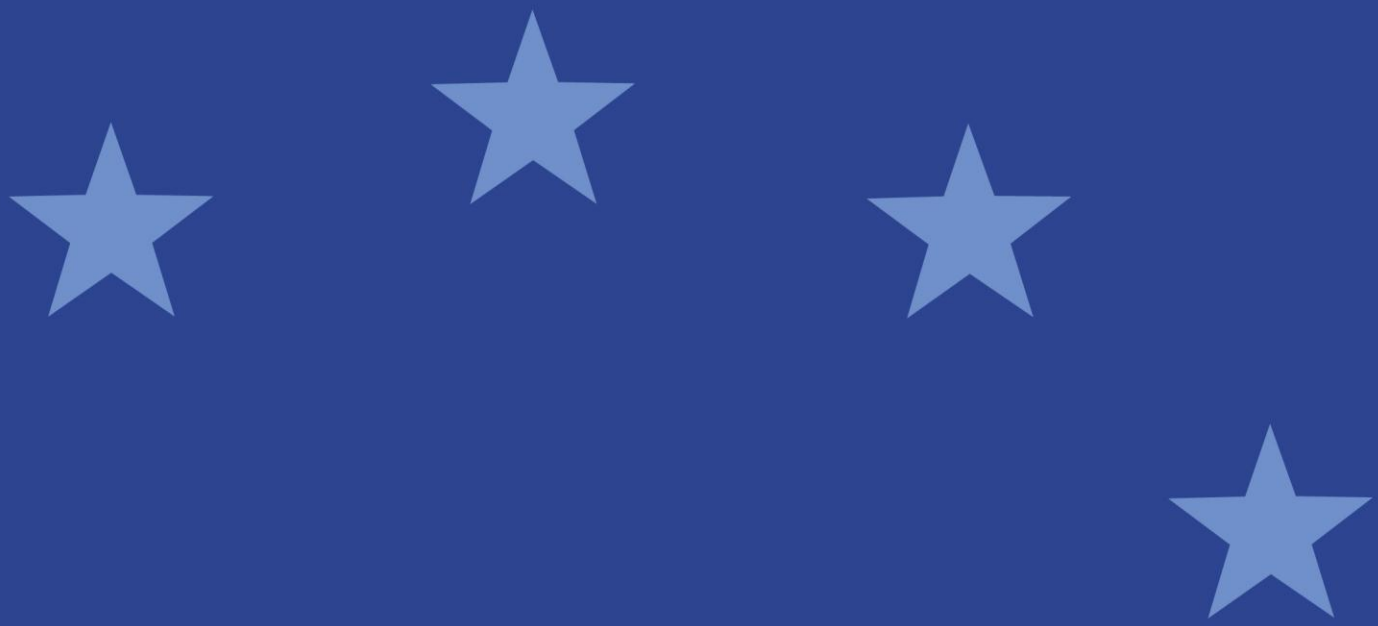
esma European Securities and Markets Authority

Final Report

Guidelines on the 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



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Acronyms used

ESMA	European Securities and Markets Authority
CDS	Credit Default Swap
MTF	Multilateral Trading Facility
IPO	Initial Public Offering
CA	Competent Authority

I. Executive Summary

Reasons for publication

The Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March on short selling and certain aspects of credit default swaps (Regulation) is applicable since 1 November 2012.

The Regulation provides for exemptions of market making activities and activities carried out by primary dealers which allow relevant entities to build short positions without being obliged to notify the relevant competent authority or to locate the financial instruments in case of short sales or to enter into uncovered sovereign CDS transactions without infringing the prohibitions set forth in the Regulation.

After the finalisation of work on the mandated implementing measures, ESMA has launched on its own initiative work on the concept of market making activities as provided for in the Regulation in order to foster supervisory convergence in the field and agree on a common approach towards application of the exemption.

ESMA consulted on possible Guidelines (Ref.: ESMA/2012/580) in mid-September 2012 and is now publishing the final outcome of this work stream.

Contents

This report includes a feed-back statement on the most important issues raised during the consultation process. ESMA's Guidelines, which are set out in Annex I clarify:

- the scope of the exemption for market making activities including the required link between the relevant financial instrument, the trading venue or "equivalent" third country venue and the membership of the notifying entity;

- how the relevant competent authority for notification is defined, in particular for notifying entities from third countries;

- the process of notification of the intent to use the exemption and its content, including common templates for notification as well as the approach to processing notifications received by relevant competent authorities and the standards that competent authorities should take into account when assessing the notifications received; and

- transitional measures relating to notifications of intention to use the exemption prior to the application of the Guidelines.

II. Feedback statement on the public consultation on the ESMA's Guidelines on the exemption for market making activities and primary market operations under the Regulation

1. 35 responses were received to the public consultation on draft Guidelines that took place between 17 September and 5 October 2012. The Securities and Markets Stakeholder Group (SMSG) established under the Regulation (EU) No 1095/2010 establishing the European Supervisory Authority (ESMA Regulation) was also consulted. ESMA also held an open hearing on 1 October 2012.

2. The main concerns related to the section on the definition of market making activities and to the general principles and qualifying criteria of eligibility for the exemption.

II.I. On the definition and scope of the exemption

3. The major concerns raised by many respondents related to the scope of the exemption in relation to the definition of the market making activities contained in the Regulation. ESMA's reading of the definition whereby the exemption should be considered on a per instrument basis, rather than on an activity basis, was questioned. ESMA's interpretation of the Level 1 definition was considered erroneous and as introducing an overly restrictive approach in this respect. Respondents were also concerned that the Guidelines would be unduly limiting the scope of the exemption by setting out the pre-condition that no firm could qualify for the exemption unless it is a member of a trading venue on which it market makes the instrument for which the exemption is claimed ("membership requirement"). This membership requirement associated with the per-instrument approach would result in financial instruments not admitted to trading or traded on a trading venue (CDS and certain sovereign bonds) being excluded from the scope of the exemption.

4. ESMA conducted an analysis of the consequences of requiring the market membership for each specific financial instrument. It acknowledges that some activities consisting of posting firm quotes on instruments not admitted to trading on a regulated market or traded on an MTF will be affected if there is a membership requirement. This impact will be bigger on non-admitted/non-traded CDSs, since Article 14 contains a prohibition to enter into uncovered position in a sovereign CDS (except for primary dealers), than on sovereign bonds and other non-admitted/non-traded instruments, where the obligations of the Regulation relate to the arrangements to ensure timely settlement and private notification of short positions only to regulators. Of course, the degree of the impact will change in the future depending on whether some or all of those instruments are admitted to trading on trading venues.

5. ESMA has taken considerable time to closely consider the Regulation and explore through a legal analysis whether there were ways to accommodate non-admitted/non-traded instruments for the purpose of the market making exemption in Article 17(1). Results of the analysis led to a negative conclusion. In parallel, ESMA consulted the European Commission on the definition of the market making activities according to the legislative text and recorded in its final Guidelines the legal analysis received from the Commission. It is reflected in the relevant section of the Guidelines confirming the initial approach set out by ESMA in its consultation paper whereby:

    - A membership requirement is needed: an entity intending to benefit from the exemption needs to be a member of a trading venue, where it conducts some market making activities, including hedging, on a specific financial instrument. In addition, it is also confirmed that the concerned instrument must be admitted to trading or traded on that trading venue. Thus, the

exemption cannot apply to instruments that are not admitted to trading on a regulated market or traded on an MTF (like is currently the case for many CDS contracts).

- The exemption applies on a per instrument basis.

6. In addition, based on the Commission analysis, the Guidelines now clarify that the exemption for approved primary dealers also covers CDS related to the sovereign debt issuer for which that dealer is exempted.

7. Furthermore, with respect to exempting market making activities on financial instruments other than shares, sovereign debt and sovereign CDS, it should be noted that the final Guidelines no longer refer formally to "related instruments", as the concept is not foreseen in the Regulation itself. Without altering the substance of the Guidelines, they now refer to the instruments referred to in Articles 3 and 4 of the Regulation, which need to be taken into account when calculating the positions, and for which hedging would be needed in shares and sovereign bond markets. Thus, the scope of application of the exemption for market making activities in these types of instruments is clarified and framed.

8. Finally, some respondents highlighted some practical consequences of the application of the exemption on a per instrument basis in relation to the 30 day notification period mentioned in article 17(5) of the Regulation in specific situations: IPOs and the inclusion of shares to stock exchange trading that are already traded on another trading venue. By amending the final Guidelines, ESMA offers the necessary flexibility to CAs to decide whether or not to prohibit use of the exemption before the 30 days are over. Thus the market maker is not hindered from using the exemption, neither from a risk or supervision perspective nor from a market perspective.

II.II. On the general principles and qualifying criteria for eligibility for the exemption for market making activities

9. Several concerns were identified in the responses to the public consultation on this section of the draft Guidelines. It was generally considered that the principles and criteria were considered to be drafted to only suit equities markets. A number of respondents also question the necessity to have such detailed, prescriptive and quantitative criteria.

On general principles

10. More specifically, with respect to the general principles, some respondents were concerned by the apparent need to introduce separate arrangements and procedures in the organisation of the exempted entities (e.g. separate arrangements for middle and back office). To mitigate these concerns, ESMA has amended the drafting of two of these principles focusing on the objectives (ensuring that market making activities can be distinguished from other activities and related information be made available) rather than on the effective arrangements to be put in place.

On principles and qualifying criteria to apply when posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on regular and on-going basis to the market

11. The quantitative qualifying criteria of time presence, sizes of orders and competitive prices set out in the consultation attracted most of the criticisms raised in the responses. They were considered as overly prescriptive if not unnecessary; not fit for certain types of financial instruments (e.g. sovereign bonds

or options on shares) considering the market structures; and not taking into account the liquidity of the concerned financial instruments.

12. In light of the above, ESMA considers that to ensure a common approach to the market making exemption, the Guidelines should describe principles that are valid for any type of instrument. Though it acknowledges that the specific qualifying criteria, particularly those of a quantitative nature, should be limited to equities and equity derivatives.

13. In addition, such quantitative criteria have been reviewed so as to take into account the situation of less liquid shares, defined as shares not considered as liquid shares under MiFID, by referring to the standards and criteria applicable to recognised market makers or liquidity providers under the rules of the trading venue where the instruments are traded. The Guidelines also include further amendments in relation to liquid shares: the principal qualifying criteria for time presence remains to be measured in percentage of overall trading time though lowered compared to the proposal in the consultation paper, and, the criterion for competitive prices and quotes or order size should be the same as the ones applicable to recognised market makers or liquidity providers under the rules where the instrument is traded.

14. However, for both liquid and illiquid shares, with the suggested approach, there is a risk related to the absence of specific trading rules concerning market makers or liquidity providers in certain trading venues for these instruments. On the one hand, there is a risk that some competent authorities, in the absence of rules applicable to those criteria, might prohibit the exemption applications received. On the other hand, the risk is that some trading venues, lacking rules on market making, attract the quoting of some participants simply to get the exemption without having to comply with any size or spread requirement. To mitigate these risks and ensure a convergent application of exemption, the Guidelines provide a number of fall back options in cases where the trading venue where the market making is performed lacks any rules on the criteria that are contained in the Guidelines (size, spread). The first fall back option would be the rules of another trading venue where the financial instruments trades actively and, when there is none, the second option would be a proportion of the average observed values (size, spread).

On principles and qualifying criteria to apply when dealing as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade.

15. In many instances, responses to the consultation highlighted that defining "usual business" only through the frequency and the systematic basis of the activity is too limiting and would exclude from the scope legitimate market making activities in instruments that are less frequently traded. In order to allow the benefit of the exemption for financial instruments traded on ad hoc and infrequent basis, the principles for qualifying for the exemption were redefined in more qualitative terms, focussing on the ability to provide prices or quotes to clients and readiness to trade upon clients' requests.

16. The exclusion of any possibility to conduct hedging in anticipation of clients' orders or requests to trade was heavily criticised by respondents as not being in line with current practices notably for risk management purposes and as being not consistent with the Volker rule in the US. In the final Guidelines, ESMA has reconsidered its position. Though mindful of not creating a loophole in the short selling regime, the Guidelines allow anticipatory hedging to take place but under certain conditions only.

II.III. Other changes

On determination of the CA

17. With respect to the competent authority to which a third country entity should send its notification, ESMA has introduced some changes in the final Guidelines in order to be fully consistent with the level 1 text. A unique single entry point for notification is defined irrespective of the concerned financial instrument, i.e. the competent authority of the European trading venue where the third country entity is carrying out most of its trading activities. There is now therefore no distinction in terms of entry depending on whether the exemption relates to sovereign debt or sovereign CDS.

On the information to be published on the ESMA website

18. The ESMA suggestion to publish information about the exempted entities detailing the financial instruments for which the exemption is used and the related trading venues where these instruments are admitted to trading or traded was not supported by the limited number of responses received on this issue. It was argued that this would go beyond the requirements of the level 1 text without providing any additional informational value to the market while being resource intensive in terms of on-going maintenance if published.

19. Considering the above, ESMA's final Guidelines do not contain any section on this matter: ESMA will publish on its website the lists of the relevant entities without further details on the financial instruments and markets, though this latter information will be made available and accessible to competent authorities.

Annex I

Guidelines on the 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

I. Scope

1. These guidelines apply to investment firms, credit institutions, third-country entities, firms as referred to in point (1) of Article 2(1) of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments (MiFID).

2. These guidelines apply in relation to notification for the market making activities exemption and for the exemption as authorised primary dealer under Article 17 of the Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps (Regulation).

II. Definitions

EEA: European Economic Area

ESMA Regulation: Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

MiFID: Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

III. Purpose

3. The purpose of these guidelines is to:

- Assist the notifying entity in the notification process, by specifying and describing the content of the written notification and providing a template notification form;

- Develop a common approach to submitting the notification form, assessing eligibility of the notifying entity's activities for the exemption and monitoring of the conditions of eligibility once the exemption is used.

III. Compliance and reporting obligations

Status of the guidelines

4. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with guidelines and recommendations.

5. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

Reporting requirements

6. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance by date two months after publication. A template for notifications is available from the ESMA website.

7. Financial market participants are not required to report.

IV. Background and Introduction

8. The Regulation published in the Official Journal of the European Union on 24 March 2012, is applicable from 1 November 2012.

9. Article 17 of the Regulation provides for exemption for market making activities and primary market operations. Provisions of the Regulation prescribe the notification of intent to make use of the exemption to be made to the competent authority as determined by Article 17(5) (the home Member State for the market making exemption) and 17(6) (the relevant competent authority of the concerned sovereign debt for authorised primary dealer exemption), while the exempted activities might also take place in other jurisdictions outside the supervisory remit of that authority. In the particular case of third country entities not authorised in the Union the notification has to be sent to the competent authority of the main trading venue in the Union in which the third country entity trades (see section VII on the determination of the competent authority).

10. In order to ensure a level playing field, consistency of market practices and convergence of supervisory practices across the EEA, ESMA has prepared these guidelines on market making activities as defined in Article 2(1) of the Regulation and on a common approach to the application of the exemptions under Article 17.

11. According to Article 2(1)(k) 'market making activities' means the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC (MiFID), which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2) where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities:

    a. by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;

    b. as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade;

    c. by hedging positions arising from the fulfilment of tasks under points (a) and (b).

12. Article 2(1)(n) defines 'authorised primary dealer' as a natural or legal person who has signed an agreement with a sovereign issuer or who has been formally recognised as a primary dealer by or on behalf of a sovereign issuer and who, in accordance with that agreement or recognition, has committed to dealing as principal in connection with primary and secondary market operations relating to debt issued by that issuer.

13. Provisions of Article 17(1) exempt entities undertaking transactions due to market making activities from net short position transparency requirements for shares and sovereign debt, the restrictions on uncovered short sales in shares and sovereign debt and the prohibition to enter into uncovered sovereign CDS positions. It should be emphasised that the exemption applies only to the transactions carried out in performance of market making activities as defined above in paragraph 11 (a) – (c); it does not apply to the entire scope of activity of the notifying entity. As recital 26 clearly states, such an exemption does not cover the proprietary trading of those persons.

14. According to Article 17(3) of the Regulation, persons exempted as authorised primary dealers as defined in Article 2(1)(n) are not required to notify net short positions in sovereign debt, are not subject to the restriction on uncovered short sales in sovereign debt instruments and are not prohibited to enter into an uncovered sovereign CDS transaction. It should be emphasised that the exemption does not apply to the entire scope of activity of the authorised primary dealers. It is also important to take into account that this exemption applies to any financial instruments, including credit default swaps related to the sovereign debt for which that person is an authorized primary dealer and is acting in that capacity.

15. Use of exemptions under Articles 17(1) and 17(3) can only be made where previous notification of intent to make use of the exemption has been made in writing to the relevant competent authority at least 30 calendar days before the intended first use of the exemption.

16. The competent authority can prohibit the use of the exemption by the notifying person if it considers that the person does not satisfy the conditions of the exemption. The justified prohibition would be communicated in writing within the 30 calendar days upon having received complete notification including all relevant information as specified in paragraph 65. When the competent authority is satisfied the notification meets the conditions of the exemption, it may inform accordingly the notifying entity without having to wait for the 30 calendar days' period to expire.

17. It is acknowledged that 30 days in advance requirement foreseen in the Regulation might pose practical difficulties in some particular instances (e.g. IPO). In this case the competent authority should be notified as soon as possible so that it may be in a position to i) process the notification in less than 30 days and ii) confirm to the notifying entity that it does not intend to prohibit the use of the exemption. ESMA understands such an express positive communication by the competent authority allows the entity to make use of the exemption from the date the notification is received.

18. In addition, the concerned competent authority can, at any time, decide to withdraw the benefits of the exemption in case there have been changes in the circumstances of the natural or legal person so that it no longer satisfies the conditions of the exemption. This may result from the competent authorities own initiative and assessment or from a subsequent notification received under Articles 17(9) or (10) from the natural or legal person indicating a change affecting its ability to use the exemption.

V. Definition and scope of the exemption for market making activities

19. In order to ensure the exemption is applied in a uniform manner it is important to achieve a common understanding of the exempted activities. More precisely, in order to qualify for the exemption, market making activities have to be undertaken, by dealing as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k), whether on or outside a trading venue, by the following entities:

    a. An investment firm which is a member of a trading venue, ; or

    b. A credit institution which is a member of a trading venue; or

    c. A third-country entity which is a member of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2); or

d. A third country entity which is member of a trading venue in the European Union; or

e. A firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC, which is a member of a trading venue.

20. Concluding on the above, there are three preconditions for particular activities of an entity to be exempted from the Regulation's provisions:

a. being a member of the market on which it

b. deals as principal in one of the capacities defined in paragraph 11 above

c. in the financial instrument for which it notifies the exemption.

21. However, the person is not required to conduct its market making activities solely on that venue or market or to be recognised as market maker or liquidity provider under the rules of that trading venue or market. Neither is there a requirement to have a separate contractual obligation to carry out market making activities. For example, a person could benefit from the exemption by trading on the trading venue or market to hedge the positions, resulting from its activities under Article 2(1)(k)(i) or Article 2(1)(k)(ii) of the Regulation, conducted outside this trading venue or market.

22. ESMA records that the European Commission services have expressed in writing their legal analysis of the market making definition in Article 2(1) k of the Regulation, which makes clear that the assessment of each and every of the above conditions for the qualification of market making activities has to be done with respect to each individual financial instrument. According to this analysis by the European Commission , market making activities on instruments that are not admitted to trading or traded on any trading venue, like is currently the case for many sovereign CDS, some sovereign bonds or non-listed derivatives, could not qualify for the exemption under Article 17(1) of the Regulation, since the membership requirement cannot be met.

23. It should be noted that the exemption only covers activities when, in the particular circumstances of each transaction, they are genuinely undertaken in the capacity of market making as defined in Article 2(1)(k) of the Regulation. Consequently, persons notifying the intent to make use of the exemption are not expected to hold significant short positions, in relation to market making activities, other than for brief periods.

24. Arbitrage activities (in particular those executed between different financial instruments but with the same underlying security) are not considered market making activities under the scope of the Regulation and therefore cannot be exempted.

25. When carrying out hedging activities under Article 2(1)(k)(iii), the size of the position acquired for the purpose of hedging should be proportionate to the size of the exposure hedged in order for these activities to qualify for exemption. The person should be able to justify upon request from the competent authority why an exact match in size was not possible. The discrepancy should, in all cases, be insignificant.

26. Once the conditions are fulfilled, market making activities of an entity in or related to the particular instrument may, in accordance with Article 17(1), be exempted from Articles 5, 6, 7, 12, 13 and 14 of the Regulation, i.e. the transparency requirement relating to the net short positions in shares and

sovereign debt, the restriction on uncovered short sales in shares and sovereign debt instruments and the prohibition to enter into an uncovered sovereign CDS transaction.

27. However, the market making activities on sovereign CDS are not exempted from Article 8 of the Regulation, i.e. the notification to the competent authority of uncovered positions in sovereign CDS in cases where the competent authority has suspended the restriction on such instruments in accordance with Article 14(2).

An exemption on a per instrument basis

28. According to Article 2(1)(k), market making activities, in their turn, are defined as dealing as principal in a financial instrument. Consequently, the exemption under Article 17(1) applies to activities in a financial instrument, i.e. on an instrument per instrument basis, and should not be considered as a global exemption for market making activities in general. The notification submitted when notifying the intent to use the exemption under Article 17(1) and further use of this exemption should, therefore, concern a financial instrument issued by a particular issuer subject to the Regulation i.e.:

    a. Shares of an issuer falling under the regime;

    b. A sovereign issuer as defined by the Regulation.

29. Any such notification of the exemption should identify:

    a. For shares, the individual instrument for which market making activities are notified for the purpose of exemption;

    b. For sovereign debt and CDS in sovereign debt if applicable, the sovereign issuer in the debt of which market making activities are notified for the purpose of the exemption.

30. If market making activities are carried out in a financial instrument, different from a share or a sovereign debt instrument, that creates long or short positions as defined in Articles 3 and 4 of the Regulation, the notification should specify the category of financial instrument according to Part 1 and 2 of Annex I of the Commission Delegated Regulation (EU) No 918/2012 and the corresponding share or issuer of the sovereign debt. Importantly, activities in the corresponding share or sovereign debt will be exempted only to the extent they are undertaken for the purpose of hedging market making activities in that financial instrument, pursuant to point (iii) of Article 2(1)(k) of the Regulation.

31. This information should allow the Competent Authority to best consider on an instrument by instrument or sovereign issuer by sovereign issuer basis, whether to prohibit the use of the exemption pursuant to Article 17(7) or not.

32. For the purpose of the exemption under Article 17(1) of the Regulation, the financial instruments referred to in paragraph 30 are understood as those listed financial instruments the positions in which must be taken into account when calculating the net short position. Namely, for shares – instruments listed in Part 1 of Annex I of the Commission Delegated Regulation (EU) No 918/2012:

    a. Options,

    b. Covered warrants,

c. Futures,

d. Index-related instruments,

e. Contracts for difference,

f. Shares/units of exchange-traded funds,

g. Swaps,

h. Spread bets,

i. Packaged retail or professional investment products,

j. Complex derivatives,

k. Certificates linked to shares,

l. Global depository receipts.

20. For sovereign issuers, instruments listed in Part 2 of Annex I of the Commission Delegated Regulation (EU) No 918/2012 :

a. Options,

b. Futures,

c. Index-related instruments,

d. Contracts for difference,

e. Swaps,

f. Spread bets,

g. Complex derivatives,

h. Certificates linked to sovereign debt.

33. In particular, a person's market making activities on derivatives and ETFs where, respectively, the underlying(s) of the derivative in question and the constituents of the concerned ETF are financial instruments falling within the scope of the regime could qualify for the exemption as long as trading in the relevant underlying is conducted for the purpose of hedging market making activities in the corresponding derivatives and ETFs.

34. This approach is in line with the text of the Regulation. It should also be recalled that in accordance with the general principles on the interpretation of European legislation, as applied generally, an exemption included in a European legal text should be interpreted narrowly. Moreover, any other interpretation would be limiting the effectiveness of the Regulation - de facto enlarging without limits the operation of the exemptions.

Membership requirement

35. Any natural or legal person intending to make use of the exemption for market making activities and notifying the relevant competent authority of its intention should be a member of a trading venue (i.e. a regulated market or a MTF as defined in Article 4(14) and 4(15) of MiFID) or of an 'equivalent' market in a third country where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(k).

36. In either case, the instrument which is the subject of the notification should be admitted to trading or traded on that venue or market of which that person is a member. For financial instruments referred to in paragraph 30, it is not required to be a member of the venue where the corresponding share or sovereign debt is admitted to trading or traded.

VI. Determination of the competent authority that should be notified

37. The Regulation specifies to which competent authority a natural or legal person should notify its intention to make use of an exemption for market making activities or as an authorised primary dealer. However, there is a distinction between a third country entity not authorised in the Union and other persons, authorised, registered or domiciled in the Union.

38.For persons authorised in the Union, the relevant competent authority for notification (RCA) is:

- for the exemption for market making activities, the competent authority of the home Member State of that person as defined in Article 2(1)(i) of the Regulation;

- for the exemption as authorised primary dealers, the competent authority of the Member State of the concerned sovereign debt.

39. For a third country entity not authorised in the Union (third country entity), Article 17(8) of the Regulation defines the relevant competent authority as that of the main trading venue in the Union in which it trades. Therefore, when a third country entity intends to make use of the exemption for market making activities for a specific financial instrument or as a primary dealer, it should notify the authority of the trading venue where it carries out most of its trading activities in Europe.

40. The third country entity should assess its activity in the course of the preceding year on the basis of the turnover (as defined in Article 2(9) of Commission Regulation (EC) No 1287/2006) per trading venue when performing market making activities in financial instruments in Europe and conducting secondary market operations on sovereign debt instruments as authorised primary dealer, and, identify on which European trading venue (i.e. regulated market or MTF) it is the most active.

41. This would provide each third country entity with a single entry point within Europe, a single European competent authority to which the notification should be addressed, irrespective of the financial instrument concerned.

VII. General principles and qualifying criteria of eligibility for the exemption

42. The below principles and criteria are not intended to supplement or change the definition of market making activities[1], but rather set the standards that competent authorities shall take into account when assessing whether an entity notifying an exemption under Article 17(5) of the SSR is entitled to benefit from it.

VII.I. General principles

43. A person, as defined above, that intends to use the exemption set out in Article 17(1) of the Regulation must:

- be a member of a trading venue where the financial instrument in question is admitted to trading or traded and in which it conducts a market making activity on that instrument

- comply with the general rules and particular requirements for market making activities imposed by the trading venue or market in the third country, where applicable;

- maintain its records of orders and transactions relating to its market making activities for which it requests the exemption so that they can be easily distinguished from its proprietary trading activities;

- implement internal procedures with respect to the market making activities for which it claims the exemption that allow these activities to be immediately identified and the records readily available to the competent authority upon request;

- possess effective compliance and audit resources and a framework to enable it to monitor the market making activities for which it requests the exemption;

- be able to demonstrate at any time to the competent authority that its market making activity meets the principles and criteria in the Guidelines.

VII.II. Principles and qualifying criteria that should apply when "posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market" (Article 2(1)(k)(i))

44. The over-riding applicable principle for all asset classes is that an entity notifying its intention to make use of the exemption for its market making activities under Article 2(1)(k)(i) must provide liquidity to the market on a regular and ongoing basis by posting firm, simultaneous two-way quotes of comparable size and at competitive prices. It is important to note that the presence, price and size requirements are not independent but interact with one another. Market making activities under Article 2(1)(k)(i) that are exempt under Article 17 will be those where a person is offering prices that are competitive and in comparable sizes, in line with the specified qualifying criteria for at least the stated mandatory time presence where relevant.

[1] In particular, these criteria do not intend to broaden or narrow the scope of market making as defined currently in MIFID or as it will be defined following the MIFID review.

45. ESMA considers it appropriate to include in this set of Guidelines the qualifying criteria against which competent authorities should assess notifications submitted under Article 17(5) in relation to equities, and equity derivatives traded on a trading venue. Criteria for other asset classes covered by the Regulation can be issued by ESMA in due course. ESMA will take account of the outcome on MiFIR and MiFID on the market making definition in order to ensure consistency of the European regulations. ESMA will continue to monitor developments in the market and may reconsider the defined qualifying criteria in the future.

46. As regards presence, a person undertaking market making activities under Article 2(1)(k)(i) must be present on the order book or be posting quotes on a trading venue for the relevant equity or equity derivative financial instrument(s) for which it requests the exemption for a sufficient proportion of the mandatory trading period. In this regard, the Regulation does not appear to require an uninterrupted presence though it provides that the presence should be regular and ongoing. Therefore, presence on the market should consist of:

    a. conducting qualifying activities each day the market is open;

    b. submitting orders that meet the below-mentioned criteria, according to a reasonable frequency, that is not interrupting the market making activity for a significant period of time during a single trading session.

47. As regards the requirement to post two-way quotes of comparable size and at competitive prices, the Regulation does not specify if the prices that are posted have to be similarly competitive on buy/sell. Hence ESMA considers that the bid-ask range proposed by the person conducting market making activities can be asymmetrical, that-is-to-say that it can be moved away from the central point of the market bid-ask range being posted for the relevant financial instrument. The competitiveness of the prices can therefore be different on bid and ask at a given time according to the directional side of its strategy, as long as the entity undertaking market making activities complies with the aim of providing liquidity to the market. In any case, the potential asymmetry should not result in either the bid or the ask price not being competitive.

48. Taking into account the above considerations, for shares qualifying as liquid shares under MiFID:

    a. a regular and ongoing presence on the market would mean that market making activities should be undertaken either on a monthly or daily basis for at least 80% of the overall trading time. This time presence may be reduced in cases of abnormal market situations as defined under the rules of the relevant trading venue. For those MiFID liquid shares whose price is determined solely by auction on a trading venue, the concept of regular and ongoing time presence does not have a meaning comparable to that prevailing for those shares for which trading is carried out on a continuous basis. In such cases the regular and ongoing presence criterion should be assessed at least against the standards defined for recognised market makers/liquidity providers in the instruments by rules of the trading venue where the instrument is admitted to trading. To claim for the exemption for market making activities for these instruments, the person should issue competitive buy and sell orders during the pre-opening auction call phase such that their quotes are present when the auction concludes and the closing price for the instrument is determined.

    b. Competitive prices should be within the maximum bid/offer spreads that are required from market makers/liquidity providers recognised under the rules of the trading venue

where they are posted for the concerned instruments. In cases where that trading venue does not provide for rules on maximum bid/offer spreads for recognised market makers or liquidity providers, reference can be made to the requirements laid down in the rules for recognised market makers/liquidity providers by another trading venue where the concerned instrument is actively traded. Where this alternative is not possible, as a last resort, competitive price should be measured as a proportion of the average spread observed on the concerned instrument in the venue where the instrument is traded. Any asymmetry between the prices of bids and offers is subject to the conditions set out in paragraph 47 above.

c. The size of the orders posted by market makers on the order or quote book should not be smaller than those required from market makers/liquidity providers recognised under the rules of the trading venue where the shares concerned are traded. In cases where that trading venue does not provide for rules on order or quote size for recognised market makers or liquidity providers, reference can be made to the requirements laid down in the rules for recognised market makers/liquidity providers by another trading venue where the concerned instrument is actively traded. Where this alternative is not possible, as a last resort, the size of the orders or quotes issued in the market making capacity should be assessed in relation to the average trading size (ATS) for the concerned instrument.

49. For shares that do not qualify as liquid shares under MiFID and for equity derivatives traded on a trading venue:

a. the requirement to have a regular and ongoing presence on the market should be assessed against the standards defined in the rules of the trading venue where the instrument is admitted to trading for recognised market makers/liquidity providers on such instruments.

b. Competitive prices should be within the maximum bid/offer spreads for market makers/liquidity providers as laid down by the trading venue. Any asymmetry between the prices of bids and offers is subject to the same conditions as set out in paragraph 47 above.

c. the size of the orders should not be significantly smaller than what is required from market makers/liquidity providers recognised under the trading venue rules where the concerned instruments are traded.

21. For non-liquid shares, where the trading venue referred to above does not provide for rules on one of the criterion set out in b and c for recognised market makers or liquidity providers, reference can be made to the requirements laid down in the rules for recognised market makers/liquidity providers by another trading venue where the concerned instrument is actively traded.

22. Where such an alternative is not possible, as a last resort and depending on the concerned criteria:

- competitive prices should be measured as a proportion of the average spread observed on the concerned instrument in the venue where the instrument is traded or ultimately should be within the maximum bid/offer spreads laid down by the trading venue;

- the size of the orders or quotes issued in the market making capacity should be assessed in relation to the average trading size (ATS) for the concerned instrument on the venue where it is traded.

23. For equity derivatives, where the trading venue referred to above does not provide for rules on one of the criterion set out in a, b and c for recognised market makers or liquidity providers, reference can be made to the relevant requirements laid down in the rules for recognised market makers/liquidity providers by another trading venue where a similar derivative contract is actively traded, if any.

50. An entity may demonstrate that it meets these criteria by reference either, ex post, to historical trading or, ex ante, to trading it intends to conduct in the future.

51. ESMA proposes that competent authorities take the following approach towards assessment of notification of intent to make use of the exemption:

a. Where a person can demonstrate that it is party to a market making or liquidity provision contract or programme with a trading venue or an issuer which meets or exceeds the above three criteria there is a presumption that its notification should be accepted by the competent authority. It should be noted that regardless of being a party to the contract, the person should, nevertheless, fulfil relevant criteria under Article 2(1)(k), e.g. be a member of a trading venue, deal as principal, etc.;

b. Where a person is not party to a contract or programme as described above it should provide evidence that it meets the criteria set out above and the other requirements laid down by Article 2(1) (k).

52. Further, the notifying person should be in a position to provide additional information or evidence upon ad-hoc request from the competent authority. In particular:

a. Evidence of comparable size of orders;

b. Evidence of competitive prices of orders;

c. Evidence of regular and ongoing presence on the market.

VII.III. Principles and qualifying criteria that should apply when dealing "as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade" (Article 2(1)(k)(ii))

53. In addition to the general principles set out in paragraph 4343, for dealing as a principal when fulfilling clients' orders or responding to clients' requests to constitute market making activities for the purposes of the Regulation, a person must demonstrate to the competent authority that it is an investment firm, credit institution, a third country entity or a firm as referred to in point (1) of Article 2(1) of Directive 2004/39/EC and that such dealing is and will be part of its 'usual business'.

54. To qualify for the exemption under this capacity market makers must

a. undertake regular provision of prices to clients or maintain the ability to provide a quote in response to client demand; and

b. stand ready to trade with clients upon request.

55. As such, the competent authority will take into account issues including:

- Whether, and to what extent, the person already deals on a frequent and systematic basis in the financial instrument in question when fulfilling client orders or responding to clients' requests. If the market making activity is performed in instruments that are traded on an ad-hoc and infrequent basis it is decisive if the market-maker is at all business times ready and prepared to provide prices to clients and stands ready to trade in response to client's request with a reasonable expectation to trade in any instrument requested by a client. These have to be in advance defined instruments or categories of instruments, e.g. the main indices or instruments of regulated market. Presentation of the underlying business strategy could be used as a relevant evidence to support eligibility of once activity under Article 2(1)(k)(ii) for exemption;

- The scale of activity (for which the exemption is notified) in comparison to overall proprietary trading of the person;

- Where the person does not yet deal on a frequent and systematic basis in the financial instrument in question to fulfil client orders or to respond to clients' requests:

  whether it has a reasonable expectation that it will do so in the future, and the basis for that expectation and the business assumptions that justify it (including in relation to its dealing for clients in other financial instruments). Reasonable expectation of dealing in a particular financial instrument can be referred to in a notification to CAs.

VII.IV. Anticipatory hedging under Article 2(1)(k)(iii))

56. A entity dealing as principal in anticipation of client orders or requests expected to materialise in the near term can benefit from the market making exemption to the extent that the anticipated hedging is necessary for the performance of actual market making activities and is not carried out on other grounds, such as speculative. Should the anticipated client's order or request to quote not be received, the position accumulated through anticipated hedging should be unwound in an expeditious and orderly manner (and in any event as soon as practicable).

57. The market maker must be able to demonstrate that trading in anticipation of clients request correlates with transactions carried out in performance of market making activities at any time.

VIII. Exemption process

58. The use of the exemption under the Regulation is based on the requirement for notification of the intent. It is not an authorisation or licensing process. However, the notified competent authority may prohibit the use of the exemption, either at the time of the notification or subsequently, if it considers that the conditions of the exemption are no longer fulfilled.

59. Considering the wide geographical scope of the exemption for a specific financial instrument and the potential impact on the European markets, the single competent authority which receives the notification for that instrument is accountable for its decision as to whether or not to prohibit its use.

60. Besides, according to the Regulation, the onus for prohibiting the use of the exemption is on the competent authority that was notified. Therefore, ESMA considers that any decision by that competent authority to refuse the benefit of the exemption to a person should be justified and made in writing.

61. Depending on national laws and regulations and though not required by the Regulation, a competent authority which is notified of the intent to use an exemption may formally respond to the notifying person that it does not object to the use of that exemption.

62. In this context, it is therefore crucial to have a harmonised application of the provisions of the Regulation relating to (a) the notification of the intent to use the exemption, (b) its content, (c) the approach to processing notifications received by relevant competent authorities and (d) the approach to assessing conditions of the exemption which may result in the decision by a competent authority to prohibit its use of exemption, including the criteria to consider, whether it be at the time of the initial notification or subsequently.

Notification of intent

63. The common approach to requirements for information provided in the notification of the intent to use the exemption should be balanced so as to ensure that competent authorities are provided sufficient information. This information should allow them to implement an efficient notification assessment process and at the same time avoid imposing disproportionate notification requirements on persons intending to make use of the exemption.

64. The notification has to be submitted to the relevant competent authority in electronic format, in accordance with the template provided in Annex I and II, in the language(s) accepted by the competent authority in that Member State and be confirmed in writing if required under the legal and regulatory framework of that Member State. Should additional accompanying documents be provided, they can be submitted in a language which is customary in the sphere of international finance.

65. Depending on the type of exemption (Authorised Primary Dealers or Market Making activities), the notifying entity should provide the following information:

    a. For Authorised Primary Dealers:

        i. Details of the notifying party;

        ii. Details of the contact person within the notifying party;

        iii. Copy of the agreement/recognition signed with a sovereign issuer or a person acting on its behalf.

    b. For market making activities:

        iv. Details of the notifying party;

        v. Details of the contact person within the notifying party;

        vi. Status of the notifying party:

1. Credit institution;

2. Investment firm;

3. Third country entity; or

4. Firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC.

vii. Market of which the notifying person is a member;

viii. A description of the activities specifying particular capacity according to Article 2(1)(k) of the Regulation:

1. Capacity under Article 2(1)(k)(i);

2. Capacity under Article 2(1)(k)(ii) and the nature of client facilitation services:

a. Fulfilling orders initiated by clients;

b. Responding to clients' requests to trade.

ix. For each capacity, the financial instrument(s) for which the intent to use the exemption is notified. It can take the form of a list of individual financial instruments or a clear specification of the instruments concerned (e.g. FTSE 100 on particular date), provided that it results in a closed list of specific instruments and allows the notified competent authority to unambiguously identify all individual instruments for which the exemption is declared;

x. In case of existing contractual agreement for provision of market making services – description of the main duties and activities under the contract or a copy of the contract;

xi. Where the market making activities are carried out on instruments referred to in paragraph 30, e.g. ETFs, listed derivatives, etc. – the corresponding category of financial instruments according to Section C Annex I of MiFID, e.g. category 3 – units in collective investment undertakings;

xii. Where no previous market making activity in a particular financial instrument can be demonstrated (e.g. IPO, intention to start a new market making business in a new financial instrument, etc.):

1. For market making activities under Article 2(1)(k)(i) capacity – indication of expected daily volumes of market making activities in a financial instrument;

2. For market making activities under Article 2(1)(k)(ii) capacity – indication of expected weekly volumes of market making activities in a financial instrument.

66. For the authorised primary dealer or market making activities exemption, the status of the notifying party (investment firm, credit institution, market member) is a condition that should be clearly assessed and cross-checked on the basis of the evidence to be provided by the notifying entity.

67. It should be noted that such an assessment may be more complex for third country entities: beyond ensuring that the third country market of the applicant is declared equivalent, cooperation and exchange of information with third country regulators may be necessary and will be carried out according to provision of Article 38 of the Regulation.

Monitoring of the conditions of the exemption

68. In accordance with Article 17(9) and 17(10) a person who has given a notification under paragraphs 5 or 6 of Article 17 shall as soon as possible notify in writing the relevant competent authority where there are any changes affecting that persons eligibility to use the exemption. In light of the notified changes, the competent authority shall assess within two weeks whether the relevant activities still qualify for the exemption.

69. As part of common supervisory approaches and practices, competent authorities might on their own initiative carry out thematic reviews to verify at any time whether activities of the natural or legal person satisfy the conditions of exemption.

Specific situation of emergency measures

70. When in exceptional circumstances a competent authority is introducing a temporary measure exercising its powers under Chapter V Section 1 of the Regulation that goes beyond the regular regime, it may decide to exempt market making activities or primary dealing activities from the measures. This is a discretionary power left to the authority introducing the measure. In particular, the competent authority might exercise a certain level of discretion when providing for such exemption. Without prejudice to further exceptions being specified by a competent authority, when an exception applies to market making activities, the latter should be understood as defined in the Regulation.

Cooperation between competent authorities

71. As provided for in the Regulation the exemption is granted by the relevant competent authority of the notifying person and, for a third country entity, the competent authority of the trading venue where most of its trading takes place) and it must be accepted throughout the Union.

72. However it is possible that for certain financial instruments the local authority of the market (which is the host authority for the notifying person) may receive more comprehensive data in order to verify the actual performance of market making activities for which the person is exempted. Namely, while performing a day-to-day supervisory function of the trading activities on the local market, the host authority might come across evidence of suspected non-compliance with the conditions for exemption for market making activities by a particular person. In such a case the host authority will submit relevant evidence to the home authority.

73. The home competent authority, having considered and analysed the evidence provided, shall undertake further cooperation in accordance with Articles 35 and 37 of the Regulation.

74. Disagreements between the competent authorities shall be settled according to provisions in Article 19 of the ESMA Regulation (EU) No 1095/2010.

IX. Transitory measures

75. According to Article 17(14) of the Regulation notification to a competent authority may be made at any time within sixty calendar days before 1 November 2012. Nevertheless, notifications made before entry into force of the Guidelines and not in compliance with requirements set herein shall be reviewed and assessed against the provisions contained in the Guidelines within 6 months after application of the Guidelines.

76. It should be noted that the Regulation does not contain a grandfathering clause for market making exemptions granted before its application. Therefore, entities whose activities were exempted from national short selling regimes before the Regulation became applicable should notify the relevant competent authorities in writing of their intention to make use of exemption under Article 17(1) of the Regulation.

Annex I

Notification of intent to make use of the exemption under Article 17(3) of Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

1	**Details of NOTIFYING PARTY**	
a)	First name LAST NAME Full company name	
b)	BIC code (if the holder has one)	
c)	Country	
d)	Address	
2	**Contact person**	
a)	First name Last name	
b)	Phone number	
c)	Fax number	
d)	E-mail address	
3	**Financial Instrument**	
	Description of sovereign issuer of debt instrument (provide information in specific spread-sheet listing the sovereign issuer(s) in CSV format)	

Date, signature _____

IMPORTANT:

This notification form is only valid if submitted together with a copy of the agreement/recognition signed with a sovereign issuer or a person acting on its behalf

Annex II

Notification of intent to make use of exemption the under Article 17(1) of Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

1	**Details of NOTIFYING PARTY**	
a)	First name LAST NAME Full company name	
b)	BIC code (if the holder has one)	
c)	Country	
d)	Address	
2	**Contact person**	
a)	First name Last name	
b)	Phone number	
c)	Fax number	
d)	E-mail address	

3	**Details of Market Making**	
a)	STATUS (of the notifying party (credit institution, investment firm, third country entity or firm as referred to in point (1) if Article 2 (1) of Directive 2004/39/EC))	
b)	MARKET MEMBERSHIP (trading venue(s) where membership exists)	
c)	DETAILED DESCRIPTION OF ACTIVITIES ACCORDING TO ARTICLE 2(1)(k) or INDICATION OF EXPECTED ACTIVITIES ACCORDING TO ARTICLE 2(1) (k)	
d)	FINANCIAL INSTRUMENT (S) (provide information in specific spreadsheet in CSV format)	
	(i) INSTRUMENT (share, sovereign issuer of debt instrument, CDS)	
	(ii) CATEGORY OF INSTRUMENT on which market making activities are conducted, only when different from (i) (by designation of the financial instrument/ underlying)	
e)	DESCRIPTION OF CONTRACTUAL AGREEMENT (main duties and activities)	

Date, signature ____

Annex III

Format of the spreadsheet (csv file) to use together with the forms for the notification of intent to make use of exemption the under Article 17(1) and 17(3) of Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

Name of the informing competent authority:

Name of the notifying person:

ID code* (e.g. BIC):

*please specify what code is provided if not BIC

For shares

No	ISIN	Name of the issuer	Market Membership (for Art. 17(1)
1			
2			
3			
4			
…			

For sovereign bonds

No	Name of the sovereign issuer	Market Membership (Art. 17(1)
1		

2		
3		
4		
…		

For soveregn CDS

No	Name of the sovereign issuer	Market Membership (Art. 17(1)
1		
2		
3		
4		
…		

For instruments other than shares, sovereign debt instruments or sovereign CDS that create short or long position

No	Category (part C, annex I of directive 2004/39/EU)	Underlying financial instrument
1		
2		
3		
4		
…		