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

6th August 2015

Consultation on Technical Standards on the CSD Regulation. The Operation of the Buy-in Process dated 30th June 2015.

Dear Sirs,

We are pleased to provide a response to the above consultation paper on behalf of the International Securities Lending Association ("ISLA"). Given the focus of our association on the securities lending market we have restricted our comments to specific questions which apply to provisions that are of relevance to our members. More broadly we have consulted with the International Capital Market Association (ICMA) and the Association for Financial Markets Europe (AFME) and fully endorse their positions.

Securities lending is a technique employed by long term investors such as pension funds, insurance companies and mutual funds as a means of generating incremental returns on portfolios. Securities loans are fully collateralised and conducted within a well-established legal framework. Banks and prudentially regulated broker dealers provide the market for securities lending by acting as principal intermediaries, borrowing securities from long term investors and using or on-lending them for a variety of purposes, including facilitating market making and trading strategies such as covered short selling. Securities lending activity is acknowledged as adding to secondary market efficiency which benefits all users of the capital markets.

In relation to the CSDR, securities lending also plays an important role in ensuring that transactions settle in a timely fashion, as investors and intermediaries can borrow securities to enable them to fulfil their delivery obligations. In fact, an assumption being made by regulators is that market participants can remedy a failing transaction and avoid penalties by borrowing securities in the market.

As outlined in our response to ESMA's CSDR technical standards consultation undertaken earlier this year our principal interest in the CSDR is to try and ensure that by implementing measures that achieve the desired market settlement benefits they do not inadvertently discourage investors from participating in securities lending. Investors consider securities lending to be an ancillary investment activity and there is evidence that applying costly settlement penalty regimes can actually serve to deter them from lending their securities.

Executive Summary

The following summarises our main comments, for which more detail is included in the answers to relevant questions and the attached Appendix.

Whilst we support the objective of lowering settlement fail rates within the system, we consider the settlement discipline regime which will be implemented under the CSDR to be operationally highly complex and will increase costs dramatically for all participants (from investors to market makers).

Although the Level 1 text clearly provides for a mandatory buy-in regime of securities lending transactions we continue to be concerned that this system will be disruptive for the securities lending markets and believe that the policy objective of lowering settlement fails would be better met if securities lending was not subject to mandatory buy-ins. Whilst we note that there are mandatory buy-in regimes elsewhere in the world, there are no mainstream markets that we are aware of where the buy-in is applied to a securities lending transaction, rather the buy-in occurs on the cash transaction which the lending transaction may support.

However whilst we fundamentally disagree with the application of mandatory buy-ins to securities lending transactions, in light of the limitations imposed by the Level 1 text, our members favour Option 1 proposed by ESMA with the trading parties being responsible for executing the buy-in, either directly or by appointing agents for the purpose.

We would take this opportunity to elaborate further on the concerns about mandatory buy-ins, in relation to securities lending which we believe will only serve to deter investors from making their securities available to be borrowed.

First investors may be subject to such buy-in risks in the context of securities lending only because they participate in securities lending programs. If they did not lend their securities there would clearly be no risk in relation to securities lending transactions that might fail. Whilst it might be considered that the costs of any such buy-ins might be offset against the revenues from securities lending or passed on to another party, it remains that investors almost universally consider the activity to be ancillary to their core business and any additional complexity can easily deter them.

Second, requiring that a failing securities loan (or loan return) be compulsorily purchased, will remedy the failing transaction and enable settlement to take place, but creates two problems, namely

- it creates an exposure that was never intended to exist, and
- it is not obvious what costs associated with the resultant market exposure created can be reasonably passed to the party that is failing to deliver.

Thirdly the CSDR regime provides for cash compensation where for whatever reasons the buy-in cannot be executed in the market. This could be highly problematic from a securities lending perspective. Where an investor recalls securities typically for reasons other than to execute a sale (e.g. risk management or corporate governance issues) a failing securities loan return here could result in a buy-in which in turn could lead to the failed to party receiving a cash equivalent if they or their agent cannot execute a buy-in. In this scenario the original investor now holds cash and consequently no longer has exposure to the original bonds. To remedy this it must try to purchase the bonds in the market and is therefore exposed to market risk (as the price of the bonds may increase, and in addition the investor will be exposed to normal dealing costs). [1]

As an alternative to a cash market purchase, it would be better if the buy-in for a failing securities loan or return was remedied with a replacement loan. We believe that it may be possible to interpret the Level 1 text in this way and this would have the advantage of allowing the settlement failure to be remedied, without creating the additional market exposures and risks associated with a purchased buy-in of the position[2]

With the CSDR regime creating new and potentially significant risks there is a real possibility that the regime will result in serious disruption to markets, as existing participants that supply liquidity by making their securities available for lending may reconsider to what extent they will continue to do so. The same is true for those that provide liquidity through the provision of market making services. Perversely these effects are likely to be greater for less liquid securities where investors will perceive that the risk of being exposed to a buy-in is greater and will therefore avoid lending these in the first place. At a time when general concerns exist about liquidity in secondary markets and when attempts are being made to make European capital markets more attractive as a source of financing, this effect would seem extremely undesirable. Lower liquidity results in higher transactions costs, more risk and volatility for investors which will surely result in less attractive borrowing terms for issuers.

Furthermore issues that we and other associations raised previously regarding the definition and objectives of the buy-in process, the scope of the regime and clarity around definitions relating to

[1] The Appendix to this response provides more details including examples of how the CSDR regime could impact existing trading flows and create additional risk within the system

[2] Please see Appendix for further details.

the term ‘participant’ have yet to be fully addressed. Lack of clarity on these issues within the Level 1 text makes the Level 2 process more complex and time consuming.

While we have already outlined our concerns and the potential implications of bringing securities lending transactions into the remit of the CSDR regime ESMA has also not specified any exceptions relating to settlements of transactions which are not the result of a trading contract. In the context of securities lending a client may choose to recall a security for a variety of reasons (such as for corporate actions management, corporate governance and risk management) that are not linked to a market facing sale or purchase. Similarly collateral movements are unlikely to have a market facing trade behind them.

In light of the above and acknowledging the Level 1 constraints in which ESMA must operate, it is essential that sufficient time be given for implementation of these measures (to allow for the development of procedures and system changes by both market infrastructures and participants) in order to attempt to avoid widespread disruption to the markets. In our last response to ESMA dated 19th February we argued that implementation of the CSDR regime should not occur before the T2S system is fully operational and thought should be given to whether a phased approach from that time would be preferable. Our views have not changed on this point.

We hope that this response is helpful to ESMA in its ongoing work and look forward to working further with you on this matter.

Yours sincerely,

Kevin McNulty
Chief Executive

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Answers to specific questions in the consultation document

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.

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.

Considering the limitations of the Level 1 text our members favour Option 1 with the trading parties being responsible for executing the buy-in, either directly or by appointing agents for the purpose.

As the parties responsible for the buy-in are those that entered into the original transaction they would have ready access to all of the relevant information including the reason for the fail to facilitate an efficient and timely buy-in process.

Although we very much support the view that the trading parties are best placed to execute a buy-in we would point out that most securities lending is undertaken by agents (such as custodian banks). Consequently in the context of securities lending the agent lender and the prime broker may be considered as the trading party, and would in all likelihood perform the buy-in on behalf of their clients (the underlying principals) i.e. beneficial owner lender or PB hedge fund client. We would ask that ESMA consider the practicalities of how the securities lending market operates today by allowing for agents, subject to the implementation of the necessary legal formalities, to undertake buy-ins for and on behalf of either lending or hedge fund clients who chose not to undertake the buy-in process themselves.

We would acknowledge that Option 1 does present certain challenges in respect of extraterritoriality where the failing participant is either not supervised by the relevant National Competent Authority or is using a third country CSD that would not be bound by the CSDR. The absence of any other mandatory buy-in regimes elsewhere in the world in respect of failing securities lending transactions will effectively increase this risk and highlight the divergence of policy in Europe compared with other developed markets. Although Options 2 and 3 offer a more defined and controllable buy-in regime structure by defaulting to a CSD initiated buy-in we believe this only passes the risk from the trading parties to the CSD who itself will have to margin against participants who may be regarded as higher risk from a fails perspective or due to their jurisdiction may not be bound by the CSDR regime.

If a buy-in is applied against a trade fail, then the trading party that is being failed to will always have the information required as to why the trade failed. Where there is a sequence or a chain of transactions that are linked then a failing transaction in the chain can be completely settled with a single buy-in at the end of the chain through a process known as pass-on. This allows the final counterparty in the chain to effectively conclude the buy-in against the failing counterparty in the chain.

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.

Under Option 2 the CSD participant effectively becomes the guarantor of last resort on failing trades. This means that unless the CSD participant is able to guarantee that it can pass on the costs of a buy –in or cash compensation it will have to protect itself against that risk. Most logically this is likely to be by way of collateralisation of any trades that it sends delivery versus payment instructions for.

Precise quantification of incremental costs associated with the CSD's requirement to collateralise exposure will be dependent on several factors including firm specific methodologies used to calculate such risk and the implied cost of sourcing and funding the required collateral. Whilst the details are not necessarily clear at this stage, it is clear that this will lead to increased costs in the settlement system in Europe which will erode its competitive position and attractiveness for both investors and issuers.

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.

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Option 1 is the closest match to the existing buy-in structure in our markets today and although not obligatory at the present time it provides some consistency of approach that would create some certainty and clarity for participants. To comply with the Level 1 text this would need to augmented with the provision of robust contractual framework between the parties.

Although we can understand ESMA's desire for the fall back to the CSD level within Option 2 we would not agree that the risks associated with the participant's obligations on behalf of its clients should effectively be ignored. Our view is very much that participants would look to both manage and mitigate that risk. Collateralisation is the most obvious way to mitigate that risk.

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.

ISLA has deliberately left this blank

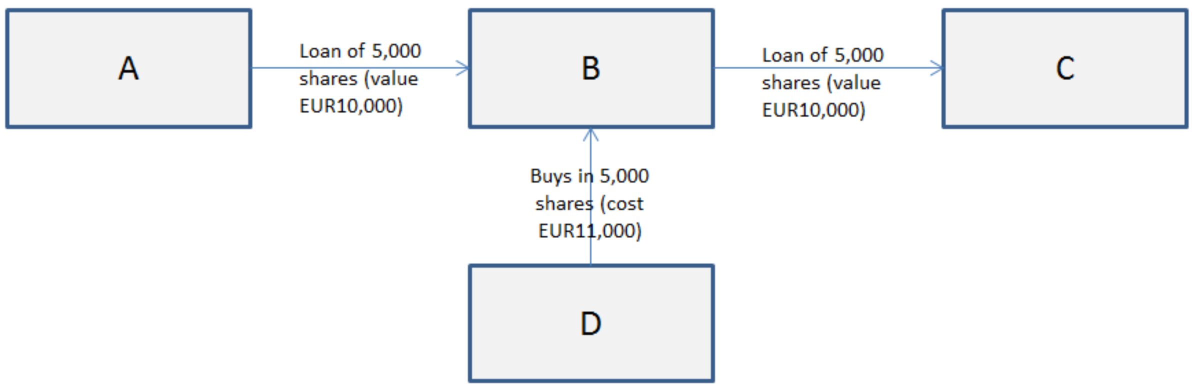
Appendix

Limitations of using buy-ins as a remedy for failing securities loans

Buy-ins are particularly problematic in the context of securities loan transactions. Whilst these generally involve the transfer of title of securities from one party to another, the obligation to return the securities at some date in the future does not create the same economic outcome as if the securities had simply been sold. Requiring that a failing securities loan (or loan return) be compulsorily purchased, will remedy the failing transaction and enable settlement to take place, but creates two problems. Firstly it creates an exposure that was never intended to exist and secondly it is not obvious what costs can be reasonably passed to the party that is failing to deliver .

A simple example illustrates this:-

Example: Buy-in to remedy a failing loan



In this example, A agrees to lend shares to B, who agrees to lend shares to C. Should A fail to deliver the shares and a mandatory buy-in is required, B appoints D to purchase the shares in the market. The loan from A is then cancelled and the delivery to C can take place, remedying the settlement failure.

However, at this point,

- B now owns 5000 shares it had no intention of buying. It must therefore sell the shares in the market to remove this unintended market exposure. Theoretically, it cannot sell the shares (as it has lent them to C) without either borrowing them from elsewhere or recalling them back from C. B had intended to act as an intermediary but is now exposed to a new market risk.
- It is not clear what cost should be passed on to A as a result of the buy-in. If instead of lending 5000 shares, A had sold 5,000 shares to B, then the cost that would be passed on would the difference in cost between the original sale and the buy-in. In the case of a loan,

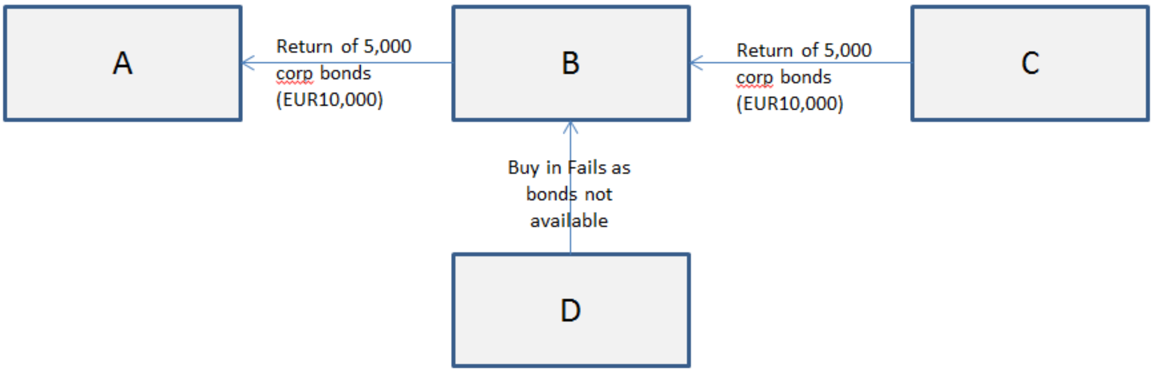
there is no equivalent cost. Should A be exposed to paying the full cost of the buy-in it is highly likely that it will never engage in securities lending.

In other words, in this scenario, CSDR resolves one problem (a failure to deliver) but creates a potentially large and difficult to hedge, market exposure for market participants.

It would be more logical if the remedy for a failing loan or loan return were to be a replacement loan, (in the same way that a failing purchase is remedied by another purchase). This would have the advantage of allowing the settlement to be remedied, without creating the additional market exposures and risks associated with a purchase. We note that there is no definition of "buy-in" in CSDR and therefore ask that consideration be given to including in the definition, the option to allow the receiving party in a loan or loan return transaction to arrange to remedy the fail through a new loan transaction (as an alternative option to an outright purchase).

A further complication for using buy-ins as a remedy for a failing securities loan exists when the buy-in cannot be executed and the situation results in a cash compensation. An example of this follows:-

Example: Buy-in cash compensation to remedy a failing loan return



In this example, C is due to return 5,000 corporate bonds to B, who in turn is due to return them to the original lender A. C fails to deliver to B and at the end of the extension period, B attempts to buy in the bonds from D, however due to lack of bonds in the market the buy-in is unsuccessful. At this point it is determined that rather than receive bonds, B will receive cash compensation in lieu of the delivery and will pass this on to the original lender. The settlement failure is remedied, however:-

- The original investor now holds cash and consequently no longer has exposure to the original bonds. To remedy this it must try to purchase the bonds in the market and is therefore exposed to market risk (as the price of the bonds may increase, and in addition the investor will be exposed to normal dealing costs).

The consequences of this are that investors will reconsider whether they wish to be exposed to such risk and may withdraw from lending, and firms that engage in market making and other forms of intermediation may limit the scope of their activities with knock-on consequences for market making and secondary market liquidity. Importantly the effects of this are likely to be greater for less liquid securities. Notwithstanding the slightly longer extension period allowed for these, this is where participants will perceive the greatest risk.

In this situation it would be highly preferable to allow the investor to allow further extensions to the buy-in and avoid a cash compensation outcome. If this were to happen, the investor retains an economic exposure to the corporate bonds (through the securities lending agreement) on a fully collateralised basis until such time as the bonds are returned. Should the investor wish to sell the bonds it could choose to initiate a cash compensation payment at that point.