19 September 2013

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Dear Ms Fabregas

Review of the Regulation on short selling and certain aspects of credit default swaps[1]

On behalf of our members, the Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA) would like to take the opportunity to provide written comments to the European Commission in the context of the current review of the Regulation on short selling and certain aspects of credit default swaps (the Regulation). We hope that the feedback below is timely and helpful to the Commission in the preparation of its report to the European Parliament and Council on the impact of the Regulation. AFME and ISDA are keen to remain part of the on-going dialogue in this area and welcome continued opportunities to engage with the Commission to discuss our views in more detail.

There is attached (i) a paper on the subject and (ii) an annex which sets out certain possible drafting points for your consideration. We would be happy to discuss these, or any other of the issues covered in this submission with you, or to provide further information about any of the matters which our members have raised if that would be helpful. As the issue is a live one in a constantly changing market environment it is possible that we may have further points in the near future.

We look forward to your comments.

Yours sincerely

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[1] Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

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AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website www.afme.eu

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Review of the Regulation on short selling and certain aspects of credit default swaps[2]

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1. Executive Summary

1.1 On behalf of our members, the Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA) would like to take the opportunity to provide written comments to the European Commission in the context of the current review of the Regulation on short selling and certain aspects of credit default swaps (the Regulation). We hope that the feedback below is timely and helpful to the Commission in the preparation of its report to the European Parliament and Council on the impact of the Regulation. AFME and ISDA are keen to remain part of the on-going dialogue in this area and welcome continued opportunities to engage with the Commission to discuss our views in more detail.

1.2 We would be happy to discuss these, or any other of the issues covered in this submission with you, or to provide further information about any of the matters which our members have raised if that would be helpful. As the issue is a live one in a constantly changing market environment it is possible that we may have further points in the near future.

1.3 We support the analysis put forward by ESMA in its technical advice (Technical Advice) on the evaluation of the Regulation in a number of areas. [3] Such impact of course affects not only our members but, ultimately, their clients.

1.4 In relation to the market making exemption, we strongly support ESMA's assessment of the negative impact experienced by market participants in this area, and are of the view that

[2]Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

[3] ESMA/2013/614 of 3 June 2013

these concerns could be addressed now through further clarification of the application of the market making exemption, as more particularly set out later in this letter.

1.5 In certain other areas, such as credit default swaps (CDS) transparency and reporting thresholds, we believe that the Commission could go further than ESMA's recommendations in addressing the concerns of market participants. The IMF, for example, does not believe that the evidence supports a need to ban purchases of naked sovereign CDS protection.

1.6 We are also mindful that the timing of the current review – required a short time after the implementation of the Regulation on 1 November 2012 – has posed challenges in terms of the availability of relevant data and market feedback on the impact of the Regulation. AFME and ISDA would therefore support a future review of the Regulation at an early date, but after at least one full year of implementation time, in order better to assess the evolution of the market and the effects of the Regulation in different areas.

2. Market making

2.1 We would highlight our strong support of ESMA's assessment of the negative impact experienced by market participants as providers and beneficiaries of market making services. We believe there to have been an overly narrow interpretation of how the market making exemption should be applied. These concerns need to be addressed, not just in the context of the Regulation, but also to avoid setting a precedent that would impact other pieces of European and national legislation.

2.2 We remain very concerned about the impact of the implementation of the exemption available in the Level 1 text for market making and primary market operations for the purposes of the Guidelines ESMA/2013/74 (ESMA Guidelines). We would like to emphasise our view that the concerns set out below on the market making exemption stem from the interpretation of the Regulation adopted in the ESMA Guidelines, and do not require a revision of the Level 1 text. We would therefore urge ESMA and the Commission to consider a revision of the ESMA Guidelines in view of the concerns articulated by ESMA in this area. (Alternatively, if the Commission and the co-legislators agree that it may be necessary to amend the Regulation text in order to clarify the position, then we would support this approach in order to reflect ESMA's recommendations in this area)

2.3 The first key issue with the ESMA Guidelines is the narrow interpretation of the "market making activities" definition with regard to the trading venue requirement[4]. Based on this interpretation, the exemption can only be used by market makers when carrying on market making activity in relation to a financial instrument that is traded on or admitted to trading on a trading venue – therefore the exemption cannot be used in relation to trading in OTC derivatives transactions. We see no basis in the Level 1 text for this distinction between instruments which trade on a trading venue and those which do not, nor for any implication that market making needs to be linked to a particular trading venue. The provision of liquidity (in particular for some sovereign debt and sovereign CDS instruments) outside of trading venues is important, as such venues may not provide enough liquidity, flexibility or tailored solutions to support all trading needs in large, bespoke and/or illiquid transactions. It is also worth noting – and giving due recognition to – the fact that it is not necessary to utilise an exchange/trading venue to make a market in a particular instrument and that the OTC markets are extremely important in providing liquidity to clients.

[4] ESMA Guidelines section VI

2.4 We agree with ESMA that the reasons for providing a market making exemption – namely that market makers play a crucial role in providing liquidity to markets within the EU and need to be able to take short positions to perform that role – apply whether the market maker is dealing in an OTC product or an exchange-traded one. We are of the view that the different treatment of market making in relation to OTC-traded products is neither justified nor required under Article 2(1)(k) of the Regulation.

2.5 The second issue is the unavailability of the market making exemption in respect of certain instruments (and associated hedging of such instruments) which do not themselves create positions in relevant companies or sovereign debt for the purposes of the Regulation's disclosure regime – for example corporate debt, convertible bonds and rights[5]. We support ESMA's assessment of the impact of this provision in the Guidelines, and its recommendation that the scope of the financial instruments eligible for the market maker exemption be expanded to include the aforementioned instruments. See also our thoughts on corporate bonds and unlisted structured products (under the heading "CDS" below).

2.6 Further to the above issues, we also support ESMA's analysis[6] concerning the burdens of the instrument-by-instrument approach for obtaining the market making exemption in the ESMA Guidelines. Possible alternative solutions could include:

2.6.1 recognising that any subsequent corporate action such as a share for share exchange on an exempt instrument is related to the original exemption and therefore does not require re-exempting;

2.6.2 exempting at the index level and at not each constituent element of the index, such that notification could be made either at the index level or at the individual share level.

3. Credit Default Swaps

3.1 We agree with ESMA[7] that the Regulation has had a severe impact on the trading of relevant sovereign CDS indices as, currently, the exposure must be a pan-EU or pan-euro area one in order to be eligible for hedging via an index which precludes exposures which do not include all Member States (MSs) in the index. We agree that ESMA should be requested to do some more work in this area with a view to providing more detailed advice on amendments to Commission Delegated Regulation No. 918/2012 of 5 July 2012 (DR 918/2012). We also agree with ESMA that where the sovereign CDS market for some individual MSs has significantly been affected since the application of the Regulation, then cross-border hedging should be allowed in these circumstances.

3.2 We note in this regard the findings in Chapter 2 of the IMF's Global Financial Report 2013, which concludes that 'Overall, the evidence here does not support the need to ban purchases of naked sovereign CDS protection' (page 1 of the IMF report).

3.3 Focusing on the difficulties of cross-border hedging, the IMF report points out (on page 20) that advanced economies have substitute markets through which negative sovereign credit risk views can be expressed. It says "....However, in many emerging market economies[*(marked on an accompanying graph and including Latvia, Hungary, Lithuania, Romania and Croatia]*, such alternatives are unavailable, so the loss of sovereign CDS as a hedging instrument could have negative consequences for other credit markets, including

[5] ESMA Guidelines section VI
[6] Technical Advice Para 155
[7] Technical Advice Para 115

the underlying bond markets, and could raise issuance costs. In addition, sovereign CDS dealers that hedge their counterparty risk on their other derivative transactions with sovereigns would face higher costs on such hedging activities".

3.4 The market making exemption does not include the ability to hedge corporate bonds. We note that the ESMA Guidelines introduce an exhaustive list of instruments that can benefit from the market making exemption when hedged with short positions in securities. As the hedging of market making in corporate bonds is not included in this list, firms then have to find a locate; this takes time, affecting firms' ability to quote in a timely fashion. In periods of extreme volatility and market stress, it is expected that clients will be very active in offloading or accessing risk, but the time taken to access the locate could prevent firms from hedging and therefore being able to trade. This reduces firms' ability properly to manage risk and has potentially broader systemic risk implications. We would therefore support adding corporate bonds to this list. A similar issue arises in relation to certain securities not admitted to trading on an EU trading venue (e.g. unlisted structured products).

3.5 On correlation tests, we welcome ESMA's clarification that it is either the quantitative or the qualitative correlation test that should be applied and not both. We note that the quantitative test is based on the relationship between price of the assets or liabilities and the price of the sovereign debt – calculated on a historical basis over the past 12 months.

3.6 However, the correlation tests impose an unnecessarily tight geographical restriction on what sovereign CDS contracts are allowed, such that the exposure being hedged must be in the same Member State as the reference sovereign under the CDS. In practice, as many industries are now global and/or operate throughout the EU, there may well be sound reasons to hedge a risk in one jurisdiction through the use of a CDS instrument related to a reference entity in another.

3.7 We support ESMA's position on conducting calculations as to whether a sovereign CDS position is a covered one at the level of a group, rather than at legal entity level only, when a dedicated entity within that group is tasked with the hedging the exposure of other entities within that group.

4. Novation

4.1 We note that ESMA have asked the Commission for an interpretation of whether the Regulation allows for sovereign CDS positions entered into before the Regulation to be novated without infringing the prohibition, via a Level 3 Q&A[8].

4.2 Novation is a means of a transferring party's (transferor) rights and obligations under a contract to a third party (transferee). Technically such novation results in a termination of the existing contract between the transferor and the remaining party and enter into a new identical contract between the remaining party and the transferee (only the identity of one of the counterparties changing). As a consequence, there is no increase in the market or systemic risk resulting from the novation, as there has been no overall increase in the volume of outstanding CDS contracts. In effect therefore, one of the benefits of novations is that they allow parties to step in or out of transactions to manage their counterparty and credit risk.

[8] Technical Advice paragraph 117

4.3 We agree with ESMA that novated uncovered sovereign CDS contracts which replace sovereign CDS contracts concluded before 25 March 2012 (or during any temporary suspension period) should continue to benefit from the grandfathering provisions set out in Article 46 of the Regulation – i.e. that they may be held until the maturity date of the CDS contract, where the net market uncovered position remains unchanged as a result of such events, and the duration and size of the novated contract have not increased beyond the original terms.

5. Transparency and reporting requirements

5.1 We would wish to go further than ESMA in this area, as we consider that the threshold level for both the notification and publication for net short positions in shares is too low, and may unintentionally penalise investors – for example, some companies we understand have apparently refused to meet or give information to investors who disclosed large net short positions. Thus the objective of greater transparency is, in part at least, defeated. We would recommend a public disclosure threshold of 3%, which is somewhat lower than the Transparency Directive thresholds. We also want to reiterate that the requirement to include preference shares and some convertible bonds in the net short position calculation is complicated. We also continue to call for a single point for data reporting and a midnight time limit for submitting notifications. Otherwise, we support ESMA in its advice, especially that the calculation method for net short positions in sovereign debt be revisited.

6. Restrictions on uncovered short sales in shares and sovereign debt

6.1 Together with the International Securities Lending Association (ISLA), with whom we have discussed this matter, we support ESMA in that internal locate arrangements should be allowed which would enable short sellers to obtain the confirmations necessary to undertake a short sale from parties within the same legal entity provided that these parties meet the necessary conditions. Likewise, we support revisiting the issue of the definition of liquid shares.

7. Requirements on buy-in procedures and penalties for settlement discipline

7.1 We trust that the more focused text of the CSD-R will supersede Article 15 and strongly support ESMA's view that this topic should be addressed in that dossier.

8. List of shares that are exempted

8.1 ESMA propose to change this to "The provisions of the Regulation apply2 to all shares of companies domiciled in the EU but shall not apply to shares of companies domiciled outside the EU unless the issuer itself has requested admission on a European trading venue"[9] and suggests drawing up a negative list based on these two criteria. We assume that "companies" means public companies. Alternatively, the scope could explicitly exclude shares which are solely admitted to trading on a European MTF, because the inclusion of MTFs in the definition of "trading venue" in this context causes practical difficulties in establishing the range of shares subject to the Regulation. AFME/ISDA welcome in this regard any solution that increases clarity and certainty as to what is covered and what is not.

[9] Technical Advice paragraph 132

9. Intervention powers and emergency measures

9.1 We reiterate that such intervention measures[10] would be best introduced by having a central page, in English, on which to post restrictions and Competent Authorities should be obliged to confirm whether any exemptions apply to their own emergency restrictions (the market making exemption being a good example). Perhaps the Commission might encourage ESMA to do some Level 3 work in this area, which could assist in the operation of the single market and reduce the burden on industry, without the need for further legislation. We would be happy to assist with this.

[10] We are aware of the Opinion of Advocate General Jääkinen on this subject delivered on 12 September 2013, on which we may submit later.

Annex

We would suggest, at least, the following changes to DR 918/2012

A. Article 15: Established in "more than one Member State" vs "in another Member State"

We understand that the introductory phrase was meant (by ESMA) to refer to the cases where the obligor of, or the counterparty to, an exposure hedged is located in another Member State, not "in more than one Member State". This is a material difference in scope which we do not understand to be intentional. However, this part of the introductory phrase ("Where the obligor of, or counterparty to, an asset or liability is established in more than one Member State...") seems to be redundant given the subsequent detailed paragraphs with exceptions. Therefore we would suggest shortening the introductory language (please see amendments below). This would bring legal clarity and keep the original meaning of the exceptions at the same time.

B. Articles 15 and 18: "Company" / "Enterprise" vs "undertaking or other entity"

Article 15 refers to "companies", but a legal form of the entity concerned may not fall into the definition of a company (e.g., if it is an association or natural person). Therefore the term "company" should be replaced by the term "undertaking or other entity". The terms "undertaking" and "entity" are commonly used in EU law. This would cover both private and public entities independently of their legal form.

Similarly, the references to "an enterprise" in Article 18 only could exclude hedging of exposures to other issuers (e.g., sovereign issuers, partnerships of undertakings or trusts). Therefore we consider that the term "enterprise" should be replaced with the term "undertaking or other entity" as well.

C. Article 15: "Loan" or "bond" vs "exposure"

Article 15 refers to "loans" made to a subsidiary, or parent companies issuing a "bond". However, a similar risk may also result from other types of exposures (e.g., derivatives exposures, foreign trade contracts, other financial or commercial contracts). It is not clear why one type of exposures would be taken into account and others not.

D. Article 15: "Assets and revenues" vs "assets, liabilities, revenues or profits"

As recognised in Article 15, the performance risk of these exposures may stem primarily from the assets and revenues of another entity related to another jurisdiction. However, again, the performance of another entity may depend not only on assets and revenues but also liabilities and profits. Therefore the words "assets and revenues" should be replaced by "assets, liabilities, revenues or profits".

E. Article 15: "Parent company" or "subsidiary" vs "a member of a group"

Entities may be linked not only on the basis of a parent / subsidiary relationship, but also by a wider group relationship. It is not necessarily the case that the parent company's performance is the crucial one: it may be the other way around. Moreover, the link may be between two "sister" companies. Therefore we would suggest using the term "a member of a group". We would also suggest amending the definition of "group" in Article 2(a).

F. Article 15: "Operations" vs "Exposures"

We consider that the term "operations" is too narrow and should be replaced by "exposures". "Operations" may not take into account exposures resulting from financial contracts, for example.

G. Article 15: "Across the Union" vs "in one or more other Member States"

The term "across the Union" in Article 15 is not very clear. The phrase "one or more other Member States" would be more appropriate and bring more legal certainty.

H. Article 15: "Index" vs "single name"

We consider that in addition to an index CDS, it should also be possible to use one or more single name CDS. The index may not cover all the relevant countries, so a basket of single name CDS trades may be more appropriate.

I. Article 14: "decline" vs "change"

We consider that the word "decline" in Article 14 should be replaced by "change", given that both assets and liabilities are referred to afterwards. One would hedge not only the risk of decline in the value of assets, but also the risk of increase of the value of liabilities.

J. Article 14: "Assets and liabilities" vs "exposures"

We are concerned that the term "correlation" may be defined too narrowly due to the fact that there is a difference between referring to "assets or liabilities" only and referring to the "risk" or "exposure" undertaking via holding of those assets. Therefore, the text should refer to "risks" or "exposures", not "assets and liabilities" only. These changes would increase legal consistency and clarity of the text.

K. Articles 19 and 20: "any person" / "position holder" vs "CDS buyer"

We would welcome consistency in referring to the CDS buyer (and not "any person" or "the position holder"). It is important to clarify that the person referred to is the buyer of CDS protection who is taking on the CDS position and has the duty to justify to the relevant authority that the transaction does not infringe the rules. It will in practice be impossible for the seller of protection to assess whether the trade is putting the buyer in breach, since that would require the seller to have knowledge of all of the buyer's long and short positions and the correlation between them. Therefore we would suggest to refer to "the CDS buyer", and to define that term.

L. Articles 14 and 20: "referenced sovereign debt"

We are concerned that the concept of "referenced sovereign debt" and similar concepts included in the text are too narrow. These concepts would be better expressed as "obligations of the sovereign which are within the scope of the CDS". The point here is that the CDS will typically not reference any specific debt obligation of the Member State. CDS will instead include terms which identify, by way of obligation category and characteristics, a generic universe of debt obligations of, or guaranteed by, the Member States which may be taken into account (i) in determining whether a Credit Event has occurred, and (ii) for the purposes of settlement of the CDS. The test of correlation should be capable of being satisfied by reference to any obligations of the sovereign which are eligible for inclusion in the operation of the CDS.

Certain Proposed Drafting amendments to DR 918/2012

Article 2

Definitions

(c) The "CDS buyer" means the party to a credit default swap that receives a payment or other benefit in the case of a credit event relating to a reference entity or in the case of any other default, relating to that credit default swap, which has a similar economic effect.

Article 14

Cases which are not uncovered sovereign credit default swap positions

1. In the following cases a sovereign credit default swap position shall not be considered an uncovered position in accordance with Article 4(1) of Regulation (EU) No 236/2012.

(a) In respect of hedges for the purpose of Article 4(1)(b) of Regulation (EU) No 236/2012, the sovereign credit default swap shall not be considered an uncovered position in accordance with Article 4(1) of Regulation (EU) No 236/2012 and shall serve to hedge against the risk of ~~decline~~ ***change*** in the value of ~~assets or liabilities~~ ***exposures*** correlated with the risk of the ***change*** ~~decline~~ of the value of the ***obligations of the sovereign*** ~~sovereign debt~~ which the credit default swap references and where those ~~assets or liabilities~~ ***exposures*** refer to public or private sector entities in the same Member State.

(b) A sovereign credit default swap position, in which assets or liabilities refer to public or private sector entities in the same Member State as the reference sovereign for the credit default swap, shall not be considered an uncovered position in accordance with Article 4(1) of Regulation (EU) No 236/2012 where it:

(i) references a Member State, including any ministry, agency or special purpose vehicle of the Member State, or in the case of a Member State that is a federal state, one of the members making up the federation;

(ii) is used to hedge any ~~assets or liabilities~~ ***exposures*** meeting the correlation test set out in Article 18.

(c) A sovereign credit default swap position, where the ~~assets or liabilities~~ ***exposures*** refer to a sovereign issuer in which the reference sovereign for the credit default swap is a guarantor or shareholder, shall not be considered an uncovered position in accordance with Article 4(1) of Regulation (EU) No 236/2012 where it:

(i) references a Member State;
(ii) is used to hedge any ~~assets or liabilities~~ ***exposures*** meeting the correlation test set out in Article 18.

2. For the purposes of point (a) of paragraph 1, a correlation shall exist between the value of the asset or liability being hedged and the value of the ***obligations of the sovereign which are within scope of the CDS*** ~~referenced sovereign debt~~ as set out in Article 18.

Article 15
Cases which are not uncovered sovereign credit default swap positions where the obligor is established or the asset or liability is located in more than one Member State
1. ~~Where the obligor of, or counterparty to, an asset or liability is established in more than one Member State a~~ ***A*** sovereign credit default swap position shall not be considered an uncovered position in the following cases, in accordance with Article 4(1) of Regulation (EU) No 236/2012, and provided that the correlation test in Article 18 of this Regulation is met in each case:

~~(a) where there is a parent company in one Member State and a subsidiary in another Member State and a loan has been made to the subsidiary. Where there is either explicit or implicit credit support to the subsidiary by the parent, it shall be permissible to purchase sovereign credit default swaps in the Member State of the parent rather than the subsidiary;~~

~~(b) where there is a parent holding company which own or controls a subsidiary operating company in a different Member States. If the parent company is the issuer of the bond but the assets and revenues that are hedged are owned by the subsidiary, it shall be permissible to buy sovereign credit default swaps referenced to the Member State of the subsidiary;~~

(ba) Where a person has an exposure to a member of a group and another member of the group is located in another Member State and that person enters into a sovereign credit default swap referencing the Member State of the second member of the group, provided that the second member explicitly or implicitly provides credit support to the first member of the group or the credit of the first member of the group is dependent on the assets, liabilities or revenues or profits of the second member of the group;

(bb) Where a person has an exposure to a supra-national issuer and that person enters into a sovereign credit default swap referencing one or more sovereign issuers that are that supra-national issuer's guarantors or shareholders;

(bc) Where a person has an exposure to an undertaking or other entity in one Member States to the extent that that undertaking or other entity would be significantly impacted in the event of a significant fall in the value of the sovereign debt of the second Member State it shall be permissible to buy sovereign CDS referenced to the second Member State.

(c) to hedge an exposure to a ~~company~~ ***undertaking or other entity*** in one Member State which has invested in the sovereign debt of a second Member State to the extent that that company would be significantly impacted in the event of a significant fall in the value of the sovereign debt of the second Member State, provided that the company is established in both Member States. Where the correlation between this risk and the debt of the second Member State is greater than the correlation between this risk and the debt of the Member State in which the company is established it shall be permissible to buy sovereign credit default swaps referenced to the second Member State.

2. A sovereign credit default swap position shall not be considered an uncovered position in the following cases, in accordance with Article 4(1) of Regulation (EU) No 236/2012, and provided that the correlation test in Article 18 of this Regulation is met in each case:

(a) where the obligor of, or counterparty to, an asset or liability being hedged is ***an undertaking or other entity*** ~~a company~~ which has ***exposures*** ~~operations~~ ~~across the Union~~ ***in one or more Member States*** or where the exposure being hedged relates to the Union or the Member States which have the euro as their currency, it shall be permissible to hedge it with an appropriate European or euro area index of sovereign bond credit default swaps;

(b) where the counterparty to an asset or liability being hedged is a supra-national issuer, it shall be permissible to hedge the counterparty risk with an appropriately chosen basket of sovereign credit default swaps referencing that entity's guarantors or shareholders.

Article 16

Justification of uncovered sovereign credit default swap positions

~~Any natural or legal person~~ ***Any CDS buyer*** entering into a sovereign credit default swap position shall, on the request of the competent authority:

(a) justify to that competent authority which of the cases set out in Article 15 were fulfilled at the time the position was entered into;

(b) demonstrate to that competent authority compliance with the correlation test in Article 18 and the proportionality requirements in Article 19 in respect of that sovereign credit default swap position at any time that they hold that sovereign credit default swap.

Article 17

Hedged assets and liabilities

The following are cases where ~~assets and liabilities~~ ***exposures*** may be hedged through a sovereign credit default swap position, provided the conditions set out in Articles 15 and 18 and in Regulation (EU) No 236/2012 are met:

(a) a long position in the sovereign debt of the relevant issuer;
(b) any position or portfolio used in the context of hedging exposures to the sovereign issuer referenced in the credit default swaps;
(c) any ~~assets or liabilities~~ ***exposures*** which refer to public sector entities in the Member State whose sovereign debt is referenced in the credit default swap. This includes exposures to central, regional and local administration, public sector entities or any exposure guaranteed by the referred entity and may include financial contracts, a portfolio of assets or financial obligations, interest rate or currency swap transactions where the sovereign credit default swap is used as a counterparty risk management tool for hedging exposure on financial or foreign trade contracts;
(d) exposures to private sector entities established in the Member State which is referenced in the sovereign credit default swap. The exposures in question include but are not limited to loans, counterparty credit risk (including potential exposure when regulatory capital is required for such exposure), receivables and guarantees. The ~~assets and liabilities~~ ***exposures*** include but are not limited to financial contracts, a portfolio of assets or financial obligations, interest rate or currency swap transactions where the sovereign credit default swap is used as a counterparty risk management tool for hedging exposure on financial contracts or trade finance exposures;
(e) any indirect exposures to any of the above entities obtained through exposure to indices, funds or special purpose vehicles.

Article 18

Correlation tests

1. The correlation test referred to in this Chapter shall be met in either of the following cases:

(a) the quantitative correlation test shall be met by showing a Pearson's correlation coefficient of at least 70 % between the price of the assets or liabilities and the price of the sovereign debt calculated on a historical basis using data for at least a period of 12 months of trading days immediately preceding the date when the sovereign credit default swap position is taken out;

(b) the qualitative correlation shall be met by showing meaningful correlation, which means a correlation that is based on appropriate data and is not evidence of a merely temporary dependence. The correlation shall be calculated on a historical basis using data for the 12 months of trading days before the sovereign credit default swap position is taken out, weighted to the most recent time. A different time-frame shall be used if it is demonstrated that the conditions prevailing in that period were similar to those at the time that the sovereign credit default swap position is to be taken out or which would occur in the period of the exposure being hedged. For assets for which there is not a liquid market price or where there is not a sufficiently long price history, an appropriate proxy shall be used.

2. The correlation test in paragraph 1 shall be deemed to have been met if it can be demonstrated that:

(a) the exposure being hedged relates to an ~~enterprise~~ ***undertaking or other entity*** which is owned by the sovereign issuer or where the sovereign issuer owns a majority of its voting share capital or whose debts are guaranteed by the sovereign issuer;

(b) the exposure being hedged relates to a regional, local or municipal government of the Member State;

(c) the exposure being hedged relates to an ~~enterprise~~ ***undertaking or other entity*** whose cash flows are significantly dependent on contracts from a sovereign issuer or a project which is funded or significantly funded or underwritten by a sovereign issuer, such as an infrastructure project.

3. The relevant party shall justify that the correlation test was met at the time that the sovereign credit default swap position was entered into upon request by the relevant competent authority.

Article 19

Proportionality
1. In determining whether the size of the sovereign credit default swap position is proportionate to the size of the exposures hedged, where a perfect hedge is not possible, an exact match is not required and limited over-provision shall be permitted in accordance with paragraph 2. The relevant party shall justify upon request to the competent authority why an exact match was not possible.

2. Where justified by the nature of the ~~assets and liabilities~~ ***exposures*** being hedged and their relationship to the value of the obligations of the sovereign which are within the scope of the

credit default swap, a greater value of sovereign credit default swap shall be held to hedge a given value of exposures. However, this shall only be permitted where it is demonstrated that a larger value of sovereign credit default swap is necessary to match a relevant measure of risk associated with the reference portfolio, taking into account as the following factors:

(a) the size of the nominal position;

(b) the sensitivity ratio of the exposures to the obligations of the sovereign which are within the scope of the credit default swap;

(c) whether the hedging strategy involved is dynamic or static.

3. It is the responsibility of the ~~position holder~~ ***CDS buyer*** to ensure that its sovereign credit default swap position remains proportionate at all times and that the duration of the sovereign credit default swap position is aligned as closely as practicable given prevailing market conventions and liquidity with the duration of the exposures being hedged or the period during which the person intends to hold the exposure. If the exposures being hedged by the credit default swap position are liquidated or redeemed, they must either be replaced by equivalent exposures or the credit default swap position must be reduced or otherwise disposed of.

4. Provided that a sovereign credit default swap position was covered at the time it was entered into, it shall not be treated as becoming uncovered where the sole reason for the position becoming uncovered is a fluctuation in the market value of the hedged exposures or the value of the sovereign credit default swap.

5. In all circumstances, where parties accept a sovereign credit default swap position as a consequence of their obligations as members of a central counterparty which clears sovereign credit default swap transactions and as a result of the operation of the rules of that central counterparty, such a position shall be treated as involuntary and not as a position that the party has entered into and so shall not be considered uncovered pursuant to Article 4(1) of Regulation (EU) No 236/2012.

Article 20

Method of calculation of an uncovered sovereign credit default swap position

1. The calculation of a natural or legal person's sovereign credit default swap position shall be its net position.

2. When calculating the value of the eligible risks hedged or to be hedged by a sovereign credit default swap position a distinction shall be made between static and dynamic hedging strategies. For static hedging, such as direct exposures to sovereign or public sector bodies in the sovereign, the metric used shall be the jump to default measure of the loss if the entity to which the ~~position holder~~ ***CDS buyer*** is exposed defaults. The resulting value shall then be compared against the net notional value of the credit default swap position.

3. When calculating the value of market value adjusted risks for which a dynamic hedging strategy is required, the calculations must be undertaken on a risk-adjusted rather than notional basis, taking into account the extent to which an exposure might increase or decrease during its duration and the relative volatilities of the ~~assets and liabilities~~ ***exposures*** being hedged and of the ***obligations of the sovereign which are within scope of the CDS*** ~~referenced sovereign debt~~. A beta adjustment shall be used if the asset or liability for which the credit default swap position

is being used as a hedge is different from the ~~reference asset~~ ***obligations of the sovereign which are within the scope*** of the credit default swap.

4. Indirect exposures to risks, such as through indices, funds, special purpose vehicles, and to credit default swap positions shall be taken into account in proportion to the extent the ~~reference asset, liability~~ ***exposure*** or credit default swap is represented in the index, fund or other mechanism.

5. The value of the eligible portfolio of ~~assets or liabilities~~ ***exposures*** to be hedged shall be deducted from the value of the net credit default swaps position held. If the resulting number is positive the position shall be considered to be an uncovered credit default swaps position in accordance with Article 4(1) of Regulation (EU) No 236/2012.