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| 18 December 2014 |

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| Reply form for the  Technical Advice under the CSDR |
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| Date: 18 December 2014 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - D Technical Advice under the CSDR, published on the ESMA website.

***Instructions***

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

1. use this form and send your responses in Word format;
2. do not remove the tags of type <ESMA\_QUESTION\_TA\_CSDR\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
3. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

1. if they respond to the question stated;
2. contain a clear rationale, including on any related costs and benefits; and
3. describe any alternatives that ESMA should consider

**Naming protocol:**

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_ TA\_CSDR \_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

E.g. if the respondent were ESMA, the name of the reply form would be ESMA\_ TA\_CSDR \_ESMA\_REPLYFORM or ESMA\_CE\_AIFMD\_ESMA\_ANNEX1

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **19 February 2015**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Disclaimer’.

# General information about respondent

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| --- | --- |
| Are you representing an association? | Yes |
| Activity: | Issuer |
| Country/Region | UK |

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

<ESMA\_QUESTION\_TA\_CSDR\_1>

The consultation paper indicates that that the price to be used should be the closing price of the regulated primary market for the relevant financial instrument.However, mandatory buy-ins could lead to potential market abuse in relation to illiquid securities. Where a buyer aggressively buys a less liquid security from a market maker, the market maker would have to increase their bid price to identify prospective sellers rather than face the threat of financial penalty of a failed settlement. Where no sellers are available, the share price would continue to rise. Where the penalty and the cash compensation is based on an artificially increased price of the securities, the “failing participant” would be bear a disproportionate penalty.

<ESMA\_QUESTION\_TA\_CSDR\_1>

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.

<ESMA\_QUESTION\_TA\_CSDR\_2>

The AIC **recommends** that the penalty system should take account of the liquidity of the instrument concerned.

The liquidity of investment company shares varies enormously. Some large investment trusts and offshore investment companies are highly liquid; smaller investment trusts and some non-UK investment companies can be much less liquid, even where they are admitted to clearing. Some observers suggest that companies outside the FTSE 350 may be regarded as illiquid. The AIC has 230 members (excluding VCTs) that are outside the FTSE 350. These less liquid companies rely on the market maker’s ability to maintain continuous buy and sell prices throughout the day.

The AIC has 69 VCT members with assets under management of nearly £3 billion. VCT shares may be particularly illiquid. VCTs have tax-favoured status in the UK. One of the tax benefits available to investors in VCTs shares is income tax relief on subscription for the shares. However, the availability of this relief depends on the investor holding the VCT shares for a minimum of 5 years. This means that secondary market trading in VCT shares can be very limited. Approximately 20% of VCT shares are held by nominees, primarily private client wealth managers, so that these shares are not available to be borrowed. Market makers customarily provide immediate liquidity and the VCTs themselves often purchase shares to provide a “backstop” exit for investors who wish to sell their shares.

In the ESMA consultation paper on the draft technical advice on the CSD Regulation, the penalty varies according to the following type of financial instrument involved:-

* equities and others,
* Government bonds,
* Corporate bonds and
* Cash.

ESMA acknowledges that the cash penalty should be proportionate and take into consideration the specificities of the different asset types, the liquidity and category of transactions. Indeed, ESMA continues that the less liquid an instrument is, the more difficult it will be to source it and the more expensive it will be to borrow it. ESMA concludes that it is therefore an important element for consideration in order to set the penalty rate.

Given this principle, the AIC **recommends** that the proposed penalty rate should distinguish between liquid and illiquid equities. The proposed penalty imposed for “equities and other assets” is 1.00bp daily rate. Even for liquid equities this rate is high. However, for illiquid securities where cash compensation is paid (as the buy-in is not possible as the securities cannot be borrowed) then this rate would accrue for potentially 22 days from the intended settlement date.

The AIC considers that such a penalty regime would disincentivise trading in small caps. [This would arise because there could be fewer or no market makers taking a position for certain small cap securities and because there would be a much wider spread for small caps.

<ESMA\_QUESTION\_TA\_CSDR\_2>

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

<ESMA\_QUESTION\_TA\_CSDR\_3>

ESMA proposes that in the limited circumstances where settlement cannot be performed for reasons that are independent from any of the participants or the CSD, the penalty would not be charged. The AIC **recommends** this proposal be adopted. The consultation on the draft technical advice continues that in order to achieve that exception, it should be possible to reduce the amount of the penalty to zero and the AIC **recommends** that this is adopted. Examples of these occurrences given by ESMA are a suspension of the instrument from trading and settlement due to reconciliation issues, specific corporate actions which imply the instrument no longer exists, or technical impossibilities at the CSD level. The consultation paper continues that in order to prevent abuse, these exemptions should be approved by the Competent Authority, either through approval of the CSD procedures detailing which specific penalties do not apply, or on a case by case basis.

The AIC **recommends** that the Competent Authority is given the ability to define categories when a penalty should not be applied and also given the authority to waive penalties on a case by case basis. The AIC **recommends** that the prevailing illiquidity of the equity should be a category which eliminates the penalty or, failing that, substantially reduce the penalty.

The AIC also **recommends** there should be an exemption for market makers from the daily penalties in much the same way that the Short Selling Regulations EU 236/2012 contained an exemption for market makers as it was recognised that market makers often need to take short positions to perform their role of providing liquidity. The importance of market makers in providing liquidity to the market should not be underestimated. The application of the penalty regime to market makers could lead to market makers ceasing to provide a market in relation to illiquid securities.

In contrast, the disapplication of the penalty regime to market makers could reduce the risk of ramped up share prices discussed in the response to Question 1 below.

Where illiquid securities are concerned and it is known that they cannot be delivered within the buy-in period, the AIC also **recommends** that the “failing participant” should have the ability to trigger the cash compensation earlier rather than waiting for the buy-in period to expire and the penalties to continue to accrue during that period.

<ESMA\_QUESTION\_TA\_CSDR\_3>

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

<ESMA\_QUESTION\_TA\_CSDR\_4>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_TA\_CSDR\_4>

Q5: Do you agree with the proposed frequency of one year for the assessment of the substantial importance of a CSD in another Member State?

<ESMA\_QUESTION\_TA\_CSDR\_5>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_TA\_CSDR\_5>

Q6: What are your views on the proposed indicators?

<ESMA\_QUESTION\_TA\_CSDR\_6>

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<ESMA\_QUESTION\_TA\_CSDR\_6>

Q7: What are your views on the proposed thresholds?

<ESMA\_QUESTION\_TA\_CSDR\_7>

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<ESMA\_QUESTION\_TA\_CSDR\_7>

Q8: Do you believe that the proposed indicators and thresholds are relevant in the case of government bonds? If not, please provide details and arguments.

<ESMA\_QUESTION\_TA\_CSDR\_8>

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<ESMA\_QUESTION\_TA\_CSDR\_8>