Regulatory technical standards on the CSD Regulation: The operation of the buy-in process

AIC submission

The Association of Investment Companies (AIC) represents some 350 closed-ended investment companies with assets under management of over £120 billion. Investment companies have their shares admitted to trading on public stock markets. The AIC's members are predominantly listed on the main market of the London Stock Exchange.

The AIC's members include UK investment trusts, Venture Capital Trusts (VCTs), UK REITs and non-EU companies.

As we explained in our earlier submissions made in February 2015 on the draft regulatory technical standards (RTS) and technical advice on the CSDR, the liquidity of investment company shares varies enormously. 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 67 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 these shares are not available to be borrowed. Market makers customarily provide immediate liquidity and the VCTs themselves often purchase their own shares to provide a "backstop" exit for investors who wish to sell their shares.

The AIC has previously expressed concern in its earlier submissions on the CSDR that mandatory buy-ins could lead to:

- Potential market abuse in relation to illiquid securities, giving rise to a disorderly market,
- Increased bid-offer spreads for illiquid securities resulting in a buyer paying more than the true value of the securities or a seller receiving less for the securities than their true value. This will affect the integrity of the financial markets,
- Increased volatility for investors which will be another deterrent for investors in publicly traded investment companies,
- Market makers of illiquid securities ceasing to make a market in those securities, thus further reducing the liquidity of those shares.

Ensuring the regime does not inadvertently reduce liquidity within the sector, or create other issues, for example, wider spreads or the withdrawal of market makers, remains a priority for the AIC.

The AIC believes that the implementation of a mandatory buy-in process will have a significant impact on the market. It may increase costs for firms and add to the burden of achieving regulatory compliance and ensuring an appropriate and effective contractual framework. This will arise from an expected increase in the number of buy-ins and the resulting consequences for market pricing and liquidity.

The AIC welcomes the fact that there is a further ESMA consultation on the operation of the buy-in process. ESMA's paper sets out three possible options for the implementation of the buy-in process, setting out the strengths and weaknesses of each option. The AIC welcomes the reference to the objectives of the Capital Markets Union in the consultation paper and **recommends** that the mandatory buy-in process be reconsidered in the light of these objectives.

Whichever option is adopted, the AIC remains concerned that the RTS risks being too restrictive in its determination of when a buy-in is ineffective. The AIC **recommends** that the scope of the RTS should be expanded beyond securities lending and repo transactions to address a lack of liquidity of the equities.

Finally, the AIC **recommends** that whatever option ESMA decides to implement, the process should be consistent with other legislation ESMA is implementing such as EMIR in respect of CCPs and MiFID II in respect of trading platforms and instruments. The implementation timeframe should provide sufficient time for market participants to prepare for all of these changes.

August 2015

To discuss the issues raised in this paper please contact:

Janette Sawden, Tax and Legal Adviser
janette.sawden@theaic.co.uk, 020 7282 5565