SHORE CAPITAL STOCKBROKERS LTD

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European Securities and Markets Authority
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Dear Sirs/Madam,

Central Securities Depository Regulation ("CSDR")

We refer to your Discussion Paper dated 20 March 2014 about CSDR. We set out below our response to questions raised in the Discussion Paper.

By way of background, Shore Capital Stockbrokers Limited ("Shore Capital") is authorised and regulated by the Financial Conduct Authority to conduct investment business in the UK. Shore Capital undertakes broking for predominantly institutional/professional clients and acts as a market-maker in around 1400 UK equities, with a strong presence on the AIM market. Shore Capital is the third largest market maker on the London Stock Exchange. It also provides research in selected UK sectors and provides corporate advisory services for mid and small-cap companies.

<u>Summary of response</u>

We welcome in principle the objective of the European authorities to improve the quality of settlement across the EU. However, we have grave concerns that adopting an unduly restrictive settlement regime could seriously harm the smooth operation of the financial markets for illiquid securities. A strict operation of the buy-in rules could seriously decrease liquidity in the shares of small and medium sized enterprises ("SME's"), in particular where these shares are not listed on a SME growth market. If an unduly restrictive approach to the operation of the "extension period" for illiquid securities is adopted, this could increase the number of settlement fails where it is difficult, or indeed impossible, to obtain shares for buying-in. This is likely to discourage Market Makers (such as Shore Capital) from providing a mechanism that currently guarantees liquidity in these securities. Ultimately, we feel that private clients could be unintentionally disadvantaged by this reduction in liquidity and that the companies whom shares are traded may find it more difficult to raise capital. Furthermore, we believe that the settlement regime proposed could significantly increase the price volatility of illiquid securities particularly at the point in the settlement cycle prior to buy-in occurring.

We would also caution ESMA that an overly restrictive buy-in regime could potentially increase the possibility of market manipulation. Where there is no stock-borrow available in a share, a person could abusively ramp-up the shares of a less liquid security by continuously purchasing stock from Market Makers who are obliged under exchange rules to deal. The

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existence of a "cash out" practice, where a buy-in fails, may serve as a catalyst for market abuse to flourish. We believe that measures designed to prevent abuse should be encouraged rather than an emphasis placed upon the detection of abuse once it has occurred.

The CSDR recognises (in the preamble as well as in Article 17 of the Short Selling Regulation (March 2012)) that market making activities play a crucial role in providing liquidity to markets, especially in less liquid securities. We therefore consider that Market Makers should be excluded from the effects of Article 7(14)(g) which enables participants to be suspended where there is a consistent and systematic failure to deliver shares, otherwise Market Makers may be unfairly penalised for performing an essential function to the market.

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?

As a firm we principally trade equities and we do not therefore have any specific comments on the different asset types to be taken into consideration. Our comments below are in relation to equities.

We consider that the adverse effects of a buying-in regime will result in a significant decrease in liquidity in certain shares and an increase in the number of settlement fails where it can prove difficult to obtain the shares for buying-in. This could result in the de-registration of Market Makers in illiquid securities or the widening of the bid/offer spread. There may be unintended negative consequences of this reduction in liquidity for private clients whom may find trading in such securities considerably more difficult. Furthermore, the ability for listed companies to raise capital in the market may be affected since the ability to adequately trade shares in the secondary market may discourage investment.

Whilst we agree to refer to the criteria for assessing liquidity under Article 2(1)(7a) of MIFIR to justify a longer period for triggering the buy-in process, we consider that ESMA should also take into account both of the following in assessing the liquidity of a particular share:

1. The criteria for assessing liquidity under Article 22 of the MiFID Implementing Regulation No 1287/2006. This provides that, if a share is traded daily with a free float not less than EUR 500 million, and one of the following conditions are satisfied, the share is considered to be sufficiently liquid:

    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. Whether the particular share in the relevant quantity is easy to borrow or purchase or can be made available for settlement taking into account the market conditions and other information available on the supply of shares. We suggest that ESMA refers to the operation of the "locate rules" in Article 6 of the Short-Selling implementing regulation No 827/2012 which deals with the types of agreements, arrangements and measures to adequately ensure that shares are available for settlement.

We consider that, where a share is considered to be illiquid, the extension period should be not less than 7 days (ie the maximum). For Illiquid shares a shorter extension period, would seriously affect the smooth and orderly functioning of the financial markets concerned, as acknowledged by ESMA in the Discussion Paper.

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?

A Proportionate Approach

We consider that ESMA should refer to paragraph 16 of the CSDR preamble when developing guidelines for CSDs on the buy-in procedure. The preamble makes clear that the procedures (and penalties) for settlement fails should be commensurate to the scale and seriousness of such fails, recognising that market-making activities (such as those undertaken by Shore Capital) in particular, play a crucial role in providing liquidity to markets within the Union, especially in less liquid securities.

Approach to penalties

We also consider that ESMA should have regard to the text of Article 7(2) CSDR which provides that the cash penalties referred to in that article shall not be configured as a revenue source for the CSD. ESMA should make clear to CSD's that the person who should be subject to a financial penalty for failure to settle should be those participants who are the original cause of the settlement failure. Participants whose positions are effectively "flat" from a matched settlement position (ie where the settlement position on both the buy and sell side are the same), and so are caught in the middle of a settlement chain, should not be penalised.

Increase in Market Manipulation

We would also caution ESMA that an overly restrictive buy-in regime is likely to increase market manipulation. Currently market makers, such as Shore Capital, have an obligation to provide two 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 share, a market maker can be taken short, with no immediate ability to flatten its position, with the risk of being bought in. If there is no stock-borrow available in a share, there is the ability for any person to abusively ramp-up the shares of a less liquid share by continually purchasing stock from one or more market makers. The opportunity for a cash settlement following a failed buy-in will thus allow the abuse of markets in less liquid shares for financial gain.

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?

We consider that ESMA should stipulate characteristics to suggest where a buy-in should be deemed not possible. We consider that a free float of not less than 40% would be an appropriate figure below which the buy-in process should be deemed not possible. Furthermore, we consider that the process of cash settlement where a buy-in fails to be inappropriate and damaging to the maintenance of orderly markets in illiquid securities.

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

We consider that a buy-in may be ineffective where a corporate event takes place, such as a takeover or delisting, and the timeline for settlement occurs after the security is no longer listed on a Recognised Investment Exchange. We are also concerned that where a listing is not cancelled but a corporate action is in motion there is the opportunity for buy-ins to be

ineffective. Finally, ineffective buy-ins may occur in illiquid securities that are unborrowable and not freely traded because the chance of stock being sourced or delivered for settlement is highly unlikely.

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

We believe that the buy-in process could have an impact on the price of the relevant shares and so could ultimately influence the value of the cash compensation. The reference price of the cash compensation should be the last publicly available price at the trading venue where the trade originally took place, prior to the initiation of the buy-in process.

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?

We consider that a proportionate approach should be taken in setting the conditions under which a participant is deemed to consistently and systematically failing to deliver shares. We would suggest that Market Makers in illiquid shares should be excluded from the effects of Article 7(14)(g) altogether. Indeed, Article 17 of the short selling regulation (March 2012) does recognise exemption for market making activities and primary market operations under certain circumstances.

We have reservations that participants that specialize in illiquid/unborrowable or irregularly traded securities may be perceived to have a relatively poor settlement performance because often this performance is due to other market participants not delivering in a timely fashion and additionally the very nature of the securities in question. Performance records for organisations that do not trade in illiquid securities may be relatively better but this could be achieved by the type of security traded rather than the ability of operations teams to manage the settlement process efficiently.

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

We welcome ESMA's comments that a proportionate approach should be taken in setting the conditions under which a participant is deemed to consistently and systematically fail to deliver shares. We believe that the threshold needs to be the right mechanism so as not to disadvantage Market Makers/brokers in undertaking normal trading activity. We would therefore suggest that Market Makers in illiquid shares should be excluded from the effects of Article 7(14)(g) altogether. Indeed, Article 17 of the short selling regulation (March 2012) does recognise exemptions for market making activities and primary market operations under certain circumstances.

The parameters for monitoring performance will need to take into account all CSDs, where securities settle in more than one location so as not to unduly discriminate or penalise participants where failure is beyond their control or has been incorrectly measured.

Yours sincerely

Simon Fine
Chief Executive