PEEL HUNT

ESMA
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07
France

22 May 2014

Dear Sir or Madam

Re: CSDR Discussion Paper

Introduction & Summary

We are writing in response to your discussion paper titled: Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSDs). Our response is specifically directed at questions 13 to 19 and focuses on our concerns that less liquid securities could be adversely affected by both a reduction in the liquidity of those securities and an increase in their vulnerability to market abuse.

These concerns are similar to those that were raised and subsequently mitigated at a late stage of the implementation of the Short Selling Regulation ("SSR"). Our letter summarises the concerns identified at the time of SSR and articulates our current concerns with the risks posed by CSDR. We believe that providing less liquid securities with an extension to the settlement period of ISD+7 days would be effective in allaying those concerns and facilitating a smooth and orderly market in those instruments. Our responses to Questions 13-19 are set out in Appendix 1.

About Peel Hunt

Peel Hunt is an independent and full-service broking house with an exclusive focus on UK Mid and Small Cap equities. We offer the following services: corporate, research, sales, sales trading, market making and fixed income.

The corporate department at Peel Hunt offers corporate broking, corporate finance and M&A advisory services to our clients. Our corporate department is highly regarded as one of the leading corporate houses in the UK Mid and Small Cap market. The team has acted on numerous equity and advisory mandates, raising in excess of £2.4bn of new capital for our clients since 2008.

Our team of market makers are registered market makers in over 2,000 traded stocks. As a London Stock Exchange ("LSE") registered market maker Peel Hunt is required, under the rules of the LSE, to provide constant two-way pricing/liquidity to LSE member firms during market hours. This liquidity facilitates a vibrant, sustainable and stable market which is necessary for the growth of small and medium sized enterprises. Peel Hunt's is regularly ranked as a top market maker in London with our activities accounting for over 4% of all trading on the LSE, executing between 25-30,000 trades per day on average.

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Short Selling Regulation

SSR provided Markets Makers with an exemption to articles 5, 6, 7, 12, 13 and 14. This was important as it recognised the function and role of market makers in providing liquidity and facilitating orderly markets.

SSR did not, however, exempt MMs from the buy-in provisions of Article 15

"1. A central counterparty in a member state that provides services for clearing shares shall ensure that procedures are in place which comply with the following requirements: (a) where a natural or legal person who sells shares is not able to deliver the shares for settlement within four business days after the day on which settlements is due ("ISD+4"), procedures are automatically triggered for the buy-in of the shares to ensure delivery for settlement;"

In response to SSR the London Clearing House ("LCH") initially determined that it would, in all instances, "automatically trigger buy-in" on ISD+4. However, after further consultation with the LSE, FSA and Market Participants it was recognised that proposed approach to the regulation presented a risk to the liquidity and maintenance of an orderly market in UK Small and Mid Cap equities. In recognition of the unintended consequences this approach would have on market liquidity and Small and Mid Cap companies' ability to access liquid Capital Markets as a source of funding; the LCH adapted its approach to:

> *"All clearing members will be subject to the regulation to initiate the buy-in process on ISD+4, with buy-in execution on ISD+5.*
>
> *An exception has been made for registered Market Makers in market-making activity in Smaller Cap securities, whereby buy-in execution will commence on ISD+11 and a reduced failed settlement charge will apply."*

This clear recognition of the risks to less liquid securities and the extent to which market makers contribute to maintaining liquidity of those securities ensured that smooth and orderly markets were maintained post implementation of SSR.

CSDR

We are concerned that CSDR will have a material, adverse impact on the liquidity of Small and Mid Cap equity markets (particularly stocks which do not currently meet the criteria set in Article 22 of the MiFID implementing regulation No 1287/2006). Reduced liquidity and potential for Market Makers to be the victim of Market Abuse may lead to their withdrawal from committed liquidity provision in these stocks. The consequence of such action would have a serious impact, not only on those Small and Medium companies already listed, but those looking to the equity markets as a viable source of funding.

> **Loss of liquidity** - In less liquid securities the concept of a buy in on ISD+4 will serve to reduce liquidity in those securities and, consequently, have an adverse impact on the price of those securities. Currently London Stock Exchange ("LSE") registered market makers have an obligation to provide 2 way prices in the Exchange Market Size, in the securities in which they are registered to make markets. This obligation means that where there is an imbalance of buyers and sellers in an illiquid security, a market maker can be taken short of a security with no

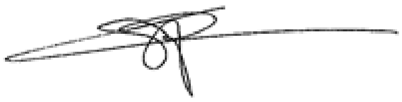
immediate ability to flatten their position and subsequently "bought in". Unlike Large Cap stocks there is not an active stock lending market to complement Market Maker provision of liquidity.

Market Abuse – Following on from the above example and taking it a step further, if there is no stock-borrow available in a security, it provides the opportunity for any person to ramp the shares of a less liquid instrument by continually purchasing stock from one, or more, market makers with the net effect, and purpose of, taking them short and causing them to be bought in or "cashed-out". Under CSDR and LSE rules a Market Maker will have no way to avoid this is as it obligated to provide continuous 2 way pricing during market hours.

In summary, we are concerned that the unintended consequences of CSDR will be a reduction in the liquidity of Small and Mid Cap securities and an increase in their vulnerability to market abuse. We believe this is a significant risk not only to current listed companies, but to all Small and Medium enterprise companies who are increasingly utilising equity markets as an alternative source of funding to bank loans and debt markets.

We would welcome the opportunity to discuss our views on the potential impact of the regulations with you further.

Yours faithfully



Steven Fine
Managing Partner

Appendix 1

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

A response from Peel Hunt LLP

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?

Peel Hunt has no specific comment on asset types.

More important is the definition of liquidity and we welcome ESMA's recognition (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 agree that ESMA should take account of 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.

In addition to the criteria noted above, we consider that ESMA should take into account one or both of the following additional elements in determining the liquidity of a particular share and therefore the appropriate length of buy in period:

1. Article 22 of the MiFID implementing regulation No 1287/2006 defines a liquid share if the share is traded daily with a free float not less than EUR 500 million, and one of the following conditions are satisfied:

    a. The average daily number of transactions in the share is not less than 500; and

    b. The average daily turnover for the share is not less than EUR 2 million.

2. The extent to which the particular share in the relevant quantity is easy to borrow or purchase or can be made available for settlement in due time taking into account the market conditions and other information available on the supply of shares. In relation to this, we suggest that ESMA has regard to the "locate rules" in Article 6 of the Short-Selling implementing regulation No 827/2012, adopting technical standards provided by ESMA, which deals with the types of agreements, arrangements and measures to adequately ensure that shares are available for settlement.

Appendix 1

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?

Assuming liquid products are defined in keeping with points 1 & 2 in our response to Question 13 (above) we would find a buy-in execution period of 4 business days acceptable for liquid products.

With regard to the length of the buy-in mechanism we believe that the key factor in considering a buy-in should be the quantum of the trade in contrast to the average daily volume. While 4 business days for liquid products seems reasonable there may be circumstances where that is not appropriate if, for example, the volume of the buy-in exceeds the average daily volume of shares traded in that security i.e. the buy-in activity would, on average exceed 25% of trading activity during the course of the 4 day buy-in period.

Following on from this, we do not believe that buy-in activity should ever exceed more than [25%] of the daily volume of a security and that the ADV of as security should be a key factor in determining the buy-in period.

We believe it important that those responsible for calibrating the buy-in conventions should take account of the following considerations in respect of the buy-in mechanism as follows:

- How long does the firm have to execute the buy-in?
- What is the deadline for parties to opt to be paid cash compensation or defer the buy-in?
- How long is the extension period after a failed buy-in?
- What is the method for the buy-in process?
- What happens in the case of a partial buy-in?

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?

An important consideration linked to the liquidity of a financial instrument is the available “free float”. We believe that a minimum “free float” threshold should be set below which a buy-in should be deemed not possible. We suggest a minimum of 40 per cent free float would be an appropriate figure.

We are concerned that, unless explicitly catered for in the technical standard, securities with a limited “free float” regime will be at significant risk of market manipulation and abuse as there is no active stock lending market in those less liquid securities. If not catered for, this will provide a platform for participants to deliberately ramp the shares of a less liquid instrument by continually purchasing stock from one, or more, counterparty with the net effect, and purpose of, taking them short and causing them to be bought in or “cashed-out”. This “Abusive squeeze” will have significant upward price pressure in a security. The opportunity for a cash settlement following a failed buy in will thus allow the abuse of markets in less liquid securities for financial gain. We believe that this will act as a significant disincentive to investors, market makers and liquidity providers alike.

Further, we believe that it would not be prudent to affect a buy –in if the total volume of buy-in exceeds 25% of the average daily volume of the security for the duration of the buy-in period.

Finally, we would consider it beneficial if buy-ins were coordinated to ensure only those that have caused a chain of settlement failure are bought in. This should swerve to ensure that participants who have a “flat position” but are awaiting delivery from a failing party are not unduly penalised. We have elaborated further on this in our below response to Question 16.

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

Failure to deliver stock can often be as a result of a chain of market participants. We believe that the CSD should not fine those participants who are “flat” from a matched settlement position (that is where the settlement position on both the buy and sell side in a particular stock are the same) but instead the firm that is causing the chain of failed deliveries.

As also noted in response to Question 15, we believe that it would not be prudent (effective) to affect a buy –in if the total volume of buy-in exceeds 25% of the average daily volume of the security for the duration of the buy-in period.

Given that Article 7(2) of the CSDR makes clear that cash penalties shall not be configured as revenue source for the CSD we believe that this is further reason why the buying-in regime should focus on the ultimate cause of the settlement failure. We believe that it is important that the Technical Standards clearly communicate this message to the CSDs.

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

We believe that the reference price should be the last market price before the buy-in would have taken place i.e. prior to the initiation of the buy-in process as this avoids any impact that the buy-in process may have on the price (and also prevents any potential market abuse or market manipulation as outlined in our response to Question 15 above).

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?

SSR acknowledges the important role that market makers play in the market through their provision of consistent liquidity. As such, SSR explicitly prevents market makers being subject to suspension. We believe a continuation of this is necessary to facility orderly, liquid markets.

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

As set out in our response to Question 16 above, we believe that the CSD should take into account those participants who are “flat” in a particular stock and focus on those firms that are ultimately causing the failed deliveries.

There is a need for both quantitative and qualitative analysis/thresholds so that, for example, account is taken of those market participants who deal predominantly in less liquid securities.