RIKSGÄLDEN
SWEDISH NATIONAL DEBT OFFICE

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European Securities and Markets Authority

Response to consultation paper on Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps

The Swedish National Debt Office (SNDO) thanks the European Securities and Markets Authority (ESMA) for the opportunity to comment on this Consultation Paper.

The SNDO's interest in this matter derives from our responsibility as issuer of the sovereign debt of the Kingdom of Sweden. Like other sovereign debt managers, we rely on access to well-functioning markets for our debt instrument to be able to meet our statutory objective of securing funding at low costs and a prudent level of risk. The Swedish government debt market is organized on the principle of market making. Based on this market structure our markets function well, offering market access to the SNDO as issuer and liquidity and depth to investors holding our bonds.

Market making is impossible without exemptions from restrictions on short-selling. This is explicitly recognized in the Regulation. Thus, in recital 26 it is stated that:

> Market making activities play a crucial role in providing liquidity to markets within the Union and market makers need to take short positions to perform that role. Imposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the Union markets. Furthermore market makers would not be expected to take significant short positions except for very brief periods. It is therefore appropriate to exempt natural or legal persons involved in such activities from requirements which could impair their ability to perform such a function and therefore adversely affect the Union markets.

The SNDO views these exemptions as essential parts of the Regulation. We would also consider the wording to be very clear on the justification for such exemptions and on the consequences of not providing them.

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Reviewing the Consultation Paper, we are concerned that ESMA has lost sight of this important observation and the intention to provide room for market making activities that is expressed in the Regulation. As a result, some of the requirements suggested by ESMA could seriously harm market makers' ability to provide liquidity and other essential services to us as issuer and to the investors that hold our bonds.

In terms of the specific questions posed in the Consultation Paper, what follows can be considered an answer to question 1: *Do you agree with the above approach regarding the definition and scope of the exemption for market making activities?*

The short answer is that we do not agree. In this response, we elaborate on the reasons for our concerns and indicate how they can be allayed.

We also provide a brief response to questions 9 and 10, arguing that the proposed criteria for presence in the market are not suitable for sovereign debt markets. Other questions in the Consultation Paper also raise important issues, but the brief time available for providing comments has made us focus on these two as the ones of greatest importance.

Lack of time to review the document in greater detail and our limited knowledge of the context in which it belongs mean that we should add the caveat that we may have failed to fully comprehend aspects of ESMA's proposal. This response reflects our best understanding of the proposals and their consequences on matters that are of great importance to us as sovereign debt managers.

1 Exemptions for market making in sovereign debt markets

We note first that based on Article 17(3) institutions acting as authorised primary dealers for a sovereign issuer are exempted from requirements related to sovereign debt instruments. Based on the notification form in Annex III, we conclude that in this case the exemption is based on *the activity* of being an authorised primary dealer, as there is no indication that individual instruments should be listed in the form.

This implies that the institution can obtain an exemption for all the instruments covered by the primary dealer agreement, including any new instruments that the sovereign issuer may introduce. This is in line with how primary dealer agreements work in practice. For example, when the SNDO introduces, say, a new ten-year bond or a three-month bill our primary dealers automatically start acting as market makers for these instruments.

However, market making activities in Swedish government debt instruments are conducted also by institutions that are not authorised primary dealers. These institutions are also essential for the infrastructure that ensures that our bonds are liquid and tradable. Moreover, each additional market maker reduces the risks of the others, including the authorised primary dealers, enabling them to offer more liquidity and depth to investors.

That such market making is essential is also the premise of the Regulation. Otherwise there would have been no reason to include exemptions for institutions other than authorised primary dealers. Such exemptions are to be made, however, although they are to be based on Article 17(1), rather than Article 17(3).

The key issue here is that based on ESMA's proposals, the market makers that are not authorised primary dealers would have to meet more far-reaching requirements to qualify for exemptions. In particular, they would have to notify the relevant competent authority that they act as market makers in each individual instrument and justify this assertion (*inter alia*) by providing information on the extent of their activities in each instrument.

We consider these requirements to be neither justified by the Regulation, nor practicable.

Both Article 2(1)(k) and recital 26 effectively refer to "market making activities" (in plural) as an element of the business plan of an institution, aimed at providing liquidity services to investors. Moreover, it is hardly feasible for an institution to be "as part of its usual business" (cf. Article 2(1)(k)(ii)) market maker in a *single* instrument. ESMA's focus on individual instruments is thus not justified by the wording of the Regulation.

We also question ESMA's qualitative arguments for its position. In paragraph 23 of the Consultation Paper, ESMA writes that "any other interpretation would be limiting the effectiveness of the Regulation".

We would argue that this is a skewed interpretation of "effectiveness". The exemptions for market making activities are not just some background noise, but an integral part of the Regulation. Their stated purpose is to ensure that market making activities can continue so that markets affected can remain liquid also after the Regulation has been implemented. An interpretation in the Guidelines that runs counter to *the intent* behind the exemption expressed in the Regulation at Level 1, in particular in recital 26, therefore does not enhance the "effectiveness" of the Regulation. Quite the contrary, it could well make the exemptions ineffective, thus changing the substance of what the Parliament and the Council have agreed upon. This is clearly an inappropriate result of guidelines issued by ESMA.

There is also no analysis in the Consultation Paper showing that exemptions on a per instrument basis give competent authorities any information that is useful for determining whether an institution meets the functional requirements in the definition of "market making activities" in the Regulation. It can therefore be argued that this requirement is *not proportionate* to the benefits it might have. The principle of proportionality must be considered a more central part of European legislation than "the principle of narrow interpretations" pointed to by ESMA in paragraph 23.

There are also practical reasons why this approach would not work in sovereign debt markets. For example, consider the 30 day notification requirement. Sovereign debt instruments include short-term bills that may have a maturity of just one month when first issued.[1] One could thus not exclude an outcome where market making is infeasible over the entire term of the instrument. This cannot be in line with the intention of the parties that decided the Regulation.

This is an issue also for a longer-term instrument. Typically, market making is especially important in the period immediately after it has been issued for the first time. The outstanding stock is then often quite small and thus the base for trading between end investors more limited. The intermediation services provided by market makers are therefore especially valuable in this phase.

The authorised primary dealers would be able to make a market from day one, but their willingness to do so would be limited by the absence of other market makers. This can feed into a vicious circle. Investors that are uncertain about their ability to resell via market makers bonds bought at the initial auctions would bid more cautiously, raising the borrowing costs of the issuer, possibly by significant amounts. Again, this runs counter to the intentions behind the decision to include an exemption for market making activities in the Regulation.

The consequences of the 30 day period may be partly offset if it is possible for institutions to make the notification *before* the first auction of the instrument. For this to work in practice it is necessary that the requirements on the information to be provided in the notification are set so accordingly. We are not convinced that the proposed format would allow this; see also section 2.

It is even possible to interpret the difficulty of combing the 30 day notification rule applied to individual instruments and the way instruments are created in sovereign debt markets as evidence that the intention of the Parliament and the Council was to base the exemption on the fact that an institution is engaged in the *activities* of market making. It would thus be similar to the exemption for the *activity* of being an authorised primary dealer.

ESMA's proposal may have been constructed with an eye to how markets for shares function. Shares are instruments with infinite maturities and companies rarely have more than one type of shares outstanding. For shares that are already quoted it is thus feasible for an institution to decide to add a new share to the list of instruments in which it is willing to make market and start doing so only after 30 days. By assumption, trading is taking place through the channels already established for this particular share. (Issues more similar to what is discussed above in relation to sovereign debt instruments may be relevant in connection to initial public offerings of shares, but we ignore such aspects here.) In principle,

[1] The SNDO typically introduces bills with a minimum maturity of three months when first issued, but as described below the point is more general.

this instrument can stay on the list as long as the share remains quoted. The notification is in effect a one off event.

As emphasised above, sovereign debt markets are different. There each issuer has a significant number of securities outstanding at each point in time and some are constantly being replaced by new ones. In a set up based on exemptions being granted per instrument new notifications have to be made all the time.[2]

We are aware, of course, that in the Regulation exemptions for market making activities in shares and sovereign debt instruments fall under the same article, namely, Article 17(1). But the requirements from which exemptions can be granted are specific to shares and sovereign debt instruments, respectively. This would seem to imply that if there are substantive reasons to use a notification per instrument for shares (an issue on which the SNDO takes no stand), it would still be perfectly possible to have ESMA guidelines that distinguish between shares and sovereign debt instruments in a way that reflects the specific aspects of the latter.

2 Criteria for ongoing presence on the market (Q9 and Q10)

Under this heading ESMA proposes a set of criteria for presence on the market that appear to be modelled entirely on how trading in shares is organized. Since sovereign debt markets are typically quite different, they do not fit in this context. For example, the requirement that an institution to qualify should be "submitting orders" frequently has little meaning in a context where market making is around telephone trading. Moreover, it is a fact that some sovereign debt instruments are traded quite infrequently, perhaps not even daily, implying that no one could qualify for exemption under these criteria.

Similarly, it is difficult to see how an agent that posts prices as a service to clients can demonstrate *ex ante* how much trading it intends to do. This will be determined by the demand for its services. A criterion that is based on something that is not subject to direct influence by the institution notifying that it wants to have an exemption does not seem to make sense. Such uncertainty could be prohibitive in the sense that the institution decides not to become a market maker for fear of being unable to live up to the criteria *ex post*.

We note that many of these inconsistences disappear if one drops the individual instrument approach discussed above and instead focusses on the activity of being a market maker. An institution could then qualify on the basis of its *overall*

[2] As an illustration, at the end of August 2012, the SNDO had 21 different securities denominated in domestic currency outstanding. Maturities ranged from one month to 27 years. Member States with bigger central government debts than Sweden (in relative and/or absolute terms) may have an even greater number of securities outstanding at each point in time. For example, a cursory check on the web site of the German Finanzagentur indicates that it currently has about 75 tradable instruments outstanding.

activity in the instruments. This would also resolve the dilemma of demonstrating activity in instruments not yet issued presented by ESMA's approach.

3 Conclusions

To conclude, the SNDO objects to the approach based on exemption per instrument proposed in the Consultation Paper. To enable institutions outside the core group of authorised primary dealers to continue to engage in market making activities in sovereign debt instruments – as is clearly the intention behind the Regulation – exemptions should be granted in relation to the *activity* of being a market maker in *classes of instruments*, for example, Swedish government bonds or other categories of similar kind.

More broadly, we argue that even though the Regulation deals with markets in shares and sovereign debt instruments within the same framework, it is essential to consider that these two types of markets are in practice quite different. This implies – as illustrated above – that a solution that might work well for trading in shares may be completely impracticable for sovereign debt trading. Given that the Parliament and the Council introduced exemptions in the Regulation specifically to ensure that market making remains possible, it is essential that subsequent work based on the Regulation is done in full recognition of this fact.

The decision to submit this response has been taken by Pär Nygren, Deputy Director General of the Swedish National Debt Office, based on a presentation by Lars Hörngren, Chief Economist. Thomas Olofsson, Head of the Debt Management Department, has also contributed.

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