Winterflood
SECURITIES

[Via online submission]

5th August 2015

Dear Sirs,

We write in response to your recent Consultation on Draft Regulatory Technical Standards on the CSD Regulation. Winterflood Securities Limited ("Winterflood") is a market maker, providing liquidity across a range of UK and European equities and fixed income instruments. Winterflood is a specialist in making markets in small and medium sized quoted companies, such as those traded on the UK's AIM market and less liquid regulated market equities. Winterflood has engaged with ESMA with regard to CSDR at every available opportunity in order to share its experience of these markets and outline the effects the proposed technical standards will have on the efficiency of these unique markets.

In reviewing the recent consultation we found that the overwhelming majority of our trading was unaffected by the specific questions posed in the consultation due to it being executed either against a CCP and/or under the rules of a regulated market or MTF. We have thus decided not to respond to the specific questions raised in the consultation. We have, however, identified one element of the draft technical standards, copied below, that we feel does not present a true reflection of the market and so should be amended to prevent unintended negative consequences.

Article 15(4) states - "*The buy-in is deemed to be impossible only when the relevant securities do not exist any longer as a result of the actions taken by the issuer of such securities. In such case, the receiving party or participant shall receive the cash compensation.*

For transactions cleared by a CCP, the CCP shall transfer the received cash compensation to the receiving clearing member."

We feel that this statement is inaccurate and does not provide buying in parties, namely Trading Venues, CCPs and CSDs, adequate scope to ensure appropriate operation of the buy-in mechanism. We note that paragraph 56 of your Discussion paper ESMA/2014/299 states:

*Article 7(7) envisages the possibility that a buy-in "fails or is not possible", in which case "the receiving participant can choose to be paid a cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period')". **There may be instances where the CCP, trading venue operator or CSD know in advance that the buy-in cannot be executed by the relevant term because the securities to be bought-in are illiquid and, as a consequence, objectively unavailable**. Even more so, a buy-in should be deemed not possible when the securities to be delivered cease to exist, including because the maturity is reached, during the extension period. **ESMA is of the opinion that it should be left to each CCP, trading venue or CSD to decide on the buy-in feasibility**, taking into account the parameters to be established in the RTS such as the characteristics of the securities to be bought-in and the relevant contracts/transactions. The decision should be preceded of competent authorities approval and therefore be sent for the CSD supervisors in advance.*

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We believe, as ESMA did in their earlier Discussion paper, that there are a broad range of logical, structural and liquidity based reasons why a buy-in may not be possible. We also note that the prospect of settlement deferral is excluded from the article where we feel it should be referenced.

It is our opinion that the proposed wording will be extremely harmful to the market for less liquid securities, with that harm increasing as liquidity decreases. The regime will thus disproportionately impact markets for the smallest of issuers. If the proposed wording is implemented as drafted then failed settlement in securities where all parties know that buy-in is impossible will be entered into the process unnecessarily. This process will have the following effects:-

- Create unnecessary administration and bureaucracy given the shared acceptance that the buy-in will fail.
- Economically penalise market makers who have been required under their market making obligations to short sell against their quotes by requiring them to pay any relevant buy-in fees.
- Additional cost/risk will be passed on either through the reduction in offered liquidity or a widening in bid offer spreads, neither of which are desirable outcomes for the market.
- Potentially prevent the use of deferral, by failing to include it within the text, to the detriment of investors wishing to receive their shares rather than cash compensation, in spite of the delay.
- Enhance the potential for market abuse in less liquid securities.

The final bullet is a point we have made consistently throughout the various consultations. The mechanism as designed is likely to act as a catalyst to 'short squeeze' situations. In these circumstances the price of less liquid securities increases as parties such as market makers with legitimate short positions seek to close out those positions at increasingly higher prices to avoid financial the penalties associated with CSDR. The requirement to pay buy-in fees in circumstances where buy-in is not possible, as acknowledged in ESMA's earlier consultation, only increases the effect of this scenario.

This situation has historically been open to abuse where parties purchase illiquid securities and then express continued buying interest, this imbalance of supply and demand forcing prices up as participants seek to close their positions and cut their losses. Under the CSDR proposals the presence of the settlement discipline and fining regime will increase the share price without additional input from the abuser. The individual will then receive cash compensation when the trade and buy-in fail. As the only input here is a simple purchase it seems unlikely that the pattern will be easily identifiable to investment firms, trading venues and competent authorities alike. The proposals thus creates the risk of undermining the market for smaller issuer's securities.

Our previous submissions have highlighted this risk with our proposals being to:-

- Be clearer on where deferral of cash compensation is possible;
- Allow venues and competent authorities to agree securities where buy-in will be impossible; and
- Disapply daily fines during the deferral period.

We note ESMA's view in paragraph 87 of the Consultation ESMA/2014/1563 that a case by case assessment of the possibility of buy-in would be impractical. While we understand this concern it would appear illogical to undermine the effectiveness of the market due to an administrative requirement that is yet to be applied.

We would propose that the text be amended to reflect the following:-

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Article 7 (7) - The buy-in is deemed to be impossible in the following circumstances:-

- *Where relevant securities do not exist any longer as a result of the actions taken by the issuer of such securities;*
- *Where trading has been suspended on the primary trading venue for the security;*
- *Where settlement has been suspended on the primary CSD for the security;*
- *Where the primary trading venue and the relevant Competent Authority agree that the security cannot be bought-in;[See note below]*
- *Where the execution of all buy-in attempts in the security by the relevant trading venue, CSD or CCP in the prior calendar month have failed; or*
- Where, during the Extension period, the security has not traded on the primary trading venue in at least 10 times the quantity to be bought-in.

In any such case, the receiving party or participant shall decide whether to receive cash compensation or opt for deferral with the consent of the delivering party.

For transactions cleared by a CCP, the CCP shall transfer the received cash compensation to the receiving clearing member.

With regard to the trading venue and Competent Authority agreeing that buy in is not possible, this would be a pre agreed list identifying securities that are publicly traded, subject to the regime but are structurally unlikely to be successfully bought in. Examples would include UK Venture Capital Trusts where tax treatments require the share to be held for 5 years to obtain tax benefits. While there remains a public quote, trading is heavily restricted. This sector would thus be a prime target for abusive squeezes.

We feel the provisions above provide a more suitable compromise between the need to calibrate the regime effectively to and the need to provide certainty and reduce administration and delay.

We are certain that the proposals as written will have unnecessary and unintended negative consequences for the markets in small and medium sized quoted companies. Given the commissions recent discussions around Capital Markets Union and MiFID II's attempts to establish SME growth markets to open capital markets to smaller issuers we feel this would be contrary to the spirit and intention of the regulation.

We remain available for discussion with you on this matter at your convenience.

Yours Faithfully

James Stapleton
Associate Director