**ETF Joint Working Group response to ESMA Consultation Paper**

**Regulatory Technical standards on the CSD Regulation**

**The Operation of the Buy-In Process**

**Introduction**

On behalf of the ETF Joint Working Group, mandated by EPTG (European Post Trading Group) reporting to the European Commission, we welcome an opportunity to comment on the Consultation Paper on Regulatory Technical Standards on CSD Regulation.

We recognize that ESMA is looking to improve settlement discipline and risk associated with failing transactions. It is important to recognize that ETFs are not the same as cash equities and fixed income securities. We would like to take this opportunity to flag the impact this regulation will have on the ETF market if its specifics are not taken into account. In our response we will demonstrate the complexity of the ETF world and why the harmonized OTC buy-ins could harm ETF liquidity, impact spreads and expose investors to higher costs. We are also concerned that the following areas have not been addressed in this consultation, which in our view are important aspects of a mandatory buy-in process:

1. Are liquidity providers who facilitate on and off exchange flow protected?
2. When and under what circumstances can a buy-in extension be granted and who makes this decision?
3. What happens when the CCP is a party in a linked transaction and fails to settle trades?
4. What happens when the ETF Issuer is a party in a linked transaction?
5. What happens when a reposition of shares fails between CSDs?
6. A lack of definition of which instruments are perceived as liquid and illiquid?
7. The RTS does not explain how the price differential between the buy-in price and the original transaction price should flow.
8. A lack of clarity on the reference price calculation when the buy-in execution fails.
9. A lack of clarity on the maximum price they buy in agent can source the shares at.

We do not believe that any of the buy-in options can be successfully implemented without changing the Level 1 text. However, in our view the Option 1 is the least worst while acknowledging the complexity of ETFs and the lack of clarity on implementing the buy-in process.

We hope our response explains well the complexity of the ETF market. We are at ESMA’s disposal should more information on ETF structures be required.

**Q1: Please provide evidence of how placing the responsibility for the buy-in on the trading party will ensure the buy-in requirements are effectively applied.**

**Please provide quantitative cost-benefit elements to sustain your arguments.**

The group recognizes ESMA’s effort to support settlement efficiency. In our view, if buy-in at trading level is implemented, there must be a structured communication which allows tracking any outstanding buy-in executions. The communication between the parties involved in the buy-in process is very important and the lack of it might cause uncertainty in estimating portfolio exposure especially when the cash compensation is to be processed. We support the settlement discipline at CCP level which in our view should also be harmonized and is currently not the case. We would like to flag that a number of OTC trades can already be cleared via CCP through the block trade facility or services provided by trading venues should the OTC counterparty be concerned about a potential fail.

We believe that the operational workload and increased buy-in risk that this regulation will impose on trading parties is significant and ESMA should not underestimate this. The group believes that the settlement fines imposed by European CSDs already enforce a settlement discipline and extending this to OTC trades could improve settlement rates without introducing significant costs and operational complexity.

The group is also concerned about the lack of clarity on the proposed buy-in rules and not providing guidance which instruments are perceived to have a low liquidity. We also believe that it is very important to consider not only a liquidity of a product but also a product type when deciding what extension period should be granted. The European ETF market is very complex and we believe that ESMA should consider this before trying to implement one rule that fits all. Examples of issues faced by investors and market makers providing ETFs liquidity on exchange and off exchange are listed below (the below list is not exhaustive)

1. ETFs cannot be created/redeemed around the clock due to primary market cut off times and fund holidays caused by local bank holidays or a closure of underlying components. In certain cases funds are closed for a number of days, e.g. Chinese Bank Holiday, Greece bailout talks.
2. ETFs tracking Indices with Asian components can only be created with an additional one day delay as Asian markets are already closed.
3. To access the ETF primary market, the market participant needs to be approved by the ETF issuer or has to place an order via third party which is approved. This can cause natural delays.
4. ETFs are listed across all European exchanges and the reposition of product between various European CSDs can be time consuming. The group recognizes efficiencies that T2S will bring but we would like to flag that not all European markets are part of T2S and therefore market participants will continue to experience delays in moving shares between European CSDs.
5. ETF lending market is not liquid and therefore liquidity providers will be forced to carry larger inventory to ensure they can cover potential buy-in risk. This again would impact costs and spreads offered to clients.
6. OTC trades could be executed on the back of exchange trades and since CCPs are excluded and costs cannot be passed back to them, market participants will be forced to look for additional cover if an exchange trade doesn’t settle on time. As explained in points a, b, c and d this is not straight forward.

Investors and market participants will also carry a costly burden of ensuring that legal agreements are revised to reflect the new regulation.

**Q2: Please indicate whether the assumption that the trading party has all the information required to apply the buy in would be correct, in particular in cases where the fail does not originate from the trading party, but would rather be due to a lack of securities held by one of the intermediaries within the chain.**

The ETF market relies on a number of parties such as ETF Providers, CCPs, market makers, local agents, brokers, official liquidity providers and CSDs. The below points aim to summarize the ETF structure and justify the need for a seven day extension for ETF products in order to protect ETF market liquidity and ETF investors.

1. ETFs issuers set-up ETFs tracking various benchmarks.
2. ETF can hold stocks, bonds, commodities, currencies or be based on the swap.
3. The underlying asset (basket of securities/cash) must be traded and delivered to the ETF issuer before new ETFs units are issued in the primary market.
4. The secondary market trades, executed on-exchange and off-exchange, can settle when there is enough shares in circulation.
5. On average it takes between two to three days to settle the primary market order.
6. Only authorized participants (AP), such as market makers and banks can enter into agreements with the ETFs issuers, which gives them a direct access to create and redeem ETF units.
7. The majority of European ETFs are cross listed on other European exchanges and trading venues.
8. It takes between two to three days to move shares between various CSDs.
9. ETFs cannot be borrowed as easily as stocks and bonds and lending pools remain quite low.
10. ETFs offer investors the ability to assemble a low cost portfolio and are the fast growing market

Based on the information published by ECSDA it is difficult to estimate the fail ratio on ETFs compared to other classes as not all European CSDs publish the fail data for this asset type. In the context of a data-gathering exercise on fails performed in February 2015 by ECSDA, only three CSDs provided separate figures for ETFs, which suggests that the fail rate for ETFs is higher than that of equities. We understand that the sample of CSDs is too small to fully estimate the ETFs fail ratio at European level.

We have also gathered feedback from a number of ETF market makers who confirmed that the fragmentation of the ETF market affects settlement ratios on their side and they believe this should be taken into account by giving a seven day extension for the whole ETF universe.

We agree that a trading party will know the counterparty it has dealt with but will not always know who is on the back of that trade, e.g. CCP. In our view it is very important to consider the linked transactions taking place in the ETF space as not taking this into account will harm liquidity and spreads.

The below scenarios summarize the type of linked transactions that ETF market participants deal with.

1. Market maker (MM) bought shares from an exchange and sells them to an investor a day later. If the CCP does not deliver the shares on time, which is possible as not all buy-ins are executed on S+4, then investor would issue the MM with a buy in notice. MM would be therefore penalized if the buy-in was executed and would need to look for additional cover which as explained earlier is not always possible. In our view the exclusion of CCPs from this process will further fragment the settlement process and impose costly burden on liquidity providers.

Market Maker

Investor

**CCP**

1. An investor bought securities from a MM and the MM placed a creation order with the ETF issuer. If the MM cannot place a creation order on the same day he sold shares to the investor and a day later the fund primary market is closed, due to a local Bank Holiday or underlying ETF components not trading, then the MM could be exposed to buy-in risk.

We believe that the nature of ETFs primary market should be considered. It is also unclear if a MM can issue ETF provider with a buy in notice and what would happen if a redemption order did not settle on time. We think additional clarity on this point is required.

Market Maker

ETF Issuer

Investor

1. Market participants are providing liquidity on and off exchange and it is important to stress that trades with a CCP are automatically prioritized by CSD participants. The below graph illustrates a case where a market participant bought shares from an exchange (CCP cleared) and sold them to a client on day 1. On day 4 the same market participant, who is obliged to provide on-exchange liquidity, sells shares on the exchange. If the CCP did not deliver shares on S+2 basis (in this case day 3) there is a high probability that the CPP will automatically net trades executed on day 1 and day 4 and the market participant will need to look for an alternative cover. We would like to emphasize again that the primary market has various cut offs and a market participant might not be able to create shares as quickly as he wish he could.

**Day 1 Day 1 Day 4 Day 4**

CCP

CCP

Market Maker

Market Maker

Investor

ETF Issuer

1. ETF market participant’s trade across a number of European trading venues and in order to settle their deliveries they have to move shares between various markets (reposition process). We believe it is important to flag that in some cases it takes two to three days to settle a reposition since the mark up mark down process is required. It is quite unclear who trading parties could pass the costs to if a reposition did not settle on time. In our view a selling party would be penalized for an unavoidable complexity of the ETF market.
2. Broker A bought securities from Broker B, broker B bought securities from Broker C and Broker C bought securities from broker D. If all these transactions are executed on the same day then there is a risk that each of the parties will look for an alternative cover shall the broker D fail and trigger a number of buy in notices. Our concern is that this could impact the ETF price as inflated demand will be triggered by buy-in notices and brokers trying to reduce a cost of potential buy-in.

**Q3: Should you believe that the collateralisation costs attached to this option are significant, please provide detailed quantitative data to estimate the exact costs and please explain why a participant would need to collateralise its settlement instructions under this option.**

We believe that the collateralization of OTC trades as part of the new buy in regime would be extremely difficult in cases where a linked ETF transaction involves a number of parties and CSDs. We recognize that this process is managed well by CCP’s, however on exchange and off exchange markets can’t be compared alike.

In our view it is unclear how the failing participant, who acts as an intermediary between trading parties, can ensure that a buy in action was initiated and how they are supposed to manage that risk. We are also unsure how collateral movements are to be instructed without supporting infrastructure.

We would also like to stress that receiving cash compensation, and implementing a buy-in rule which allows it, will significantly impact the portfolio management process as portfolios could become imbalanced when a trading party receives cash instead of securities. In our view it is important to ensure that buy-in rules are clearly defined to ensure they do not harm the receiving party who has hedged its portfolio when the original trade was executed.

**Q4: If you believe that option 1 (trading party executes the buy-in) can ensure the applicability of the buy-in provisions are effectively applied, please explain why and what are the disadvantages of the proposed option 2 (trading party executes the buy-in with participant as fall back) compared to option 1, or please evidence the higher costs that option 2 would incur. Please provide details of these costs.**

Option 1 could work if there is a robust framework in place which can support this process and products specifics are taken into account. We support discipline implemented at the CCP level and we would like to stress again that some CCPs allow market participants to net trades across a number of days which would not be the case for OTC transactions when the mandatory buy-in regime is implemented.

In our view Option 1 is better than Option 2 as the CSD participant does not always have a direct relationship with all trading parties and in many cases it would be impossible to allocate cash compensation within a short time frame. Until the CSD participant can allocate cash compensation and close down the risk it is exposed to, the need for collateral would be justified. We would also like to stress that the CSD participant would not always be able to pass cash compensations in a linked transaction when one trading party is outside of EU, is a CCP or if the ETF provider itself is a party that failed or the trading party failed to.

**Q5: Please provide detailed quantitative evidence of the costs associated with the participant being fully responsible for the buy in process and on the methodology used to estimate these costs.**

In our view option 2 and option 3 would trigger a similar collateral requirement. We also believe due to OTC trades not being netted in the same way as CCP trades are, the collateral requirement that trading parties would need to place could be overestimated. In our view both options, 2 and 3, demonstrate that the impact of the proposed buy-in regime is very significant and impacts all market participants.

We are not in a position to provide collateral estimates due to the length of the consultation period.