Quoted Companies Alliance

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The European Securities and Markets Authority (ESMA)
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07
France

19 February 2015

Dear Sirs,

<u>ESMA Consultation Paper on Technical Advice under the CSD Regulation</u>

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Secondary Markets Expert Group has examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

Response

We welcome the opportunity to respond to this consultation. We have responded to the questions below that we believe will have an impact on our members, small and mid-size quoted companies.

Q1: What are your views on the proposed basis for the cash penalty calculation?

We believe that the proposed basis for the cash penalty calculation is the best possible scenario solution. We agree that the cash penalty should relate to the value of the failed transaction and that the principle of neutrality should be applied so that there are no disadvantages among securities holding models.

We agree that the cash penalty should be proportionate and take into consideration the specificities of the different asset types, the liquidity and category of transactions. However, we are concerned with ESMA's choice to set the proposed daily flat penalty rate at 1.0 basis points (bp) for all equities, as we explain in detail in our response to Q2.

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

Yes, we consider that these penalty rates, as drafted, will disincentivise trading in small and mid-size quoted companies' stocks. Small and mid-size quoted companies both on regulated markets and especially on SME Growth Markets will see trading in their stocks reduced, as liquidity providers, such as market makers, will be disproportionately penalised for any failure of settlement, which is highly likely to occur with these less liquid securities.

Proposing a penalty of the same amount of basis points both for liquid and illiquid shares, while providing for a longer execution period, can result in higher total amount of penalties for illiquid shares (in addition to significant buy in costs and administrative costs). These added costs will act as a disincentive for liquidity providers to make a market and trade these less liquid stocks, such as those of small and mid-size quoted companies. This will have a wider impact on the market, with increased costs for retail investors and a further reduction in liquidity in small and mid-size quoted companies' stocks.

As a result, this will make it more difficult for small and mid-size companies to raise equity finance on capital markets. ESMA should take this into consideration and align its Technical Advice with the European Commission's efforts to cut the cost of raising capital, particularly for SMEs, reducing their dependence on bank funding, and to increase the attractiveness of the European Union as a place to invest.

The proposed fining will in effect result in larger fines for small and mid-size quoted companies; for example, we have calculated fines could be 22 bp over a period of 8 days for companies on SME Growth Markets. Given the illiquid nature of SME Growth Markets and the inevitable outcome that trades of shares on these markets will take longer to settle, this is very severe. In this case, more time to settle acts as a disincentive and makes the extension period punitive.

By not creating different penalty levels based on the liquidity levels used to determine the extension periods, the proposal is actually more punitive on less liquid securities, such as those of small and mid-size quoted companies, than on liquid securities.

The Technical Advice as currently drafted undermines the purpose of SME Growth Markets. Moreover, the proposed rules are not in the spirit of Level I regarding SME Growth Markets and recognising the effect of liquidity on settlement performance.

As emphasised by ESMA, "liquidity is important as it will impact how special is the financial instrument and therefore the borrowing costs for such instrument". However, as ESMA notes "the less liquid an instrument, the most difficult it will be to source it and the more expensive it will be to borrow it" (p.35). In its analysis, ESMA has overlooked the fact that there is no active borrowing in less liquid stocks.

According to research conducted using SunGard Lending Pit service (which provides data on availability, utilisation and cost of stock lending arrangements), 98% of FTSE 100 securities were available to borrow somewhere in the lending market, while only 20% of AIM was similarly available[1].

Furthermore, we understand that stock lending is often heavily restricted in small and mid-size quoted companies' stocks, due to several issues such as the perceived extra market risk by institutional investors, retail stocks not being available for lending, smaller average free floats and the lenders' concerns regarding the risk posed by the lack of market liquidity and credit risk.

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[1] SunGard's Astec Analytics (http://financialsystems.sungard.com/solutions/market-data/astec-analytics) delivers intraday transparency to the global securities financing markets through its flagship service, Lending Pit. Data is gathered continuously throughout the trading day, with results delivered back to participant clients. More than 2 million trades are gathered each day, across more than 42,000 active securities held by over 67,000 lending funds making it the most comprehensive and timely data source on the market.

In its current Technical Advice, ESMA has excluded the concept of differing levels of liquidity within equity markets. According to the trading data of the London Stock Exchange, the value traded on order books in FTSE 100 securities (101 unique securities) is 52 times that of AIM's (167) unique order book traded securities. These statistics exclude quote-driven securities, which are too illiquid to be traded on an order book.

In the UK, small and mid-size quoted companies rely on market makers to provide liquidity in trading their stocks. Market makers act as a liquidity buffer, making sure that buyers and sellers can be matched over an extended time period. Within ESMA's proposed Technical Advice, market makers will be fined for providing this buffer, leading to price distortion and possibly withdrawal of liquidity, all of which will, in turn, severely undermine the trading in less liquid, small and mid-size quoted companies' stocks and make it more difficult for these companies to raise the finance they need to grow and create employment throughout Europe.

We believe that ESMA, for the purposes of calibration, should <u>proportionally</u> consider the costs and consequences of a failed trade to understand the effects of the penalty for small and mid-size quoted companies. The size of the fine should also take into consideration the length of extension and buy in periods.

While we do not believe 1 bp is the correct level of fining, we propose that, a cap be applied. Using 1 bp as an example, the maximum fine value would be set and applied pro rata across the available fining days (i.e. 8/8 = 1 bp per day liquid and 8/22 = 0.36bp per day SME illiquid). Therefore, we suggest that a less harmful solution would be to set a fining level that reflect the total fine ESMA believes to be punitive and then prorate backwards.

Liquidity	**Extension Period**	**Buy in Period**	**Total Period**	**Alternative Daily Rate**	**Alternative Max Potential Fine**
Liquid	4	4	8	1.00bp	8bp
Non-Liquid (Cleared)	4	7	11	0.57bp	6.27bp[2]
Non-Liquid (Not Cleared)	7	7	14	0.57bp	7.98bp
SME Growth Markets (Liquid)	15	4	19	0.42bp	7.98bp
SME Growth Markets (Non Liquid)	15	7	22	0.36bp	7.92bp

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

[2] The differentiation between cleared and non-cleared trades in the same share should not create differing fine regimes, in our view.

Yours faithfully,

Tim Ward
Chief Executive

APPENDIX A

Quoted Companies Alliance Secondary Markets Expert Group

Simon Rafferty (Chairman)	Winterflood Securities Ltd
Jon Gerty (Deputy Chairman)	Shore Capital Group Ltd
Paul Arathoon Andrew Collins William Garner	Charles Russell Speechlys LLP
Jessica Reed	Farrer & Co
Mark Tubby	finnCap
Nick Anderson Clare Forster	Henderson Global Investors
Fraser Elms Katie Potts	Herald Investment Management Ltd
William Lynne Claire Noyce	Hybridan LLP
Peter Swabey	ICSA
Jeremy Phillips	Nabarro LLP
Ian Wright	Numis Securities Limited
Sunil Dhall Andrew Palmer	Peel Hunt LLP
James Stapleton	Winterflood Securities Ltd