Deutsche Börse Group

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Response to

European Securities and Markets Authority (ESMA)

Consultation Paper ESMA/2012/98

Draft technical advice on possible delegated acts concerning regulation on short selling and certain aspects of credit default swaps

Frankfurt / Main, 09 March 2012

Introductory remarks

Deutsche Börse Group (DBG) appreciates the opportunity to respond to ESMA's consultation paper on ESMA's technical advice on possible delegated acts concerning regulation on short selling and certain aspects of credit default swaps.

DBG especially sees the need for clarification of what constitutes a significant fall in value for financial instruments. We elaborate on questions raised in the ESMA's consultation paper in more detail below.

Detailed remarks

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.

The threshold of 20% for less liquid instruments seems to be too low. According to our analysis, we find that this threshold would produce around 200 trigger events per year only for instruments traded in our Entry Standard market segment – nearly 1 trigger event per day. Therefore we suggest increasing the threshold. Increasing it to 30% would result in only 63 trigger events.

Regarding the group of instruments mentioned in 158.c (share price < 0.50 Eurocents), we suggest increasing this threshold as well. In many cases these instruments are very illiquid, so that the spread can be high – in many instances also in double-digit percentage areas. Therefore it might be the case that normal executions at the spread would trigger the threshold. Ideally, these instruments would be exempt from the provision, or alternatively a threshold of at least 50% would be appropriate.

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.

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.

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.

DBG trades about 23.000 bonds, ranging from German sovereign bonds, European sovereign bonds to jumbo bonds and corporate bonds (industrial and financial issuers).

DBG favors ESMA's approach to define a significant fall in value in bonds on basis of the increase in yield.

However, the recommended thresholds seem to be problematic as they seem to work only for the Investment Grade space, if not only for the High Grad space. For Sub-Investment Grade bonds, which regularly have a large spread between the bid-side and the ask-side of a market maker quote, yield may regularly increase by more than 5% (or 7% for a single sovereign bond) if a buy order is executed on the ask-side of the quote and a sell order is executed on the bid-side of the quote shortly after.

DBG recommends establishing a more granular approach by defining different thresholds for different rating classes and maturities. Besides different volatilities and bid/ask spreads in different rating classes this approach would also address the fact that the volatility of a bond decreases over time.

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

We welcome the proposed ESMA approach to units in collective investment undertakings including ESMA's assessment to not set a significant price fall threshold for UCITS. However, we would like to highlight that UCITS ETFs are subject to the same set of rules as other UCITS. Hence, following ESMA's argument that Article 1.2.b UCITS Directive 2009/65 acts as a rule which keeps prices close to the NAV of the UCITS, and additionally considering Article 32.5.b UCITS Directive 2009/65, which states that investment companies which market their units exclusively through one or more stock exchanges on which their units are admitted to official listing shall intervene on the market to prevent the stock exchange values of their units from deviating by more than 5% from their net asset values, we believe it to be preferable and more transparent to propose a single approach applicable to all UCITS including ETFs rather than two different approaches which depend on the UCITS' investment objective. A single approach regarding UCITS would also be supported by the fact that more than 99% of all ETFs currently admitted to trading in the Regulated Market of Frankfurt Stock Exchange are in fact UCITS. We therefore would like ESMA to consider applying the proposed UCITS approach to both UCITS and UCITS ETFs.

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?

We agree with ESMA's proposed approach to not set a threshold for a significant fall in value of the unit price of a listed UCITS.

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

As stated in our answer to question 48, we believe it to be preferable to define a single approach applicable to all UCITS including UCITS ETFs. Such an approach would not require setting a threshold for a significant fall in value of the unit price of an ETF. However, if ESMA would like to define a threshold specifically for ETFs, we would consider 10% as a reasonable percentage figure.

With regard to leverage or reverse ETFs, we would kindly ask ESMA to reconsider the proposed classification as traded derivative instruments as such classification would result in increased complexity due to differing rulesets being applicable across the existing range of ETFs when determining the respective thresholds for a significant fall in value. Furthermore, taking into consideration that many leverage or reverse ETFs are being cross-listed on several European markets with each market and corresponding CCP employing its own methodology to arrive at the margin parameters referenced for determining the respective ETF's threshold, it can easily be seen that such regulation would result in differing thresholds for affected ETFs across Europe, thus potentially representing an additional source of uncertainty in times of financial stress.

We therefore would like to propose the following rules for determining thresholds for a significant fall in value of leverage or reverse ETFs: For reverse ETFs, the same threshold should be applied as is proposed for ETFs in general (i.e. 10%) as both types of ETFs can typically be expected to experience price variations of the same magnitude on a daily basis. For leverage ETFs including leveraged reverse ETFs the percentage should be adjusted to a factor which reflects higher price variations due to the use of leverage. As leverage and leveraged reverse ETFs typically offer market exposure with a leverage factor of two on a daily basis, the percentage figure to use for this type of ETF should accordingly be increased to 20%. Such regulation would both limit the complexity of the ruleset to be implemented as well as ensure a harmonized approach across European markets when determining the thresholds for a significant fall in value of leverage and reverse ETFs.

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.

We agree. It is important to include in this group also all OTC traded derivatives which have a single financial instrument as underlying. Otherwise any imposed restriction on trading venue traded derivatives will move business OTC and undermine the effectiveness of possible short selling limitations or transaction restrictions.

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?

We disagree. Measuring it by the margin level set by the clearing house is not appropriate. To mention just two practical issues: In a portfolio margin model each instrument is seen a part of an overall portfolio exposure and no individual margin requirement is calculated for individual instruments. Another issue is that the buyer of option pays the premium in most cases upfront and accordingly has no margin requirements. At the same time it would be perfectly normal for a deep out of the money option holder to lose 90 or even 100% of the option premium in one day or see its option value quadruple in one day.

More practical issues arise if a product is cleared on multiple clearing venues.

We propose the following alternative:

We can broadly differentiate the derivatives which do not have a single financial instrument as underlying into two categories:

- Derivatives with an index as underlying
- Derivatives with a basket of underlying or an underlying which is not traded on a trading venue

Derivatives with an index as underlying

Establish thresholds for a significant fall in value for the underlying index, similarly to the concept of derivatives with a sole financial instrument underlying. As index characteristics differ widely, we recommend differentiating similar to shares, three categories of indices based on their level of volatility, as measured by the annualized standard deviation of the daily index level changes. We propose three four different levels:

- Historic Volatility of index is below 15%: Significant Fall Threshold 10%
- Historic Volatility of index is between 15-30%: Significant Fall Threshold 20%
- Historic Volatility of index is above 30%: Significant Fall Threshold 30%
- Indices based on derived underlyings (e.g. volatility indexes, dividend): no threshold

Historic volatility should be calculated as the annualized standard deviation of the daily index level change of the last 5 calendar years.

As pointed out in our response to Q51, it is important that through that model also all OTC traded derivatives will be covered by any regulatory action, i.e. in case the DAX index violates its threshold and the competent authority decides to take action, this action needs

also to apply OTC traded DAX derivatives.

Derivatives with a basket of underlying or an underlying which is not traded on a trading venue

In many of those cases the derivative itself has become the benchmark, e.g. commodities, interest rate products, widely watched by the market. We therefore recommend for those product to define the threshold for a significant fall in value on the basis of the so-called "Delta-One- product" on that underlying (basket). The "Delta-One product" moves linear with the underlying (has a constant delta of 1 or close to 1 throughout the entire life cycle). This would be futures, forward rate agreements, standard contract of differences and also most swaps. In case a product reaches its threshold and that triggers any regulatory action, they should then apply to all derivatives based on that underlying including options as well as all venues trading derivatives on that underlying including OTC.

To define thresholds on a non-linear instruments such as options makes no sense as their percentage price range could on a normal day be between -100% and + several 1000%, depending on the degree of moneyness and time to maturity.

When it comes to defining the concrete thresholds for "Delta-One" products, we propose a similar approach as above: It should be based on the level of volatility of the derivative, as measured by the annualized standard deviation of the daily price changes. We propose again three different levels:

- Historic Volatility of index is below 15%: Significant Fall Threshold 10%
- Historic Volatility of index is between 15-30%: Significant Fall Threshold 20%
- Historic Volatility of index is above 30%: Significant Fall Threshold 30%

As above, historic volatility should be calculated as the annualized standard deviation of the daily index level change of the last 5 calendar years.

To define thresholds on non-linear instruments such as options or products of derived underlyings (e.g. dividend futures) makes no sense as their percentage price range could on a normal day be between -100% and + several 1000%, depending on the degree of moneyness and time to maturity respectively would have very low volatility on most trading days until special events takes place.

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?

See question 52.

We trust you would have found these comments useful and remain at your disposal for further discussion. Should you have any questions please do not hesitate to contact:

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