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The European Securities and Markets Authority (ESMA)
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22 May 2014

Dear Sirs,

Discussion Paper – Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)

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. Prior to the adoption of the CSDr, we campaigned that the buying-in regime as worded would lead to reduced liquidity for less liquid securities and thus negatively affect the ability of small and mid-size quoted companies to raise finance, grow and create jobs. We understand that the CSDr text is agreed and that there is no opportunity to amend its terms. Therefore, we ask ESMA to consider in its Technical Standards the fact that there needs to be flexibility in the settlement discipline for both shares on a 'SME Growth Market' and also those equally less liquid shares on regulated markets.

In the UK, there are around 580 companies listed on the regulated market outside of the major UK indices with market capitalisations below £1bn, which are less liquid than the very largest companies. These are now subject to an inappropriate buying-in regime under the CSDr. As a result, these companies could see liquidity in their shares drop dramatically due to the change in trading economics faced by liquidity providers, such as market makers, where market liquidity is low and there is no active stock borrowing market, a feature common outside of the FTSE 350 in the UK. This makes it much more difficult for them to attract investment and raise equity finance.

These rules make it not cost effective for market makers to make markets in less liquid stocks, which will overall result in less liquid markets and consequentially have a significant impact on SMEs. Retail investment will also be reduced with the withdrawal of liquidity.

We believe that ESMA should ensure an efficient settlement regime, while recognising that less liquid small and mid-size company stocks both on SME Growth Markets and on regulated markets need this to be calibrated differently to ensure that smaller companies can continue to grow and create jobs. ESMA has the opportunity to put forward flexible and proportionate technical standards regarding the execution period. We believe that the focus of the criteria should be on the liquidity for both cleared and uncleared securities.

We have provided below more detailed answers to those questions which we believe could cause the greatest impact on small and mid-size quoted companies. Due to the absence of details regarding the proposed fining regime and buying-in, we have not provided quantitative data in our answers.

Responses to specific questions

Q13: CSDR provides that the extension period shall be based on asset type and liquidity. How would you propose those to be considered? Notably, what asset types should be taken into consideration?

We agree that it is important to address settlement fails in a way that enhances and promotes settlement efficiency and certainty. Regarding liquidity, we agree that it is a crucial question to optimally determine how less liquid instruments are identified and what is the time-period before those securities are subject to a buy-in.

We are therefore concerned about those shares which are “not traded frequently and may need a longer period to ensure an orderly and robust market” (paragraph 51 of the discussion paper). We strongly believe that a sufficient period of time should be allowed for a transaction to settle before a buy-in is initiated, in order to prevent another fail. We are particularly concerned on behalf of issuers with less liquid securities.

We welcome the consideration given by ESMA to the liquidity issue, and we agree that this “needs to be treated with some care as the adverse effects of a buying-in regime could be a decrease in liquidity in certain instruments and an increase in the number of settlement fails where it can prove difficult to obtain the securities for buying-in” (paragraph 51).

We understand that ESMA is aware of the fact that equities, and in particular those admitted to clearing, are not always liquid. In the UK, a significant number of less liquid securities, including those admitted to the Main List of the London Stock Exchange and AIM, is subject to clearing and dependant on liquidity offered by market makers. Indeed, small and mid-size quoted companies with less liquid securities often rely on the market maker’s ability to maintain continuous two way firm quotes throughout the trading day regardless of whether the security is cleared or bilaterally settled. The market makers’ ability to close the trade in the market becomes limited or non-existent if the security is less liquid, which increases the risk of the price being systematically increased (and thus unrepresentative of the demand and supply price) in their attempt to buy back these less liquid instruments to avoid settlement discipline regime.

In light of the above, and in view of the scope of CSDr, we suggest that the differentiation between whether a security is liquid or not depends on the possibility for a participant to close out a short position on the trading day either through a market purchase or through obtaining a loan of the security.

Not doing so could have very detrimental results for the market and consequentially for the SMEs with less liquid securities including increased price volatility, widened bid offer spreads and reduced levels of liquidity offered, and could undermine market stability due to an increase in market makers' costs. We would like to highlight that this would be of significant detriment to shareholders and could potentially create an environment conducive to abusive share ramping and short squeezes.

We believe that it is important to have a definition of liquidity in line with the criteria for assessing liquidity under article 2(1)(7a) of MiFIR, namely (i) the average frequency and size of transactions over a range of market conditions, having regard to the nature and life-cycle of products within the class of financial instruments, (ii) the number and type of market participants, including the ratio of market participants to trade instruments in a given product, and (iii) the average size of spreads, when available. We note also the existing provisions provided by Article 22 of the MiFID implementing regulation No 1287/2006 which defines a liquid share under the current MiFID environment. We would also point out the 'locate rules' in Article 6 of the Short-Selling Implementing Regulation No 827/2012, which outline the use of liquidity as a method to differentiate the arrangements most suitable for securities, ensuring they are available for settlement.

Q14: Do you see the need to specify other minimum requirements for the buy-in mechanism? With regard to the length of the buy-in mechanism, do you have specific suggestions as to the different timelines and in particular would you find a buy-in execution period of 4 business days acceptable for liquid products?

As noted in our introduction:

- The period may need to be longer for less liquid securities.
- The execution period should be appropriate to facilitate the execution of buy-in trades without significantly impacting the market. ESMA should not allow buy-ins to have a distortive price effect, not representative of investment.
- The settlement discipline should be targeted at those who 'cause' settlement failures.

Q15: Under what circumstances can a buy-in be considered not possible? Would you consider beneficial if the technical standard envisaged a coordination of multiple buy-ins on the same financial instruments? How should this take place? / Q16: In which circumstances would you deem a buy-in to be ineffective? How do you think different types of operations and timeframes should be treated?

We believe that both questions should be answered simultaneously, as we consider that the situations where the buy-in should be considered not possible and ineffective are essentially the same.

We consider that a buy-in could be deemed not possible or ineffective where the buy-in is against the sole market maker in the security (i.e. the only party that the buy-in could execute is the party that is failing settlement), or in the cases where the buy-in would lead to an additional failed settlement (for example, in the case of insufficient supply of the security to buy stock for guaranteed delivery). Multiple buy-ins in the same security could be aggregated to facilitate better execution and minimise the market impact associated with the execution. However, we note that multiple buy-ins in the same security would probably indicate that there is a significant lack of liquidity with the market for the security and that forced buy-ins may have a significant and undesirable market impact.

Q17: Do you agree on the proposed approach? How would you identify the reference price?

We would agree that in normal market conditions the reference price should be identical to the last market price before the initiation of the buy-in process; however, as stated above, it might be that the last traded /quoted price has been inflated by a squeeze on the market. In this case, the identified reference price will be unrepresentative of the true market for the security and harmful for less liquid stocks. The consequential short squeeze selling in less liquid securities will enhance the abusive environment and distort the market. Therefore, we suggest that ESMA puts forward more than one reference price methodology depending on the nature of the security and the nature of the settlement failure.

We are particularly concerned with the less liquid securities in the market, as short squeezes will mostly be happening in less liquid stock of smaller quoted companies. Therefore, we would suggest that when a short squeeze occurs due to a lack of liquidity, the exchange suspends the trading and delays the buy-in/cash-in process until an investigation is finalised to determine the causes and resolve the squeeze. The exchange – with the approval from the competent authority - should also be given the right to set up an arbitrary reference price more representative of the true market for the security.

Q18: Would you agree with ESMA's approach? Would you indicate further or different conditions to be considered for the suspension of the failing participant?

We consider this topic to be of a very sensitive nature, and we ask ESMA to consider the possible outcome scenarios of setting up the rules for defining thresholds to trigger the decision-making process to suspend participants failing to deliver the financial instruments, especially in what relates to small and mid-size quoted companies. We believe that there could be a significant risk to the market in certain classes of security.

We underline the fact that, while systematic settlement failure is less likely to occur in liquid securities, it is much more likely to occur in the case of less liquid securities due to lack of liquidity in the market and the unlikelihood of a loan being available. Therefore, we believe that it is crucial to identify the 'cause' of these settlement fails to better understand their implications, and be aware of the fact that there may be unjust situations which could potentially harm smaller quoted companies.

ESMA should take into consideration that smaller quoted companies rely, in many instances, on market makers to ensure that their stocks are being traded. It would be very harmful for SMEs if the market makers became uninterested in trading less liquid stocks with fear of suspension from failing to deliver the financial instruments. This could ultimately have the perverse and undermining effect of pushing SMEs out of the market, which would put at risk and be contrary to the good work being developed through the new MiFID. We believe that smaller companies with less liquid stock should be able to publicly trade and the right conditions for that should be created and maintained.

Additionally, we are concerned that market makers specialising in less liquid securities will appear disproportionately poor in their settlement performance in comparison to participants who also trade more extensively in more liquid securities. Therefore, we are concerned that a simple average applicable across all market makers may be discriminatory against those supporting liquidity and specialising in SME Growth Markets.

Subject to our comments above, we agree that the approach proposed by ESMA is appropriate but should be calibrated to take into account the nature of the securities involved and the liquidity of the instrument.

Q19: Please, indicate your views on the proposed quantitative thresholds (percentages / months).

It is not possible for us to suggest figures without more details of the current settlement performance. We believe that settlement performance is, at the moment, at an acceptable level; we therefore ask ESMA to consider the current settlement performance in the imposition of these thresholds, and focus on those firms that are ultimately causing the failed deliveries.

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

Yours faithfully,

Tim Ward
Chief Executive

APPENDIX A

Quoted Companies Alliance Secondary Markets Expert Group

Simon Rafferty (Chairman)	Winterfloods
William Lynne /Claire Noyce	Hybridan LLP
Andy Thompson	Wealth Management Association (WMA)
Paul Arathoon /Andrew Collins/William Garner	Speechly Bircham LLP
Sunil Dhall /Mitchell Gibb	Peel Hunt LLP
Richard Everett	Wragge Lawrence Graham & Co
Jon Gerty	Shore Capital Group Ltd
Brian McDonnell	Olswang
Robert Scavera	Numis Securities Limited
James Stapleton	Winterflood Securities Ltd
Peter Swabey	ICSA
Mark Tubby	finnCap