would also suggest that the firm seeking to use the exemption should only need to notify its home Competent Authority (in the case of authorised firms) or the most relevant Competent Authority (in the case of exempt firms), and that regulators should share this information (cf. the passport regime).

- 22. Should the conditions for use of emergency powers be further defined?*
- 23. Are the emergency powers given to Competent Authorities and the procedures for their use appropriate?*
- 24. Should the restrictions be limited in time as suggested above?*
- 25. Are there any further measures that could ensure greater coordination between competent authorities in emergency situations?*

Where regulators identify specific issues as a result of the private disclosures made to them or otherwise, we agree that they should have powers to intervene where necessary to ensure continued market confidence and financial stability. However, we believe it is essential that these powers are narrowly drawn (emergency situations) and that they are subject to clear and objective criteria to provide greater certainty over the circumstances in which they will be used and to ensure consistency between Member States.

We agree that Competent Authorities should provide advance notification to the other Competent Authorities and ESMA when they intend to use their emergency powers. We agree that the notification should include details of the proposed measures, the financial instrument coverage, the reasons for the measures, the evidence supporting those reasons and the date on which the measures are intended to take effect and end. We also agree that such information should be made public and easily accessible to all market participants. In addition to the contents of the notification suggested by the Commission, we consider it important that the notification should provide clarity on any cross-border implications. By their nature, emergency measures will likely be imposed within a very short timeframe. In order to ensure that the measures are implemented smoothly, it is important that market participants understand the scope of the measures and their application, including any cross-border implications.

- 26. Should competent authorities be given further powers to impose very short term restrictions on short selling of a specific share if there is a significant price fall in that share (e.g. 10%)?*

No. In order to guard against disorderly price changes, we believe the additional information provided by the public disclosure of (aggregate and anonymised) short sales positions as well as existing mechanisms, or limit-up/limit-down mechanisms, provide reasonable safeguards.



27. *Should the power to prohibit or impose conditions on short-selling be limited to emergency situations (as set out in the previous section)?*

Yes. We consider that an emergency power is sufficient. The ability to impose conditions on short selling outside of these circumstances could undermine the benefits of a clear and consistent pan-European short selling regime. It is important to ensure that any issues related to uncoordinated, unilaterally imposed conditions are resolved.

28. *Are there any special provisions that are necessary to facilitate enforcement of the future legislation in this area?*

No comment.

29. *What co-operation powers should be foreseen for ESMA on an ongoing-basis?*

No comment.

30. *Do the definitions serve their intended purpose?*

As noted in our response to questions 19-21, we noted that the Commission's definition of "local" differs from that set out by CESR in its report. We strongly believe that the definition of local should include both article 2(1)(d) and article 2(1)(l) exempt firms.

To more accurately capture the firms that we believe the exemption is intended to cover, we would suggest a definition in terms of: an investment firm or local [*which means an article 2(1)(d) or article 2(1)(l) exempt firm*] which is a member of an RM or MTF and which deals as principal, which as part of its usual business regularly and on an ongoing basis provides liquidity by posting firm quotes at relevant prices or fulfils orders initiated by clients or in response to clients' requests to trade and to hedge positions arising out of those dealings.