Winterflood SECURITIES

[Online Submission]

22nd May 2014

Dear Sirs,

ESMA/2014/299 - Discussion Paper - Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)

Winterflood Securities Limited ("Wins") is UK investment firm regulated by the Financial Conduct Authority. The Company's primary business is that of a Market Maker. Wins is a member of the following Exchanges and major MTFs – The London Stock Exchange, ISDX, Equiduct, Euronext, Deutsche Borse, Nasdaq OMX Europe, Irish Stock Exchange, BATS Chi-x Europe and Turquoise. Wins is the largest Market Maker in the UK in respect of stock coverage, and is also the largest Market Maker in the UK in respect of retail trade volume.

We note under recitals 16 and17 of the regulation of the European Parliament and of the council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC regulation (the 'Regulation') that *"market making activities play a crucial role in providing liquidity to markets within the Union, particularly to less liquid securities. Measures to prevent and address settlement fails should be balanced against the need to maintain and protect liquidity in these securities"* and provide our response in this context, primarily in relation to equity markets. As the largest Market Maker in the largest Small Cap market in Europe we feel we can provide a useful insight into how the Regulation and the proposed technical standards will affect these markets and also shed some light on the operation of these markets in contrast to more liquid markets.

We also understand that the Level 1 regulation is now agreed and that there is no opportunity to amend or adjust those terms. We have, however, provided context to our response to hopefully provide a greater understanding of how we have arrived at our answers as a liquidity provider specialising in less liquid securities, and as to how the provision of liquidity will be adversely affected by the proposals and hence how liquidity will be affected.

The regulation states quite clearly in recitals 15 and 65 that settlement discipline should be targeted at those who 'cause' settlement failures. It also states in recital 16 that the discipline regime should be *'scaled in such a way that maintains and protects liquidity of the relevant financial instruments'* and that, in recital 18, the buy-in mechanism should be aimed at *'minimising the number of buy-ins to the extent compatible with the requirements of this Regulation'*. Based on these three assertions we believe that any technical standards need to facilitate or mandate the following concepts to ensure fairness, efficiency and market stability[1]:-

[1] In the example Trade1 and Trade 2 are for the same volume of the same security with the arrows reflecting the flow of the security.

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1) Markets in the same instrument type can be differentiated by their liquidity and that an effective deterrent to poor settlement behaviour for the most liquid securities may be inappropriate and extremely damaging to markets in less liquid securities.
2) When assessing whether a participant is 'causing' the failure to deliver a security, the CSD's assessment should analyse the net settlement profile of the participant for each relevant security. Where the participant's settlement profile is flat or positive i.e. securities held + securities due >= securities owed then the participant is not the cause of settlement failure and no settlement fines or buy-in should be conducted e.g. Where the settlement of trade 2 is prevented due to participant A having insufficient securities to settle trade 1, participant A is the root cause of settlement failure for both Trade 1 and 2. Thus Participant A should be considered the cause of failure and Participant B should not.
3) Where trade 1 is due to settle after trade 2 then participant B is responsible for a settlement fail only for the period between the respective Intended Settlement Dates ("ISD"). As participant B's settlement profile is flat i.e. securities held + securities due >= securities owed then no buy-in should be conducted against participant B as it is unnecessary to facilitate settlement.
4) Given the above, where the prohibition of naked short selling exists for certain instrument types the only party who may legitimately fail to settle a trade in such an instrument is a Market Maker as they are the only person permitted to enter into a naked short sale. Furthermore registered Market Makers are obliged to enter into such a short sale with other market participants. On this basis consideration should be given to this obligation when assessing the treatment of the failing participant.

We have not provided quantitative data to support our arguments as without details of the proposed fining regime it is impossible for us to assess how the Regulation and the proposed technical standards will affect the economics of liquidity provision in less liquid markets.

Q1 - Which elements would you propose ESMA to take into account / to form the technical standards on confirmation and allocation between investment firms and their professional clients?

While the utilisation of technical solutions to streamline the trade allocation and confirmation is welcomed we'd be concerned if the proposals created barriers to entry for certain participants i.e. by creating significant additional technology costs. There is also a risk that the costs associated with such measures could be multiple if such services are provided over closed networks and are not required to be interoperable. The concern would be that mandatory requirements might drive the creation of an unregulated monopoly which would be undesirable for all participants.

Q4 - Do you share ESMA's view that matching should be compulsory and fields standardised as proposed? If not, please justify your answer and indicate any envisaged exception to this rule. Are there any additional fields that you would suggest ESMA to consider? How should clients' codes be considered?

We agree that matching should be a compulsory and that standardization across CSDs will reduce technical complexity.

Q5 - Do you agree with the above proposals? What kind of disincentives (other than monetary incentives such as discounts on matching fees) might be envisaged and under which product scope?

We agree that participants should be operationally prepared to enter settlement instructions promptly and certainly by the end of T+1. We also agree that there may be incentives to require participants to delay their settlement instruction input e.g. insufficient capital to fund settlement through custodian, desire to avoid failed settlement. We therefore agree that there should be disincentives for late submission of instructions and late matching. We also agree that participants should not be fined when submitting a timely and accurate instruction where matching is delayed by the failure of the

counterparty to instruct settlement or where the counterparty's settlement instruction is incorrect thus preventing matching.

Question 6 - In your opinion, should CSDs be obliged to offer at least 3 daily settlements/batches per day? Of which duration? Please elaborate providing relevant data to estimate the cost and benefit associated with the different options.

Our opinion is that it is absolutely necessary for there to be either ongoing or multiple settlement batches each day to facilitate the maximum possible settlement success rates. It is likely that certain participants, particularly Market Makers, will require the proceeds of sale transaction to fund their purchases and that this may require multiple cycles to ensure that all trades are settled. Settlement may also require funds to be realigned between different countries and CSDs hence CSDs should maximize the number of matching cycles within a day and ensure that they cover a significant proportion of the day to facilitate funds transfer and settlement.

It would seem inappropriate for trades to not settle where there is adequate funding and adequate security holdings but there are insufficient settlement cycles to facilitate the exchange. This is especially true given the proposed fining regime.

We have significant concern that improperly configured fining regime could significantly damage the market for less liquid securities and that therefore all steps must be taken to maximise the likelihood of settlement and target the source of failures where they are inappropriate.

Question7 - In your view, should any of the above measures to facilitate settlement on ISD be mandatory? Please describe any other measure that would be appropriate to be mandated.

The use of optimisation algorithms may be advisable in so much as they may assess the true 'cause' of a settlement failure and thus allow for targeted settlement discipline to be provided under Article 7. As described earlier, we feel the concept of 'Cause' is crucially important to ensuring the regulation achieves its objectives and minimises unintended consequences such as reduced liquidity and/or wider bid offer spreads.

To refer to the opening of our letter, we believe that assessment of a participant's net settlement position may be relevant when assessing who is at the root of a chain of settlement failure. This, of course, requires that accounts at the CSD are held at a sufficiently granular level so as to not allow the activities of one participant in a shared settlement account to either create or offset the actions of another.

In either case a participant with offsetting settlements should not be disciplined under the new regime.

Question 8 - Do you agree with this view? If not please elaborate on how such arrangements could be designed and include the relevant data to estimate the costs and benefits associated with such arrangements. Comments are also welcome on whether ESMA should provide for a framework on lending facilities where offered by CSDs.

We agree with the CESR-ESCB view cited in paragraph 31 and the analysis in paragraph 34.

In our experience the costs associated with such services are exceptionally high and would likely be uneconomical as a means of preventing settlement failure. Where such facilities are provided they should be at the request of participants and should not have a mandatory element. We'd expect to be able to use such systems as a lender of last resort having had the opportunity to seek loans from alternative and more economical sources first. The costs associated with the facility should be minimal.

Question 13 - 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 acknowledge ESMA's concern through Paragraph 51 that *"the issue 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".*

We have encountered, on some occasions, an assumption that equities, and in particular those admitted to clearing, are always liquid. From our experience we can state that this is most definitely not the case. The most relevant example being that a significant number of less liquid securities, including those admitted to AIM, being subject to clearing and yet dependant on liquidity offered by committed, registered Market Makers.

Registered Market Makers are required under exchange rules to maintain continuous two way firm quotes throughout the trading day regardless of whether the security is cleared or bilaterally settled. Market Makers are therefore obliged to naked short sell, as is specifically permitted under the Short Selling Regulation ("SSR"), where clients and counterparties wish to purchase such securities. Where the security in question is liquid it will be easy for the Market Maker to close any such short positions on the trading day or possibly borrow the securities to facilitate timely settlement. Where the security is less liquid then the ability to close the trade in the market is limited or non-existent either on trading day or potentially over a number of trading days. It is also the case that the availability of securities lending depletes in line with the drop in liquidity due the risk to lending counterparties of a failed return, as envisaged in paragraph 34. Its stands to reason therefore that failed settlement will be more prevalent in the markets for less liquid securities.

On this basis we would argue that, for the purposes of the Regulation and to deliver the objectives stated in its recitals, the differentiation between whether a security is liquid or not will depend 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. It's worth noting here that non Market Makers are prohibited from undertaking naked short sales and hence the only selling participants failing to deliver should be those providing liquidity as Market Makers.

To facilitate this we draw ESMA's attention to 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 also draw reference from the "locate rules" in Article 6 of the Short-Selling implementing regulation No 827/2012 which attempt to utilise liquidity as a means to differentiate the appropriate arrangements required for securities to ensure they are available for settlement.

There is an argument that would suggest that the Market Maker could simply increase their bid price in order to encourage more sellers to the market, thus resolving their short. A key benefit of the liquidity provision of a Market Maker, critical for less liquid securities, is the price stability that they create through the constant presence of a committed buyer/seller for the security. The primary determinant of the price of a security should be the demand and supply of that security from the investor community and not the settlement requirements of Market Makers. We are concerned that the discipline provisions will, in all likelihood:-

- create increased volatility towards the end of the trading day as Market Makers seek to identify sellers of less liquid securities;
- widen bid offer spreads;
- reduce the levels of liquidity offered by Market Makers; and
- inflict costs on Market Makers that would make it economically impossible to offer liquidity in less liquid securities hence undermining market stability.

Market Makers are, amongst other things, required to maintain orderly markets. The description above demonstrates how, if improperly calibrated, the imposition of too short an extension period would undermine this objective. This would be of significant detriment to shareholders of all types, including direct and indirect retail investors and pension funds.

These same factors also, unfortunately, create an environment conducive to abusive share ramping and short squeezes. Where an abusive participant chooses to aggressively buy a less liquid security from a Market Maker, the Market Maker would, due to the threat of financial penalty of failed settlement, have to increase their bid price to identify prospective sellers. Where no such sellers are available, as may be the case for less liquid securities, the share price would continue to increase. The buy-in would either fail, due to the illiquid nature of the security, or be deemed impossible and the abusive participant opt for cash compensation of the trade as envisaged under Article 7(7) of the Regulation which would reflect the ramped value. While such abusive activity is forbidden we believe that prevention rather than detection is the most effective control and hence any proposal that simplifies, enhances or increases the reward for market abuse is undesirable.

In practice therefore we feel that the shortest extension period should only be offered to those securities that can be easily repurchased or borrowed to facilitate settlement. A longer extension period should be offered in all other circumstances. Failure to do so could lead to price volatility and significant liquidity withdrawal for less liquid securities.

Question 14 - 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?

The execution period would need to be adequate to facilitate the execution of any buy-in trade with minimal market impact, which will be determined by the liquidity of the specific security. Buy-ins should not be permitted to have distortative price effect on the market price as they do not reflect investment. We also have concerns that the disciplinary periods of a cleared and uncleared trade may end on an offset basis creating complexity from a settlement management perspective where corresponding buys and sells may not be forced to settle at the same time. Our opening section deals with the concept of cause and that a net flat or positive settlement profile would not result in any form of settlement discipline.

The period may thus need to be longer for less liquid securities to facilitate the successful execution of the buy in without creating price volatility.

We are also concerned that there could be situations where the aggregate value of disciplinary costs exceeds the value of the unsettled portion of the trade. We believe the proceeds paid to the receiving party should never exceed the market value of the trade where the trade results in cash compensation.

Question 15 - 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?
Question 16 - In which circumstances would you deem a buy-in to be ineffective?

In our view a buy-in would not be possible or ineffective in the following circumstances:-

1) Where the only party with whom the buy-in may execute is the party that is failing settlement i.e. where the buy-in is against the sole Market Maker in the security.
2) Where there is insufficient supply of the security to buy the stock in for guaranteed delivery i.e. where the buy-in would lead to an additional failed settlement

We'd also draw attention to the potential risks posed by the existence of a list of such securities from a market abuse perspective. The list of securities that cannot be bought in would represent a list of securities that were vulnerable to extreme short squeeze activities by moving directly to the cash compensation period. As stated earlier, we believe that prevention rather than detection is the most effective control against market abuse.

We believe that any punitive elements in relation to a buy-in should be levied via the fine mechanisms and not via the quality of buy-in execution. It's conceivable therefore that multiple buy-ins in the same security could be aggregated to facilitate better execution and to minimise the market impact associated with the execution.

We'd note that multiple buy-ins in the same security would likely indicate that there is a broad settlement issue with the settlement profile for the security i.e. a significant lack of liquidity and that forced buy-ins may this may not be productive and may have a significant unintended and undesirable market impact. In addition it's likely that multiple failed settlements in a security will be connected in a chain and that resolution of the root cause failure may then unwind a significant number of downstream failures thus reducing the number of buy-ins as envisaged in recital 18.

Question 17 - Do you agree on the proposed approach? How would you identify the reference price?

We agree that there may be a need for more than one reference price methodology depending on the nature of the security and also the nature of the settlement failure.

We have concerns as to how beneficial the cash compensation mechanism will be for certain types of investor. While institutions may be well informed as to the status of the trade and may therefore be able to promptly re-invest the proceeds of a buy-in to ensure they have achieved their required investment it seems unlikely that Retail customers will be in the same position. There's a risk that in pursuing the management of settlement risk through settlement discipline that a poorer outcome may be achieved. We have already covered our concerns as to the price pressure effects that the proposals will likely have on the price of less liquid securities. The risk presented by the cash compensation mechanism is that the Retail customer's trade is cashed out prior to a share price increase and hence they will not have realised the gains they would have been entitled to had the trade remained open. We are concerned that there may be onward liabilities sought by investors in such cases.

We would suggest that where a short squeeze were either deliberately or accidentally occurring due to a lack of liquidity the exchange in question may look to suspend trading in the security and either delay the buy-in/cash compensation process until such time as the squeeze could be investigated and resolved. In such a case the reference prices may be unreliable and unrepresentative of the true market for the security and hence the exchange may require discretion to set a reference price arbitrarily, albeit with approval from the competent authority.

Question 18 - 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 agree with the requirement for a proportionate response in this area. We note that, given the ban on naked short selling and the assumption made at the beginning of our response regarding the cause of settlement failure, the only people who will be assessed under this approach will be those who have breached the short selling regulation, who should be disciplined appropriately and those carrying out Market Making activities.

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As has been stated earlier the likelihood of systematic settlement failure in liquid securities seems less likely in the majority of circumstances due to the relative ease by which the security can be repurchased or borrowed. The same is not true for less liquid securities where liquidity may not be sufficient to facilitate a purchase, making it significantly less likely that a loan available (also driven by the lack of liquidity).

Registered Market Makers are obliged to naked short sell upon request under exchange requirements and specifically permitted to do so via an exemption from certain aspects of the SSR. Both the SSR and the Regulation cite the important role the Market Makers perform in relation to less liquid securities.

It seems, therefore, that the provisions of Article 7 (9) will be highly likely to fall only on Market Makers. Furthermore it seems more likely that Market Makers whose business is focussed on less liquid securities, where they provide the greatest benefit to the market, will be significantly more likely to be caught by the proposed measures. Suspension of such parties from the trading could have a material effect on the market for a security.

On the basis of the objectives set in the recitals this would seem to be totally at odds with the objectives of Recital 16 as quoted earlier. The provisions here view all participants as being equal where, in fact, Market Makers are obliged to sell securities with no guarantee that they may repurchase them or borrow them.

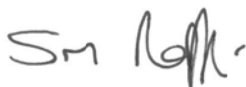
On that basis we view that there may need to be differentiated requirements between those utilising an exemption under the SSR, such as Registered Market Makers who we would suggest should be exempt, and those who are not. It would seem logical to us that those who have no right or obligation to naked short sell be measured against a more severe standard than those who do fill that role.

Question 19 - Please, indicate your views on the proposed quantitative thresholds (percentages / months).

We'd suggest it is difficult to identify specific figures without an understanding of settlement performance as it currently stands. It's our view that settlement performance is currently at an acceptable level and that therefore the imposition of these thresholds should reflect the current settlement performance with only significant outliers likely to breach the thresholds.

Please feel free to contact us for clarification of any of our points or to explore any of the suggestions we have made.

Yours Faithfully



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