CONSULTATION RESPONSE

AmCham EU's response to the consultation on ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps

American Chamber of Commerce to the European Union
Avenue des Arts/Kunstlaan 53, 1000 Brussels, Belgium
Telephone 32-2-513 68 92 Fax 32-2-513 79 28
Register ID: 5265780509-97
Email:info@amchameu.eu

Secretariat Point of Contact: Aylin Lusi aylin.lusi@amchameu.eu +32 2289 1033

9 March 2012

Background and Analysis

AmCham EU believes that both short selling and trading in sovereign credit default swaps (CDS) are legitimate strategies for market participants to pursue. A proportionate and balanced EU-wide regulatory regime, of the type envisaged by the Short Selling Regulation, therefore has the potential to bring welcome clarity and certainty to all market participants.

In relation to ESMA's recent consultation on possible Delegated Acts in this area, AmCham EU wishes to offer its comments on one issue: the conditions under which a CDS transaction is considered to be hedging against a default risk, or the risk of a decline of the value of the sovereign debt.

In Box 6 (pages 31 and 32) of the consultation paper, ESMA propose a series of general conditions that must be met in order for a sovereign CDS position to avoid being regarded as 'uncovered'.

These include the requirement that the obligor or counterparty of any asset or liability being hedged using sovereign CDS:

"is located in the same Member State as the reference sovereign for the CDS"

This condition amounts to a prohibition of the use of sovereign CDS as a hedge against a risk that arises in another Member State. However, AmCham EU believes that such a prohibition cannot be justified on the basis of the Regulation, and that there are strong policy reasons not to pursue it.

We believe that such an additional restriction is not justified by the Regulation itself, which does not impose a ban on the cross-border use of sovereign CDS.[1]

Article 4 of the Regulation obliges a holder of sovereign CDS to hold assets or liabilities that are "*correlated to the value of the sovereign debt*", but it does not state that these must be located within the same Member State as the issuer of the sovereign. Moreover, recital 21 notes that the use of sovereign CDS should be based on the broad principle of an "*insurable interest*", and while this principle *"includes…assets or…liabilities which refer to public or private sector entities in the Member State concerned"* the text does *not* limit the concept of an insurable interest to such cases.

[1] We note that there are other restrictions to the hedging exemption – for instance the requirement that correlation be "significant" and "consistent", and the requirement that correlation may only be demonstrated by virtue of correlation having existed during the previous 12 month period – which likewise narrow what was clearly intended in the Regulation itself to be a broad exemption which would allow legitimate hedging activity.

AMCHAM EU
AMERICAN CHAMBER OF COMMERCE TO THE EUROPEAN UNION
SPEAKING FOR AMERICAN BUSINESS IN EUROPE

CONSULTATION RESPONSE

We are concerned by the implications of such a prohibition. Not only will it prevent firms from undertaking legitimate risk-management activities, it fails to take account of the increasingly integrated European (and particularly eurozone) markets.

In the context of a single market and the Treaty-based freedoms on which it is based, the Member State in which the correlated asset is located should be irrelevant. Provided the Regulation's legitimate requirement for '*correlation*' has been met, the Delegated Act should not seek to introduce an additional condition that discriminates on the grounds of the national origins of the asset being hedged. Given that there are many examples of sovereign debt in one Member State being correlated with assets in another, this ban on cross-country hedging is not a proportionate restriction.

AmCham EU is concerned that drawing such a prohibition along Member State boundaries will discourage cross-border investment flows, by raising the costs of legitimate and prudent risk management techniques.

The most appropriate hedge for an investment might <u>not</u> be the CDS of the sovereign in which the initial investment is legally located, but rather CDS written on the sovereign in which the key customers or suppliers are located. A potential investor in the parent legal entity of a pan-EU group would be entirely justified in seeing the key risks to her capital arising in the Member State where the key *affiliates* are located and from which the group derives large parts of its income. But such a hedging strategy would now become significantly more expensive, as an alternative to sovereign CDS would have to be found. And if the risk mitigation options available to an investor become more expensive, then either the rate of return has to increase to compensate, or levels of investment will simply reduce.

AmCham EU is concerned by the potential consequence of this prohibition for cross-border investment flows, and particularly for investments into smaller, peripheral Member States. If risks can only be hedged using a CDS contract written on the sovereign debt of the Member State in which the investment occurs then investment in those Member States with smaller and less liquid CDS markets will become relatively less attractive.

AmCham EU believes that where a reasonable correlation can be demonstrated between the sovereign debt on which the CDS is written and the asset or liability the market participant holds there should be no discrimination along national lines. Such a restriction is disproportionate and runs counter to the realities of the EU single market and the Treaty freedoms.

CONSULTATION RESPONSE

***

AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate U.S. investment in Europe totalled €1.4 trillion in 2009 and currently supports more than 4.5 million jobs in Europe.

***