EUROPEAN PRINCIPAL TRADERS ASSOCIATION

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Mr. Felix Hufeld
President of the Executive Board
Federal Financial Supervisory Authority (BaFin)
60391 Frankfurt am Main

VIA E-MAIL

Amsterdam, 27 March 2020.

Dear Mr. Hufeld,

FIA European Principal Traders Association (FIA EPTA) represents 29 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures and ETFs.

Our members are important sources of liquidity for investors accessing exchanges in Germany (including the Xetra and Eurex exchanges operated by Deutsche Boerse AG) and across Europe. As market makers and liquidity providers our members contribute to efficient, resilient, and high-quality secondary markets that serve the investment and risk management needs of end-investors and companies throughout Europe.

We are contacting the Executive Board of BaFin to register our concern regarding the safeguarding of market liquidity and orderly price formation on German and European exchanges. The global COVID-19 pandemic is causing significant market stress. We welcome the very useful clarifications which BaFin made available over the past week which helped to ensure certainty to market participants. However, looking forward, we would caution BaFin and other public authorities in Europe against applying policy measures that risk introducing even greater stress into the system.

In particular, we would strongly advise against applying either a generic short-sale ban or, alternatively, a more targeted ban on increasing net short positions. Such bans would make it impossible for regulated investment firms, such as our members, to continue to act as market makers and provide liquidity to end-investors and companies. Such measures will mean that regulated market makers can no longer comply with MiFID II requirements to supply two-sided quotes. A short-sale ban would, in particular, significantly hurt end-investors, as they need market maker liquidity to be able to hedge their new or current investments using exchange-traded derivatives on Eurex.

End-investors and companies count on our member firms to provide, on a continuous basis, two-sided quotes in futures, ETFs and options listed on the Eurex markets. Investors use these products to protect themselves against financial risk and to risk manage their exposures against extreme price movements in fixed income, (sovereign and corporate) bond and equity markets, including on Xetra.

A short-sale ban would make it very difficult, or even impossible, for investors to use such risk management products. This would be a calamity given the continued uncertainty caused by the COVID-19 emergency which makes it more essential than ever before that end-investors have efficient access to transparently priced risk management products. Not having access to these products would increase market volatility and expose end-investors to even greater risk which will cause financial instability.

We would reiterate that the ability for regulated firms to use covered short-selling is an important mechanism to allow markets to ensure transparent and orderly pricing of assets. There is no empirical evidence that banning short-selling reduces market volatility. Furthermore, it should be noted that the very significant downward price movements that German and European markets experienced recently were driven by market participants responding to global fundamental economic factors caused by the COVID-19 pandemic.

Over all, European markets have continued to operate in an orderly fashion, supported by the robust regulatory framework put in place by MiFID II to ensure that markets can continue to function well in stressed market circumstances. Well-functioning financial markets are essential for end-investors to be able to navigate these challenging times and we would strongly caution against any undue measure which would put at risk orderly market functioning.

MiFID II rightfully created a rigorous regulatory framework around the market making and FIA EPTA members are strongly committed to upholding these regulatory expectations which are fundamental to ensuring the orderly and transparent functioning of European financial markets. Should they be subjected to a short-sale ban, however, then FIA EPTA members would not be able to perform the essential role of providing liquidity that is expected from them.

Specifically, for market makers in listed derivatives markets, covered short-selling is a necessary tool to hedge their listed derivatives positions which increase due to their role as liquidity providers and counterparties to end-investors buying or selling futures and options to manage their financial risks.

Furthermore, as a short sale ban would cause liquidity to dry up, end-investors would be exposed to even greater financial risk. Buying risk protection may then become prohibitively expensive or be even completely unavailable to end-investors due to a short-sale ban. Hence, we call on the Executive Board of BaFin to desist from a generic or even limited ban on short-selling whose consequences, we are convinced, will be much worse than the market conditions which gave rise to it.

We appreciate your consideration of the concerns we express above and remain at your disposal should you require any further information.

Kind regards,

Piebe Teeboom
Secretary-General, FIA European Principal Traders Association

CC:
Elisabeth Roegele
Felicitas Linden

Annex:

How short-selling enables market maker to provide liquidity to end-investors seeking protection from financial risk

We explain the essential role of short-selling for market makers and how it enables end-investors to risk manage their exposures by way of the following example below:

- Exchange-traded derivatives enable end-investors to protect themselves against further downward price movements. An asset manager can, for example, protect his downside by buying put options. I.e., he gains the right to sell the underlying instrument at a pre-agreed price point, even if the price of the underlying is even lower than this level.
- This way, his position is totally covered in case of a further drop in the underlying price. If the price of the underlying instruments increase, he only loses a small "insurance" premium (the options premium).
- The counterparty to this trade would be a market maker such as FIA EPTA member firms. In this example, the market maker will sell put options to the asset manager. I.e., the market maker has the obligation to <u>buy</u> the underlying at the agreed price from the asset manager, which may by that time be worth (much) less.
- The market maker then needs to hedge his own option position for risk management purposes, otherwise the market maker will have an open risk to the downside (i.e., to a price drop below the level at which he will need to buy the underlying instrument from the asset manager).
- The market maker will therefore immediately hedge himself, i.e., he will <u>sell</u>, pro-rata, the underlying which he may need to buy at a later time from the asset manager if the asset manager decides to exercise the put option. If the market maker cannot sell the underlying instrument itself, he will alternatively sell a highly correlated product like an index future or even an ETF to hedge himself.
- This selling creates a <u>short</u> position in the underlying for the market maker. When the asset manager exercises the put option, the market maker will then borrow the underlying through a lending agent so the market maker will be able to deliver the underlying to the buyer in t+2.
- So in summary: in order to enable the asset manager to insure himself against downward price risk, the market maker ends up selling put options to the asset manager and at the same time short-selling the underlying. A short-sale ban would make it impossible for the market maker to act as a counterparty for the asset manager's risk management trade.