afme/ ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION ISDA® International Swaps and Derivatives Association, Inc.

9 July 2010

AFME, ISLA and ISDA Joint Response to the European Commission's public consultation on short selling

On behalf of our members, the Association for Financial Markets in Europe ("AFME"), the International Securities Lending Association ("ISLA") and the International Swaps and Derivatives Association ("ISDA") appreciate the opportunity to respond to the European Commission's June 2010 **c**onsultation paper on Short Selling**.** We hope to continue dialogue with the regulatory community and policy makers and welcome the opportunity to discuss in depth, the responses provided in this paper at your convenience.

AFME, the Association for Financial Markets in Europe, promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME was formed on November 1st 2009 following the merger of LIBA (the London Investment Banking Association) and the European operation of SIFMA (the Securities Industry and Financial Markets Association). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit the AFME website, www.AFME.eu.

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has more than 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America. www.isla.co.uk

The International Swaps and Derivatives Association, or ISDA, was chartered in 1985 and has over 820 member institutions from 56 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify sources of risk in the derivatives and risk management business and reduce those risks through: documentation that is the recognized standard throughout the global market; legal opinions that facilitate enforceability of agreements; the development of sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

AFME, ISLA, ISDA, henceforth "We" are pleased to respond as follows.

Executive Summary

We appreciate the opportunity to respond to the Commission's public consultation on short selling. We support your objectives of harmonising rules for short selling across the EU, reducing systemic risk and deterring abusive short selling. We hope our comments will be helpful in developing proportionate rules to deal with the issues of concern.

As a well-established trading activity that is an integral part of the financial system, short selling is essential for market making and widely accepted by investors and regulators as helping to enhance price discovery, counteract supply/demand imbalances and provide liquidity to the market in the relevant securities. By taking on the risk of loss themselves and covering the sale to the client at a later time, it is a way for financial institutions to ensure that they can meet their clients' requirements to purchase specific securities at a designated time and price.

We strongly agree that short selling is not abusive and believe that as an investment activity it is no more susceptible to market abuse than any other form of transaction. Any rules that apply to short selling must be proportionate and applied consistently across Europe.

Our positions on the proposals in the consultation paper are:

- **Private reporting**: we support private reporting to regulators if it is felt they will benefit from such disclosure. We believe that regulators should have access to data on short positions (for systemic risk reasons) in OTC derivatives, including CDS, and are happy to cooperate with regulators to identify appropriate improvements to current regulatory transparency tools. To limit implementation costs and avoid confusion it is important that the definitions of short selling and net short positions are clear and workable for the industry. We will work constructively with ESMA in this regard through a joint ESMA-industry working group to develop these issues. Ensuring clarity of these definitions will facilitate compliance monitoring and rule enforcement.
  For sovereign bonds specifically, while we do support full transparency to regulators, we believe that the EC should consider the role of EU member states as issuers of sovereign debt. In these cases, as the state is also a market counterparty to the reporting institution, we believe caution is needed to ensure that national Debt Management Offices are not put in such a position that it appears that they could be causing informational asymmetries that disturb the markets.
- **Public transparency**: the transparency proposals in this paper will have a damaging impact on markets (e.g. reduced liquidity and increased borrowing costs for governments and firms) and we believe there is no case for greater public disclosure of short positions than exists for long positions. For equities we would support the publication of aggregated privately notified short positions by

regulators as an aide to greater market transparency. Since the possible adverse effects of such transparency on government bonds are not yet well understood, we strongly advise against such measures for these markets.

- **Uncovered short selling**: we support the objective of preventing transactions where the seller has little or no intention of covering the sale. We believe however that blanket bans on uncovered short selling are disproportionate and will negatively impact on other selling and securities lending activity. Uncovered short selling can have important benefits for the market as a whole (in terms of liquidity and investor confidence) e.g. in 'proxy' hedges (as detailed later in this submission). For bonds specifically, bans would entail significant costs for governments (in their role as issuers of debt), investors and dealers. We believe that the most appropriate way to discourage abusive uncovered short sales is through application of reasonable and consistently applied settlement discipline measures such as buy-ins (which would apply to any persistent settlement failure).
- **Emergency powers**: we support the proposal for regulators to have powers to act in ways designed to restore order and confidence in emergency situations. However, banning short selling in difficult market circumstances can increase stress and volatility and may actually serve to undermine confidence. Care is needed when defining the circumstances in which emergency powers may be used.

We feel it is very important for the functioning of both primary and secondary markets that exemptions from transparency requirements and uncovered short selling should exist for (at a minimum) market making and underwriting activities. As market makers do not take directional positions in the market incorporating them in the requirements would not provide any meaningful information, risks misinterpretation, and will lead to unnecessary costs. Also, Primary Dealers are especially sensitive to the above mentioned informational asymmetries which could arise out of the role of the state as both issuer and receiver of reported information.

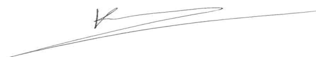
AFME, ISLA, ISDA and our respective members again thank you for the opportunity to comment on this consultation. We have aimed to provide as much detail and constructive feedback to the questions posed in the document as possible. We remain fully at your disposal for further engagement and correspondence.

Yours faithfully,

AFME

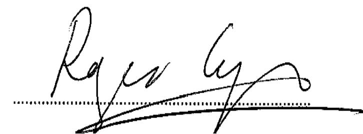
Sander Schol

ISLA



Kevin McNulty

ISDA



Roger Cogan

Responses to Consultation Paper Questions

A. Scope

(1) Which financial instruments give rise to risks of short selling and what is the evidence of those risks?

We do not see short selling as a potential source of systemic risk than any other buying or selling activity.
The Commission's consultation paper lists a number of the risks associated with short selling, namely that:

- it can be used in an abusive fashion to drive down the price of financial markets;
- it can contribute to disorderly markets;
- in extreme market conditions it can amplify price falls and effect financial stability;
- it can result in market asymmetries; and
- in the case of uncovered short sales it can increase the risk of settlement failures and price volatility.

While we believe that such risks are real we also believe they are limited, for example:

- We do not believe that short selling amplifies price falls. Studies[1] have shown that bank share prices did not stop falling after short selling bans were introduced by various regulators in autumn 2008. There is in fact evidence[2] that the temporary bans and disclosure regimes had a negative impact on liquidity, volatility and spreads in the securities affected.
- Uncovered (or 'naked') CDS positions can be a force for liquidity, and hence a limiting force on price volatility (e.g. in CDS/sovereign debt markets).

However, we support the idea of a uniform Europe-wide approach on short selling – as underlined in previous submissions to the European Commission (e.g. on market abuse). The uncertainty and cost created by disparate national approaches has a damaging effect on financial markets and firms.

(2) What is your preferred option regarding the scope of instruments to which measures should be applied?

We support Option B: while there are many similarities in the issues affecting short selling of financial instruments there are nevertheless differences that need to be addressed. A single set of rules that would apply equally to shares, sovereign bonds and derivatives

[1] See http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf
[2] **Spillover Effects of Counter-Cyclical Market Regulation: Evidence from the 2008 Ban on Short Sales** (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571315)

would be difficult to develop as these instruments are structured and traded in different ways.

A good example of a class of instruments which must not be inadvertently included in the scope of short selling legislation is foreign exchange (FX). Virtually all FX transactions involve contracting to sell one currency while buying another, for delivery today or at any point in the future. Academically, anyone executing an FX trade who does not already have the currency to be sold physically on account at that moment could be deemed to be selling "short". However, trying to apply this concept on a transactional basis to the mainstream FX market would almost certainly make the market virtually inoperative (it has only been attempted within some small emerging markets with very restrictive currency regimes).

Similarly, at a portfolio level the majority of FX market participants use FX for hedging currency exposures in other asset classes, facilitating cross border trade and investment, making payments and managing balance sheets. Attempting to determine "economic net short positions" with respect to each currency in any meaningful and consistent way across participants would be extraordinarily difficult. Furthermore, the vast and deep FX market is probably the least prone to manipulation and therefore has the least need for regulation in this area. For all these reasons, care must be taken that new short selling regulation is not inadvertently applied to FX in a way that would impose an unnecessary and unworkable operational burden upon the market, the main consequence of which would most likely be to drive the main activity in this market outside the EU.

We do not believe that short selling restrictions should be applied to non-financial instruments. We believe that any measures applied should be based on published evidence that such measures are justified (following analysis of the workings of the market and its practices) and on clear evidence that such measures will benefit the financial system. It is not clear how securities with multiple listings should be dealt with (e.g. listing in both Europe and Asia) when considering which positions are short. Care will be required in determining how these should be dealt with, so as not to, for example, dissuade companies from dual listing their shares in Europe.

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

As far as possible measures should also apply to transactions carried on outside of the European Union. If measures do not apply extra-territorially, it will provide scope for firms to engage in regulatory arbitrage, potentially giving rise to preferential treatment for non-EU based transactions. Extra-territorial transparency requirements should cover instruments admitted for trading on a venue within the EU to ensure consistent treatment for investors both within and outside of the EU.

A simple ban on uncovered short selling would be difficult to enforce outside of the EU. For example, a regulated firm entering into a principal-principal trade with an unregulated client will not know whether that client is a short seller and will not be able to substantiate any information and explanations it is given. Therefore, any scheme not covering hedge

funds regulated outside the EU will prove ineffective. For that reason we strongly recommend that abusive uncovered short selling be restricted through the development of consistent and measured settlement failure penalties that would naturally apply to all investors.

B. Transparency

(4) What is your preferred option in relation to the scope of financial instruments to which the transparency requirements should apply?

Option B: the transparency regime should apply to EU shares and EU sovereign bonds
For sovereign bonds specifically we note that, while we are generally supportive of full transparency to regulators, we believe that the EC should consider the role of EU member states as issuers of sovereign debt. In these cases, as the state is also a market counterparty to the reporting institution, caution is needed to ensure that national Debt Management Offices are not put in such a position that it appears that they could be causing informational asymmetries that disturb the markets. (For further remarks on transparency for sovereign bonds, see question 7).

Short positions through equities or CDS should not be disclosed to the public (except in aggregate form) as this will inhibit participation in the market and negatively impact liquidity in equity, CDS and bond markets. This would make borrowing more expensive for sovereigns, effect national budgets and finances, and companies wishing to raise new capital. Regulators should be able to request and receive contract information from trade repositories (including the DTCC) and from the firms themselves, for systemic risk reasons (including where these pertain to short selling).

(5) Under Option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?

This would be disproportionate as there has been no convincing case presented to support the introduction of transparency requirements on all instruments that can be sold short.

(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?

We agree in part. For equities we support a private disclosure regime for short positions that will assist regulators' ability to supervise their markets. Regarding public disclosure of equities, neither of the FSA and CESR consultation processes on short sales established that they are more susceptible to misuse than purchases or other types of sales. We therefore disagree with the proposal to require individual investors to publicly disclose short positions at the thresholds suggested as it will result in unfair information asymmetries.
Analysis published earlier this year[3] shows that public short selling disclosure requirements damage equity market efficiency. The analysis compared securities that are the subject of public disclosure and showed that affected securities had much lower liquidity and significantly higher bid/ask spreads than similar but non-disclosable securities. The effects of this represent a very significant cost to all users of the markets

[3] Oliver Wyman report into: "The effects of short-selling public disclosure regimes on equity markets" http://www.managedfunds.org/downloads/Oliver_Wyman_Financial_Services_Report.pdf

and we expect to be able to offer some estimates of these costs shortly. The findings in this report are backed by our prime broker member firms who have confirmed that their clients avoid short selling beyond disclosure thresholds to avoid signalling their trading strategies to the broader market.

We do however support transparency on terms that would be fair and beneficial to the market as a whole. For equities we suggest that this could be achieved through disclosures by regulators of aggregated privately reported short positions on an anonymous basis. Beyond that we believe that public short position reporting could be considered on the same terms as for long position reporting under the Transparency Directive. This would also prevent an asymmetry of information being published into the wider market with different thresholds for long and short disclosure,

(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?

For sovereign bonds (and CDS where applicable) while we are generally supportive of full transparency to regulators, we believe that the EC should consider the role of EU member states as issuers of sovereign debt. As in this case the state is also a market counterparty to the reporting institution, we believe caution is needed to ensure that national Debt Management Offices are not put in such a position that it appears that they could be causing informational asymmetries that disturb the markets. Before introducing such a requirement we would thus advocate a broad consultation in order to precisely delineate the information flows between primary dealers, other market participants, national regulators and the Debt Management Offices.

This issue is particularly pertinent within the Eurozone, where the net position in one eurozone government's bonds will be partially driven by holdings of the bonds of other governments. Justifying a participant's positioning to a national regulator may thus require disclosing total holdings of all other eurozone government bonds to that regulator. We would need to be sure that all national DMOs would be comfortable with such disclosure.
Reporting the net position of the bank overall in the bonds of each member state is a difficult task. Net positions can be found in a lot of areas within a firm (Fixed Income, Asset and Liability Management, portfolio management, etc.) and also across different legal entities. Because of this, the confidence in the data will be really difficult to ensure.
To ensure clarity the definition of "net" needs to be more precisely defined. At any given time, our members are short certain instruments and long others. This raises a number of questions:

- Should this be overall position vs. a sovereign?
- Should it be calculated on a duration-weighted basis?
- If the CDS is not a perfect hedge how should this be accounted for? We recommend that for CDS the issue of proxy hedging is taking into account when defining

whether a firm is net short. For example, should a firm which has invested significantly in the property market of a specific country be viewed as 'net' short if it believes it has hedged this risk through a short CDS position (on the basis that property prices will be negatively affected by a deteriorating market view on the creditworthiness of that country, but that this situation would be offset by a consequent rise in the value of a short CDS position)? In this situation, we believe that the firm should not be seen as net 'short' a country, but as hedging 'long' country risks.

To resolve these issues and limit implementation costs it is important that the definitions of short selling and net short positions are clear and workable for the industry. We will work constructively with ESMA in this regard through a joint ESMA-industry working group that would develop these issues. Ensuring clarity of definitions will facilitate compliance monitoring and rule enforcement.

Even if much care is taken to clarify the definitions, interpretation of the data could still prove difficult. For example, during recent market developments it would have been entirely consistent for a hypothetical investor to be short Greek bonds (based on concerns about issuer risk) and also short German bonds (in the belief that overall risk aversion was too high and German bonds were thus too expensive). The existence of a short position can be a statement about relative value not credit concerns.

Public disclosure of data on sovereign bonds is particularly inadvisable. Not only would it increase the confusion around interpretation of the data, it would be harmful for the markets. It would make it hard for market participants to exit (and therefore enter) positions and will decrease liquidity significantly, thereby increasing the cost of capital.
For example, because of the status of the Eurex Bund futures (and Obl and Schatz) as prime focuses of liquidity in the fixed income markets, any reporting obligation that highlights modest positions is likely to catch many shorts in these futures so numerous market participants will be required to disclose short bund future positions. This is likely to lead to diminished liquidity in this contract if the reporting requirements are for public disclosure.
For equities, our members support the publication of aggregated privately notified short positions by regulators as an aide to greater market transparency. Since the possible adverse effects of such transparency on government bonds are not yet well understood, we strongly advise against such measures for these markets.

Concerning CDS, we highlight that regulators are already able to get information on CDS transactions through the DTCC Trade Information Warehouse (TIW). For example, the TIW recently provided information to European regulators (including the European Commission) on positions taken on Greek sovereign debt. Provision of information to regulators for financial stability purposes is the key purpose of the TIW[4]. We believe that,

[4] To date, the DTCC has received 34 requests for information from regulators outside the US, and all 34 have been answered within the time stipulated by the regulators involved. As well as information to regulators, the TIW also makes aggregated CDS transaction information available to the public.

in seeking information from the market in relation to short CDS (and other derivative) positions, regulators should benefit from but not duplicate the functionalities offered by trade repositories.

(8) Do you agree with the methods of notification and disclosure suggested?

Subject to the matters raised in our answers to questions 6 and 7 we are supportive of private disclosures of short positions to regulators. The proposed method of notification and disclosure appears to be acceptable but please note our comments on costs in question 10. We do not agree with the proposals for public transparency for the reasons already mentioned.

The CESR model poses that calculation of net short positions should include such positions created by trading on and off market and include economic net short positions in shares created by the use of derivatives such as options, futures, contracts for differences and spread bets. It may be difficult to calculate exposure across some derivatives particularly those that include optionality and or aggregated bond index exposure. For example I can have a 1yr trade based on 10yr CMT (French 10yr Govt Bonds). Should I measure this exposure in terms of 10yr notional or 1yr notional? Often people have exposure to bonds that don't yet exist – for example 'the benchmark 10yr German bond'. Calculating notional on this might be somewhat arbitrary.

On the frequency of reporting as governments currently receive monthly reports from their PDs on secondary market trading volumes, it would make sense to report short positions on a monthly basis as well (as opposed to reporting on a daily basis). This would also limit the costs for reporting.

(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?

It is very important for the functioning of the markets that exemptions from transparency requirements should exist for (at a minimum) market making and underwriting activities. As market makers do not take directional positions in the market incorporating them in the requirements would not give any meaningful information and will lead to unnecessary costs. Also, market makers are especially sensitive to the above mentioned informational asymmetries which could arise out of the role of the state as both issuer and receiver of reported information (see question 7).

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

We would respectfully note that as part of the MiFID framework, European investment firms must report transactions in financial instruments admitted to trading on EEA regulated markets (and related derivatives) to allow the regulators to monitor for market abuse. Firms have expended considerable resources in meeting these requirements. We assume that this reporting system is delivering the tangible value to regulators it was designed to do.

The costs of implementing a transparency regime can be considered in two categories:

Costs to the markets of implementing the regime
Our members advised that they have been able to comply with current temporary reporting regimes for short selling (of equities) on restricted numbers of securities using largely manual processes. To comply with a widespread reporting regime such as the one proposed would require the implementation of complex reporting systems capable of calculating net short positions and determining whether these would trigger a notification to regulators. It is difficult to estimate accurately the cost of implementing such systems but we think for larger financial firms a systems project of this magnitude would be reasonably expected to take up to 18 months. We therefore ask that the market be given a reasonable period in which to implement any reporting requirements.

Costs to users of the markets created by market inefficiencies
For equities, analysis[5] published earlier this year suggested that existing public short selling disclosure requirements in the UK resulted in a 25% reduction in equity market liquidity and a 46% widening in trading spreads. While the public disclosure thresholds for the UK market are set at 0.25% it is clear that investors are unwilling to take short positions that will result in public disclosure. This must ultimately harm overall market efficiency.

Public transparency for the government bond markets, for the reasons mentioned in question 7, will lead to increased spreads, reduced liquidity and turnover. This in turn will lead to higher borrowing costs for the government. It will also lead to high compliance costs. Transparency to regulators only will also lead to significant costs. Firstly there is the cost of compliance and then the additional costs that could stem from the informational asymmetries arising from the state acting as both issuer and receiver of reported information. These costs in the end will be passed on to end investors like pension funds.

Whatever principles are ultimately agreed upon, materiality thresholds should be set in terms of the investors and entities to which it applies. In the worst case scenarios in terms of applying the options, there would be significant impact from reduced activity across the market. We believe that similar impacts will be felt if short selling of sovereign CDS is

[5] Oliver Wyman report into: "The effects of short-selling public disclosure regimes on equity markets" http://www.managedfunds.org/downloads/Oliver_Wyman_Financial_Services_Report.pdf

banned or made subject to onerous public transparency requirements (which, if not aggregated, or made very granular, could have a similar effect to a ban). The uncertainty created by German government actions in this regard meant that their actions did not have the desired soothing effect on the sovereign debt markets of either Germany or other EU sovereign debt issuers.[6]

[6] The day after the German ban was announced, the Markit iTraxx Europe index widened by 13 basis points, while protection on Greek bonds widened by 50 basis points. Spreads on Markit iTraxx and other related indices have not contracted, and protection on Greece has widened by a further 190 basis points (as of 5 July 2010).

C. Uncovered short sales

Questions:

(11) What are the risks of uncovered short selling and what is the evidence of those risks?

A concern that some regulators have is that uncovered short selling in equities markets leads to unsettled transactions which contribute to systemic risk. In reality, this risk appears very small given the very high percentage of transactions that settle on or within a very short time of the intended settlement dates for the trades (and trades fail for a variety of other reasons unconnected with short selling). Exchanges and clearing systems also have their own mechanisms for dealing with any broker that fails to provide securities for settlement. The Consultation Paper suggests that uncovered short selling may also contribute to increased price volatility. We do not believe this to be true and can find no evidence that supports this.

For Sovereign CDS, research to date indicates that CDS markets are not contributing to widening sovereign spreads, but rather widening sovereign spreads are contributing to increased CDS activity[7]. We are not aware of any evidence suggesting that CDS drive bond spreads higher. Several regulators have looked at this issue and the findings included:

- The *German financial regulator, Bafin*, which looked at this issue back in March, and could find no such evidence.
- *CESR* has looked at this issue. The situation, as of 30 April, according to the CESR Chair, Eddy Wymeersch, was that CESR has "not seen clear signs of speculation or abuse in these markets."
- The *California State Treasurer – Bill Lockyer* - concluded, in a 22 April 2010 statement, that "CDS trading's effect on bond prices is not significant enough to cause concern at this time". The statement was made after analysis of data received following a letter (dated 29 March) to 6 investment banks asking them for data regarding their involvement in trading activity in the municipal CDS market. While the statement also concluded that "the banks themselves, during the period covered, did not bet against the credit quality of California GO bonds" and that there did not seem to be any "conscious decision" by the banks to short Californian bonds via CDS, Mr. Lockyer announced that he would be requiring quarterly reports from market participants.

These findings are not surprising. Much of the debate focuses on the protection buyer but there are two parties to every CDS and there is just as much chance of *downward* pressure on credit spreads from the act of selling protection , whether uncovered or not.

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[7] See for example: Barclays paper 'sovereign CDS;The canary or the cat?'; 12 February 2010, Citi's paper 'Sovereign CDS: you can't blame the mirror for your ugly face'; 1 March 2010.

We believe that there is evidence to suggest that CDS cannot be driving sovereign bond spreads. For example:

- The April 2010 Financial Stability Report of the IMF examined data on the sovereign CDS market – including specifically whether changes in CDS on a given day might be influencing bond spreads on succeeding days and concluded that "sovereign CDS has unlikely exerted a significant influence on government bond markets, for Greece or other sovereigns."
- The DTCC – as mentioned – provides information to regulators and the public alike (albeit at different levels of granularity) on CDS broken down into several categories, including by counterparty and by underlying reference entity (in the case of Greece these would be bonds issued by the Hellenic Republic). As of the week ending 25 June, the total net notional volume of all (uncovered and otherwise) CDS referring to bonds issued by the Hellenic Republic was approximately $6.6 billion, in comparison with a Greek government bond market worth well over $400 billion (i.e. net notional is less than 2% of the size of the underlying bond market). [8]

The current net notional figure is actually significantly lower than the figures between January and March, which ranged from $8.5 billion to $9.2 billion (probably because fears of regulatory overreach have led to closing of positions). Nevertheless, even these figures represented a very small market when measured against the underlying market size.
So to summarise, the DTCC data on Greek CDS (available to the general public):

- suggests that the size of the Greek sovereign CDS market is tiny in comparison with the underlying Greek bond market; and this pattern is evident for all sovereign debt markets (net notional value of aggregate open positions on CDS on Eurozone sovereign CDS approx. $100 billion vs. a total government bond market worth over $7 trillion) and cannot in these circumstances be influencing it; and
- does not indicate that there has been any huge surge of open interest in CDS written on Greek bonds.

(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?

We are not aware of any studies that point to a significant risk of uncovered short selling of government bonds. By definition, there is a risk that the bond will not be available for settlement (settlement risk). However, the existence of broad and liquid repo markets for government debt means that sellers can usually have a high degree of confidence they will be able to source bonds before settlement when necessary. Although market-wide data are hard to obtain, based on our experience we would say that the actual percentage of trades

[8] The net notional figure is, in the case of Greece, the maximum possible net funds transfers between net sellers of protection and net buyers of protection (through CDS) that could be required upon the occurrence of a credit event relating to Greek sovereign debt.

that fail to settle is very small, and these failures have a very limited impact on the markets. We would also highlight that fails-to-deliver do not necessarily indicate the existence of uncovered short selling they can occur for a number of different reasons, on both long and short sales.

(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?

Bans on uncovered short selling will impact on all selling and securities lending activity and would entail significant costs for investors, dealers and governments (in their role as issuers of debt). Requiring an investor to always pre-borrow securities will result in over-borrowing (for example, where a short sale is closed out on the same day, or when an investor borrows shares but subsequently decides not to sell short). In liquid equity and bond markets, investors that wish to take a short position will generally sell first and then arrange to borrow the securities in time for settlement. For less liquid securities the investor will be advised as to the likelihood of being able to borrow the securities by the prime broker and will agree whether it is necessary to secure shares in the market before selling. We believe this system works well today.

For market makers it is perfectly normal to take an uncovered short position (in the definition provided by the EC). A Primary Dealer (in the government bond markets) may sell short in advance of an auction in order to free up balance sheet capacity and this helps ensure the success of the DMO's primary issuance programme. To be able to provide liquidity, a market maker also has to be able to sell a bond first before he covers his position (see also question 19).

The most logical way to restrict uncovered short selling is through the application of consistent and measured settlement failure penalties. This approach has the benefit of applying equally to all investors (within and outside of the EU) and will not negatively impact on legitimate short selling and other market activity.

Our opinion is supported by the FSA, which stated in its February 2009 Discussion Paper entitled *Short Selling* that 'A ban on uncovered shorts would address the risk of settlement failures brought about by the inability of uncovered short sellers to source stock to fulfil their delivery obligations.' However, the FSA went on to say, '…that settlement risks are adequately mitigated in the UK by Recognised Investment Exchanges and Recognised Clearing Houses which have appropriate arrangements in place to (a) ensure the timely discharge of the rights and obligations of parties to a transaction and (b) intervene where settlement does not occur.'

The FSA also stated that, 'To the extent that non-delivery remains an issue, it is probably more proportionate to address that through tightening of settlement rules rather than by introducing a blanket ban on uncovered shorting.' However, the situation in the Greek debt

markets, where an introduction of forced buy-ins drastically reduced liquidity, shows that forced buy-in mechanisms should be applied with care[9].

For the sovereign bond market, a proven way in which countries prevent settlement failure (especially those caused by squeezes) is by creating a facility in which the DMO or the Central Bank acts as a lender of last resort in the repo market (like for example in Belgium, Portugal, the UK and the Netherlands). In these countries a facility exists for the creation of 'synthetic' bonds that can be temporarily used to iron out stresses and inefficiencies in the repo and cash markets. These kinds of facilities address some of the important issues behind settlement failures and could therefore serve as an important example to other countries.

An issue which needs to be dealt with explicitly concerns the situation where an investor sells securities that have been lent. The vast majority of securities lending takes place on a callable or overnight basis and the market has always operated on the basis that lenders should be free to sell securities that are on loan at any time. When this happens the lender subsequently recalls the securities from the borrower who must deliver within the normal settlement time frame. Such sales of lent securities must not be considered as uncovered short sales as the seller is clearly not short in terms of economic interest. To do so would severely restrict supply in the securities lending market as lenders would hold back securities to cover any potential sales activity. Custodian lenders have indicated that in markets where sales of lent shares were deemed to be uncovered short sales under temporary rules imposed in 2008 (such as in France and Italy), they have held back up to 50% of available inventory from the securities lending market.

The conditions for uncovered short sales listed are also not, in our view proportionate for 'uncovered' CDS shorting. The premise laid out (that the prospective short seller would have to have 'borrowed the share', have 'entered into an agreement to borrow the share' or have 'evidence of other arrangements which ensure that it will be able to borrow the shares at the time of settlement') is based on an assumption that short selling of this nature is a purely speculative activity (we assume that the reference only to 'shares' here is an unintended omission, and that the word 'security' - or for CDS, bonds - could be inserted here instead), implying unhealthy conflicts of interest, and facilitating abusive behaviour.

In this regard, it is worth underlining that positions in 'uncovered' CDS are often for hedging purposes, including uncovered CDS referencing sovereign debt. For example:

- International banks that extend credit to corporations and banks located in a particular country may use sovereign CDS to hedge credit or counterparty exposures, or to provide country-level risk diversification.
- Investors in the debt or equity of companies in a specific country may use sovereign CDS as a "proxy hedge" against potential systemic shocks that would reduce the value of their positions. It is our understanding that earlier this year

[9] In Greece, settlement fails were exacerbated by credit risk of domestic counterparties which became more acute when forced by-ins were introduced.

proxy hedgers were significant buyers of Greek sovereign CDS because individual Greek bank CDS were much less liquid.

- Investors with large real estate or other corporate holdings in a country may similarly use sovereign CDS.
- Portfolio managers may use sovereign CDS to hedge against country, liquidity and market risk related to a portfolio comprising debt or equity positions and to better diversify their portfolios.
- Large banks, which typically do not require highly-rated sovereign entities to post collateral for swap arrangements may use sovereign CDS to hedge against the risk posed by these uncollateralised exposures (in fact, a recent IMF report suggested that this may have been a factor driving sovereign debt spreads in the early part of 2010).

In relation to uncovered *corporate* CDS, we would give the example of a CDS contract providing protection against default by a large motor company, which can act as a proxy for default protection in relation to a (much smaller) supplier for which CDS may not be so readily available, and illiquid. It is possible to get hedging benefits from CDS referring to underlying debt correlated to the risk you are trying to hedge.

There is significant financial risk in entering into a uncovered CDS position with a view to profiting from issuer default and a speculative uncovered CDS position is not the 'easy' option many have suggested. When buying protection through CDS, the protection buyer essentially pre-pays a large part of the expected compensation through an upfront payment, as well as annual coupon payments so if default does not occur, losses can be substantial.

Regarding the suggestion that CDS holders - uncovered or otherwise – would not favour restructuring of a underlying entity, we would like to highlight that the decision as to whether a credit event has taken place is decided not by one firm or a small group of firms, but by the Determination Committee, an industry-appointed group of legal experts, balancing the interests of, and including, both sell- and buy-sides. These experts take decisions based on the letter of contracts between counterparties (though CDS contracts are generally standardised). The structure of the Determinations Committee was agreed under the guidance of regulators in the so-called 'big bang' process in April 2009.
It should also be pointed out that concerning settlement risk in CDS, the industry has already developed a framework to mitigate risks associated with non-delivery of obligations by counterparties.

Across the OTC derivatives market, netting[10] reduces gross credit exposure (according to BIS figures from December 2009) to just 16% of the gross market value of OTC derivatives

[10] When a participant in derivatives business becomes insolvent, it may well have several financial transactions 'open' with another participant in derivatives business. All of these transactions can be 'closed out' and settled, recognising the current market value of these contracts, and establishing a 'net' profit or loss between counterparties. This process is known as 'bilateral close-out netting'. ISDA is best known for the ISDA Master Agreement – an industry standard contract through which the rights and obligation of

contracts, while the use of collateral further reduces this amount to an estimated figure of less than 5% of gross market exposure. It is our understanding that counterparty exposures in the credit derivatives business are even more highly collateralised than is the norm for other OTC derivative contracts.

While this question addresses uncovered short selling of shares specifically (and associated risks), for sake of thoroughness, we underline that ISDA and market participants have developed a cash settlement mechanism ensuring orderly settlement of CDS, which has proven its value during the financial crisis, and has now been 'hardwired' into ISDA documentation (as exhorted by regulators).

(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?

We do not, as noted in our answers above. For equity and bond markets we believe that the only risks relevant to uncovered short sales are related to the potential for unsettled transactions. Whilst we do not believe that this risk is evident in the market we believe that the most appropriate way of managing it would be through a measured application of settlement disciplines.

We believe that a ban on uncovered CDS (whether referring to corporate or sovereign issuers) would be a bad idea for several reasons:

1) *We believe that, in the long term, it could actually tighten credit conditions* leading to corporations and sovereign states alike having to pay more interest on their borrowing, with consequences for public expenditure, taxpayers, employers and employees.

The removal of 'uncovered' CDS counterparties from the market (whether acting as dealers providing a risk management solution to clients seeking protection through CDS or as professional investors – for example those who face a 'country' risk of some kind that can be hedged through a sovereign CDS) will fatally undermine liquidity in these markets, making it much more difficult and costly to hedge sovereign debt and discouraging buying (by the market) of sovereign debt.

2) *In the short term (immediately after a ban), there is at least a significant chance that it may cause a major lack of confidence in European markets* in general, including sovereign debt markets, but also other EU markets. We note that credit spreads on Eurozone reference entities widened significantly after the ban on short-selling introduced unexpectedly by Germany on 18 May, with many market participants ascribing this to the uncertainty caused by this ban.
3) *Short-selling bans generally don't work*. Bank share prices continued to plummet after regulators took action on short-selling in September 2008, for example. As

counterparties to derivatives contract are made clear. One of the key elements of the ISDA Master Agreement is the legal certainty provided regarding the use of 'netting'.

the IMF points out[11], in relation to the possibility of a ban on uncovered sovereign CDS, "an outright ban would merely prompt substitution to another asset correlated with sovereign risk. The most direct method would be to short the underlying bond, simply transferring more pressure to the cash market. Alternatively, to the extent that proxies are available (such as local equities, corporate CDS, or currency), pressure is transmitted to related markets, such as Greek bank equities or CDS."

4) *It is difficult to distinguish between "good" and "bad" use of CDS, if regulators are so inclined.* As the IMF points out, "recent proposals to ban 'naked' CDS exposures could be counter-productive, as this pre-supposes that regulators can arrive at a working definition of legitimate and illegitimate uses of these products. A general definition of naked shorts remains elusive for both market participants and regulators, reflecting the wide spectrum of activity that can constitute naked positions, ranging from hedging activity to outright speculation."

(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)?

For equity and bond markets we agree that consistent buy-in procedures are an effective way of reducing incidences of uncovered short selling where a market participant has no intention to deliver the security. There are already buy-in procedures in place for many equity markets but these are inconsistent (for example, Austria is S+3, Germany is S+5 and France is S+7). This creates complexity for investors and any proposal for special buy in rules for short sales would make the process even more fragmented. We see no reason however why short sales should be subject to a more stringent set of buy-in rules than any other purchase or long position sale (as this risk equally applies to these). Care needs to be taken when considering the time frame for triggering buy-in procedures to avoid overly penalising users of the markets. A consequence of short trigger periods is a reduction in the supply of securities that investors are willing to lend, as they would not want to risk being bought in on loaned shares that are subsequently sold but not returned by the borrower on settlement date. Reductions in supply will negatively impact market liquidity as lenders hold back shares from the lending market to cover potential sales.

If it proves difficult however to establish a sensible and consistent buy-in regime for all equity markets, an alternative to this might be to require sellers to pre-locate (as opposed to pre-borrow) securities prior to a short sell. This system has similarities to the one described in the consultation paper and has the additional advantage of being largely market convention already.

[11] See http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf

(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.

We believe that a limitation or ban on naked CDS would actually damage sovereign bond markets. Such a ban – even if market makers were exempt – would undermine liquidity in CDS markets, and make hedging more challenging and expensive for potential sovereign debt investors. This would make debt more difficult and more expensive to sell to the market, with consequences for interest rates, public deficits, public expenditure, and ultimately, public services.

As discussed at length in response to Question 11, we believe that sovereign debt spreads in the early part of 2010 were driven by risk aversion. As also addressed in question 11:

- regulators have not found any evidence to suggest that the use of naked CDS was a driving force behind widening bond spreads;
- data available from the DTCC suggests that the sovereign CDS market is a tiny fraction of the size of the underlying government bond market and cannot therefore be driving it.

(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, we consider that a requirement to flag and cover each short sale order would introduce costly and complicated processes that would adversely impact the efficiency of trading in the relevant securities. Such a requirement would amount to a major re-engineering of applicable trade processing systems and order handling.

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

Dealing with the real risk of uncovered short selling in equity markets (the potential for large numbers of persistently failing sales) needs particular care. As we mention above, simple bans will impact on market liquidity and result in over-borrowing of securities (which will create unnecessary loans that need to be unwound). Whilst we propose that this should be solved through the application of consistent and measured settlement disciplines it is essential that buy-ins are not triggered too early as this will deter investors from lending securities. Some custodians have indicated that they will hold back up to 50% of their supply from the lending market in countries where forced buy-ins occur on SD+1. Reducing securities lending supply will harm market liquidity and reduce lending returns to pension funds and other investors.

For CDS and bond markets please also see our answers to question 13. The result of a restriction of naked short sales will result in a withdrawal of liquidity, wider spreads and lack of confidence in the market.

We believe that it is true of all derivative markets that they have (overall) a smoothing effect on underlying markets, by providing investors with the reassurance that they can hedge price risks in that market. Limitations, for example through bans, or onerous and intrusive public transparency requirements will make underlying markets more volatile, by taking away this reassurance.

D. Exemptions

Questions:

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

Yes. Such an exemption is imperative for the efficient functioning of all markets including equities, bonds, and derivatives. This has been explicitly recognised for the equity markets in both the Transparency Directive and MIFID, as well as by IOSCO in its treatment of short selling regulation. The exemption should apply to both transparency around short sales and uncovered short selling restrictions. Regulators should also consider whether market-making activity in all types of securities should be exempted from any emergency measures implemented as market-makers are more, not less, important when markets are distressed.

For the exemption of market makers from the transparency requirement in the government bond markets, we refer to our answer to question 9.

Regarding an exemption for the conditions for uncovered short selling, from a market-maker's perspective it will be impractical for lending transactions to be concluded prior to or simultaneously with the respective bond sale. Such a requirement will result in a withdrawal of liquidity, wider spreads and lack of confidence in the market. This results from the fact that uncovered short selling (as defined by the consultation paper) is an integral and very important part of market-making in all securities markets.

For example, the PDs have to be willing to go short bonds (uncovered) in order to fulfil the role of liquidity provider to clients (including the debt management offices themselves) by acting as a buffer between timing of supply and demand flows in individual bonds.

A market maker may sell a bond that they do not own in response to a client purchase. Maintaining a long inventory in every bond for every country would be prohibitively expensive for any bank and expose it to unsustainable levels of risk. A PD may also sell a bond short as a hedge for other bonds that they have purchased to manage risk within the PD's portfolio.

'Naked' short selling, in the definition of this consultation document, also plays an important role in the sovereign Primary Markets. Primary Dealers may short a bond into an auction to free up balance sheet for the upcoming supply. The short position is covered at the auction. In times of increasing supply, limiting the possibilities of PDs to absorb supply will lead to increased borrowing costs of sovereigns and may even lead to systemic risks.

It is thus essential for market operations that market makers be permitted to short bonds and shares (nakedly).

Note that, in some markets, market-makers are defined as market participants. In others, they are habitual liquidity providers. It is important that the exemptions from the proposed measures cover both situations. Also, both inter-dealer and dealer-to-client market-making needs to be recognized in the exemptions for market maker. As a definition of market maker we suggest the MIFID definition in Artice 4 of MiFID (2004/39/EC)."'Market Maker ' means a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital at prices defined by him."

Any regulation of short selling must also recognize the role played by banks and other liquidity providers that underwrite or sub-underwrite new share issues. Banks and other entities may look to hedge[12] their commitments and reduce their risk by selling short securities against their underwriting/sub-underwriting commitments, which would leave them in a neutral position (i.e. flat) in terms of their economic interests. This activity supports the primary role of the capital markets and thus should also be exempted from public disclosure requirements. Disclosure of hedging activities will make them more difficult and risk being misinterpreted by the market. In addition, these hedging activities are not really short sales under the economic interests analysis - the bona fide hedged position is flat, i. e. neither long nor short. Failure to exempt bona fide hedging transactions will increase the costs of raising capital by diminishing the number of willing capital providers for the underwriting/sub-underwriting roles.

CDS market makers take on both long and short CDS positions through dealing and offsetting. For large investment firms acting as dealers in OTC derivatives markets, the large majority of their short positions are taken through the dealing function (it should be explained that these firms do not necessarily record whether these transactions are hedges, investments or arbitrage).

We are concerned that, in the CDS market, an exemption from bans or onerous transparency requirements for market makers *only* will not be enough. Restrictions on other participants in risk transfer markets will reduce the number of participants in these markets, making it more difficult and more expensive for dealers to continue to fulfil this role. This will be priced into the costs of hedging thereby discouraging potential bond investors.

It should be taken into consideration that, despite the criticism frequently levelled at speculators, without some ‘speculation’ – i.e. a willingness to take on risks – there could be no hedging (essentially, the isolation and transfer of specific risks).

(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?

There are both practical and policy reasons to exempt securities for which the principal trading market is outside the EEA from EU short selling regulation. As a policy matter, the main responsibility to maintain an orderly and fair market rests with the market that is the centre of most trading — usually in the home jurisdiction of the issuer. This is not to say that there should not be cooperation among the regulators, but the decision-making authority should rest with the main market. As a practical matter, it will be very difficult to monitor the trading in the most active trading centre from afar, and enforcement will be problematic even with the active assistance of the other regulatory authority. There is also the concern that the UK remains an attractive venue for issuers and investors by minimising the regulatory burden of trading in the UK. Of course, the same principle should apply to the case where the main trading of a UK issue is in the UK with trading also taking place outside the EEA.

There have to be effective protocols of cooperation among regulators and markets both in and outside the EU so that decisions made in a home jurisdiction can be monitored in the secondary trading venues and enforcement efforts assisted.

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

Without the exemptions for market-makers they would be subject to much greater risk on their capital because other market players would be able to trade against their disclosed positions. As market makers hold themselves out continuously to make a market in securities a market has liquidity, so that investors who wish to buy or sell may do so with a market-maker. This activity is a service to the whole market, since without liquidity investors would be unsure of being able to trade out of their positions at a reasonable price and thus would be less willing to invest. Therefore, it is reasonable and necessary to reduce risk for market-makers who will commit more capital to their activities and provide investors with tighter price spreads.

Similarly, if market makers are no longer able to perform naked short sales, this will result in a withdrawal of liquidity, wider spreads and lack of confidence in the market. Furthermore, as explained in question 19, if market makers are no longer able to short a bond into an auction this will lead to increased borrowing costs for sovereigns and may even lead to failed auctions (with the ensuing systemic risks).

Underwriters and sub-underwriters use their capital to help issuers raise capital by placing securities with end investors. This activity benefits the market and the issuers, since the success of a placing is dependent on potential investors' confidence that the issue is well priced and that the market is willing to invest in the issue as priced. When underwriters and sub-underwriters hedge their own risks by selling the shares, they are not really short in economic terms because they also have a commitment to buy securities if they are not

placed with end investors. As noted above, hedging is made more difficult if it is disclosed. The increased risk caused by disclosure will result in fewer entities being willing to take the underwriting risk which will force underwriting fees up and increase the cost of raising capital.

Similar rationales exist for all bona fide hedging as discussed in our answer to Question 19 in the case of CDS, etc.

E. Emergency powers of competent authorities

Questions:

(22) Should the conditions for use of emergency powers be further defined?

We support the proposal for regulators to have powers to act in ways designed to restore order and confidence in emergency situations. We also believe however that banning short selling in difficult market circumstances can increase stress and volatility and may actually serve to undermine confidence.

EU government bonds, particularly for the large issuers such as Germany, France and Italy, are valued by investors because they are perceived to be some of the most liquid markets in the world. Regulations suggesting that liquidity could be withdrawn at short notice under loosely defined circumstances would have a permanently negative effect on investor sentiment (and thus a long-term drag upon national government funding costs). It may lead to a loss of investor confidence in times when confidence is most needed. The likely effects would be reduced liquidity and wider bid/offer spreads.

Times of "emergency" are precisely the times when market participants most need liquidity to manage their risks. Certain interest rate and currency risks are hedged through short CDS/ bond positions so restricting the ability of investors to hedge positions via CDS purchases at times of "emergency" may have the knock-on effect that long-only bond investors sell their positions at the first sign of market distress.

For these reasons, care is needed to narrowly define the circumstances in which emergency powers may be used. They should not be evoked arbitrarily. We believe the current power definitions are too vague and broad. We draw attention to the following statement: "adverse developments which constitute a serious threat ... to market confidence in a Member State". This fails to distinguish between loss of market confidence driven by exogenous events or investor panic, and loss of confidence driven by genuine concerns about liquidity and solvency or national government policies.

(23) Are the emergency powers given to Competent Authorities and the procedures for their use appropriate?

See our answer to question 22.

(24) Should the restrictions be limited in time as suggested above?

Yes, we agree with the limitations in time as suggested.

(25) Are there any further measures that could ensure greater coordination between competent authorities in emergency situations?

To limit the potentially negative effects on the markets (as described in question 22) we would strongly advise that financial institutions are consulted before emergency powers are evoked. We also recommend that a mechanism is developed to coordinate among exchanges in the case of dual listed securities (if the security is barred from short selling in one country but not in the other).

(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%)?

Very short term restrictions (in terms of hours) in cases of extreme price movements are probably more useful than the other emergency powers proposed. However these restrictions should be calibrated appropriately for each instrument (price movements are much easier to monitor for exchange listed equities vs. seldom-traded corporate bonds, for example).

It should be noted that there already are sufficient controls across trading venues in Europe via price tolerance checks that are deemed sufficient while still permitting transparent price discovery.

F. Powers of competent authorities

General comments:

We note the suggestion in the EC consultation paper that competent authorities could be given an additional power in individual cases to seek further information from a person about the purpose for which they entered into a CDS transaction. We support the ability of the relevant competent authorities to seek information on individual transactions where market abuse is suspected. The competent authority in question should, however have a legitimate cause for concern and be able to evidence that; and the request should be routed through the relevant competent authority for the person that has entered into the transaction in question.

Question:

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

As described in our answer to question 22, the negative effects of banning short selling are such that the situations in which these powers can be evoked should be defined narrowly. This means evoking them only in true emergency situations and defining these situations as narrowly as possible.

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

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

(30) Do the definitions serve their intended purpose?

We believe that the current definition of 'net short position' could lead to rules which take insufficient account of the important and legitimate role of proxy hedging through so-called 'naked CDS'. If the calculation refers only to the underlying security in a CDS, the illusion could be given that there is no underlying exposure being hedged by the naked CDS in question. As demonstrated earlier however, such a contract can be used quite legitimately and valuably to hedge another correlated risk.