



22 City Road
Finsbury Square
London
EC1Y 2AJ
Tel: +44 (0) 20 7448 7100
Email: info@thewma.co.uk
Web: www.thewma.co.uk

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 the Wealth Management Association¹

The Wealth Management Association (WMA) welcomes the opportunity to respond to this ESMA Discussion Paper. We have focussed in particular on the buying-in aspects (Questions 13-19 of the Discussion Paper) in view of the vital and unique role that market makers (referred to in the UK retail market as Retail Service Providers) play in the UK in providing electronic quotation and dealing facilities to UK retail brokers. The attached explanatory note provides further background on the importance of the UK RSP Model.

Question 4: Do you share ESMA's view that matching should be compulsory and fields standardised as proposed?

Yes, matching should be compulsory and we have no comment on the proposed standardised fields.

¹ The Wealth Management Association (formerly the Association of Private Client Investment Managers and Stockbrokers - APCIMS) is a trade association representing 183 Wealth Management firms and Associate Members. With formal contracted client relationships our firms deal in stocks and shares and other financial instruments for individuals, trusts and charities and offer a range of services across a spectrum spanning execution only through to full discretionary services.

Our member firms act for over 4 million private investors and carry out around 20 million transactions a year in the marketplace. Our members also manage £600 billion of wealth in the UK, Ireland, Channel Islands and Isle of Man, operate across more than 580 sites and employ approximately 32 000 staff.

Our aim is to ensure that any changes including operational, regulatory, tax and other business matters across Europe and the rest of the world are appropriate and proportionate for our wealth management community and, most importantly, their clients.

Incentives for early input of settlement instructions

Question 5: Do you agree with the above proposals? What kind of disincentives (other than monetary incentives such as discounts on matching fees) might be envisaged and under which product scope?

CSDs such as Euroclear already have matching and settlement discipline regimes in place to help to ensure efficient input, matching and settlement of transactions in the CREST system is maintained at a high level. WMA believes that this is an adequate mechanism to disincentivise inefficient processing of transactions.

Lending facilities

Question 8: Do you agree with this view? If not please elaborate on how such arrangements could be designed and include the relevant data to estimate the costs and benefits associated with such arrangements. Comments are also welcome on whether ESMA should provide for a framework on lending facilities where offered by CSDs.

We understand that existing centralised lending facilities are available but they are not necessarily cost-effective, particularly in respect of less liquid securities. Such facilities whilst made available should be optional to use by the relevant market counterparties.

Buy-in mechanism

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?

The WMA has no specific comment on asset types as the vast majority of our members' trades are equities.

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:

- 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.
- 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.

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?

Whoever has responsibility for setting the market norms should take account of a number of issues 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 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 a narrowly focussed regime will potentially increase market manipulation and abuse in those less liquid stocks where there is not an active stock lending market. This will be caused by a participant deliberately ramping 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 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. This will act as a significant disincentive to investors, market makers and liquidity providers alike.

It will be important for Competent Authorities to monitor this closely.

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.

Given that Article 7(2) of the CSDR makes clear that cash penalties shall not be configured as a 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. It is important that this is clearly mandated by ESMA 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?

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

As previously highlighted market makers play a crucial role in ensuring that retail investors are able to trade their shares quickly and efficiently and at minimum cost. WMA believes therefore that the CSD Regulation should mirror the Short Selling Regulation and in particular Article 20(3) which provides for exceptions for those such as market makers from the ability of a competent authority to prohibit or impose conditions in respect of short selling. Recital 26 of that Regulation also recognises that:

“Market making activities play a crucial role in providing liquidity to markets within the Union and market makers need to take short positions to perform that role. Imposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the Union markets. Furthermore market makers would not be expected to take significant short positions except for very brief periods. It is therefore appropriate to exempt natural or legal persons involved in such activities from the requirements which could impair their ability to perform such a function and therefore adversely affect the Union markets.”

WMA believes that ESMA should take the above into account and ensure that, in view of their crucial role, market makers would not be subject to suspension.

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.

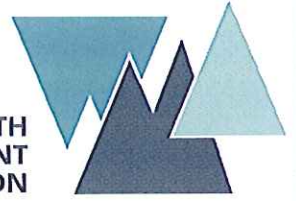
There is a need for both quantitative and qualitative analysis/thresholds so that, for example, account is taken of those market participants who deal predominantly in less liquid securities.

WMA hopes that ESMA find these comments helpful and constructive and would be happy to discuss any aspect of this response in more detail.

Wealth Management Association
22 City Road
Finsbury Square
London EC1Y 2AJ
Tel: +44(0) 20 7448 7100
info@thewma.co.uk

22 May 2014

WEALTH
MANAGEMENT
ASSOCIATION



The UK retail service provider (RSP) model: An explanatory note

Second Edition: October 2013

This booklet has been produced by

The Wealth Management Association (WMA)

Legal Disclaimer

The information contained in this booklet is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate information there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation. This booklet and its contents do not constitute financial or other professional advice, and specific advice should be sought about your specific circumstances. In particular, this booklet does not constitute a recommendation or endorsement by the WMA.

Feedback

If you have any feedback or comments on this paper please contact the WMA team via email at info@thewma.co.uk or telephone on +44 (0) 20 7448 7100.

Table of Contents

<u>INDEX</u>	<u>PAGE</u>
SUMMARY	3
BACKGROUND	3
KEY BENEFITS	4
ANNEX 1	6
ANNEX 2	7

SUMMARY

In 2012 there were around 18.8 million “retail” trades (those trades that are undertaken for individuals) in the UK of which 15 million were cash market equity trades. Of those, 95 per cent were executed through the UK Retail Service Provider (RSP) system, a quote-driven system operated by UK market makers.

Some of the key benefits and advantages of using the RSP system are as follows:

- **Price competition and best execution** – Up to 30 market makers may be competing for each order and such competition helps ensure investment firms can meet their “best execution” obligations.
- **Agency trades** – All trades undertaken between brokers and RSPs are done so on an agency principle and therefore client assets (both cash and stock) are segregated from the assets of both market counterparties.
- **Single execution and single settlement** – With no requirement to use a central clearing facility, RSP trades guarantee a single-filled execution and single settlement, keeping the costs of the trade to the retail broker to a minimum and facilitating segregation of assets.
- **Immediacy** – Unlike client orders that are placed on an order book, RSP trades are executed immediately with up to 30-second hold period to enable the underlying investor through the broker to confirm whether they wish to proceed with the trade or not.
- **Transparency** – All RSP trades are reported on-exchange under the rules of the relevant Stock Exchange.
- **Cost** – There is no charge for brokers using the RSP service.

BACKGROUND

Historically, all trades in the UK were dealt via a quote-driven system involving agency brokers and market makers. In 1997 the London Stock Exchange introduced an order-driven market (SETS) and in 2001 started using the London Clearing House (LCH) as the central counterparty for SETS between trading and settlement. Ultimately retail brokers found that a quote-driven system was more tailored and beneficial to their clients’ needs. The annex compares a trade executed via the RSP model to that executed on an Order Book using a central counterparty.

The RSP forms the backbone of the UK retail stock broking market, its primary role being to provide electronic quotation and dealing facilities to retail stockbrokers and other investment firms.

In practice a stockbroker will electronically connect to a number of competing RSP firms, requesting the RSPs’ most competitive quote for their client’s order. The brokers will select the most competitive price offered allowing their clients to benefit from price competition between RSPs and to deliver best execution to their clients.

One key element of the model is the price calculation mechanism employed by the RSP systems. Market Makers invest significant capital in the development of technology to allow the most competitive prices to be formulated and hence the most order flows to be won. RSP systems consolidate price data from the market data feeds of the regulated markets and MTFs (the “Exchanges”) in order to build a consolidated best bid/offer across those venues. The RSPs’ investment in consolidation therefore provides significant benefits for the retail investor while reducing the risks associated and successfully delivering best execution.

KEY BENEFITS

The key benefits of the RSP model are detailed below:

- Self Determination
 - The RSP model allows retail clients to access and interact with markets at their own discretion. The UK retail client has benefitted from the development of the RSP system which has significantly reduced the cost of trading and opened up equity trading to a wider audience.
 - This deeper pool of capital has assisted listed companies, particularly those admitted to small cap markets such as Aim and Plus Markets, to weather the financial crisis. These markets have provided access to much needed funding to create economic growth and jobs while offering returns to investors. This has been of critical importance given the widespread contraction in bank lending since the economic crisis and the smaller returns available to savers.
- Reduction in the cost of trading
 - Single execution means no clearing fees and a single settlement².
- Protects the investor
 - While executed away from the exchange systems, trades are reported to an Exchange as 'on exchange' trades. Investors therefore receive the full protection of exchange rules to ensure, inter alia, prompt settlement and protection from counterparty default.
- Pre-trade transparency
 - Registered market makers are required to make firm quotes in minimum sizes determined by an Exchange throughout the trading day. The RSP references these prices and hence cannot be considered a 'Dark Pool'.
 - Investors are shown the full terms of trade (price, quantity, settlement date) prior to committing to the trade. This allows client certainty that their trade has executed at a known price. This is not possible through other execution methods and offers the best element of a limit order (price certainty) and an 'At Best' order (immediacy).
 - Prices provided by RSPs represent the tightest spreads available in a security by referencing multiple order books/market maker quotes in order to match the markets' best price.³

² Cost is a key factor in obtaining best execution of a Retail Client order.

³ Price is a key factor in obtaining best execution of a Retail Client order.

- Highly competitive
 - Up to 30 market makers may be competing for each order. The RSP system helps enable investment firms to comply with the MiFID requirement to take all reasonable steps to obtain the best possible price for their clients.
 - Under the RSP model the market maker does not charge for access to RSP prices and no commissions are paid to RSPs for execution.

- Highly efficient
 - RSPs run highly automated systems: a very high percentage of all executions are processed and settled on a straight through processing (STP) basis which significantly improves the likelihood of settlement.⁴
 - STP also significantly reduces the operational costs of the RSP and broker, thus allowing low dealing costs and a very competitive broker market; best execution for retail clients should be considered against the full cost of a trade rather than just its price and the RSP model significantly improves this area to the benefit of the retail client.
 - The RSPs' price consolidation allows a single point for clients to access the prices available across numerous venues.
 - Electronic trading via the internet allows investors instant access to the market; thus investors can easily take advantage of the market situation or dispose of existing positions.⁵
 - Guaranteed execution: once a quote is received by the client, the price is held firm to allow the client to decide.⁶

- Highly Liquid
 - In addition to price improvement, market makers will offer liquidity improvement, providing more liquidity at current market prices than is available on the regulated market and MTF order books.⁷

As the above description makes clear, the UK's retail execution model for equity business is a well developed, competitive system that is highly efficient and delivers significant benefits to its end client, the retail investor. The service delivers against all of the execution factors determined by MiFID as the footnote references demonstrate. The model is highly effective and offers many advantages over the retail execution models prevalent in other markets, including those found elsewhere in the EU.

⁴ Likelihood of settlement is a key factor for the best execution of a Retail Client order.

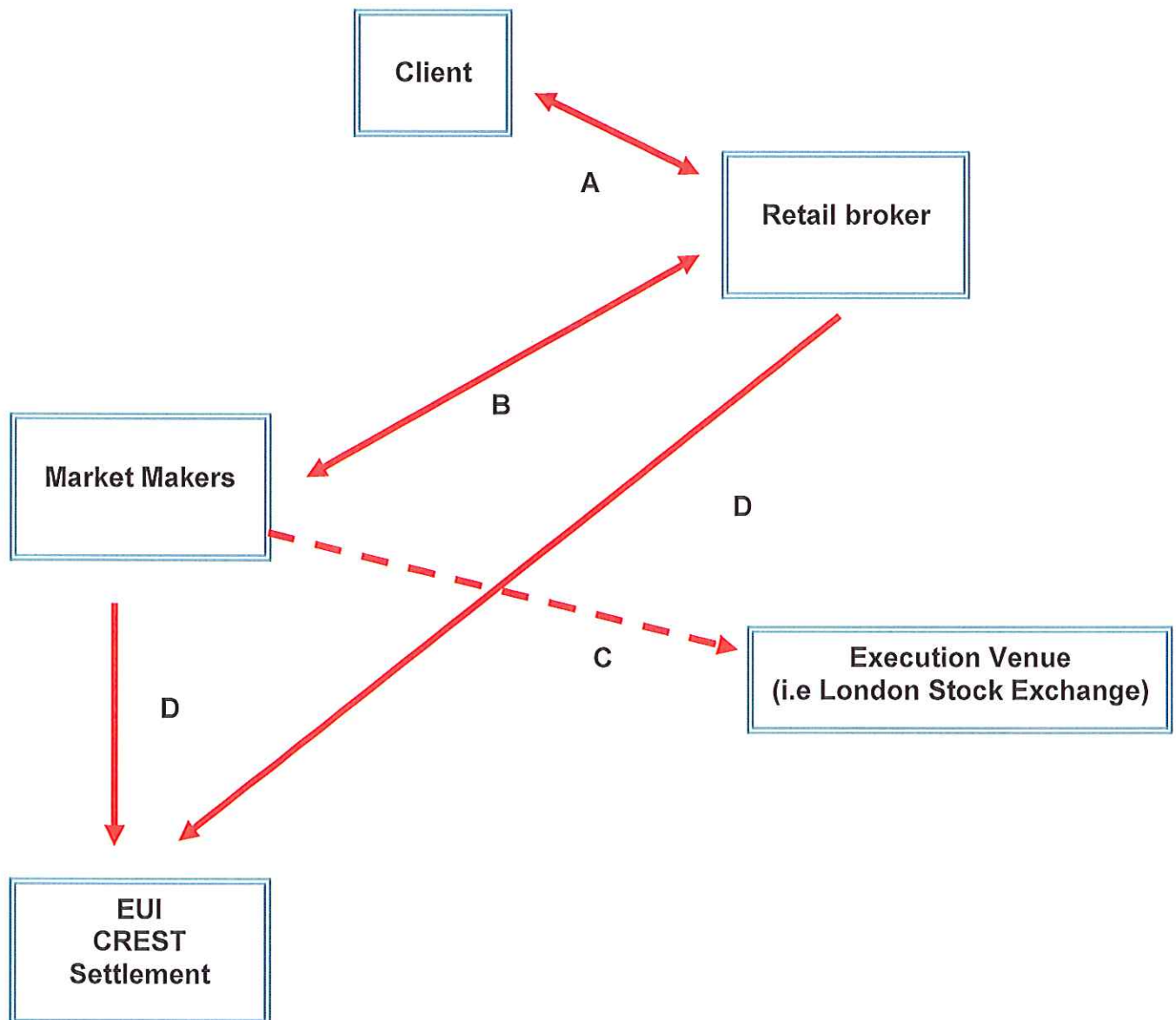
⁵ Speed is a key factor in obtaining best execution of a Retail Client order.

⁶ Likelihood of execution is a key factor for the best execution of a Retail Client order.

⁷ Likelihood of execution is a key factor for the best execution of a Retail Client order.

Annex 1

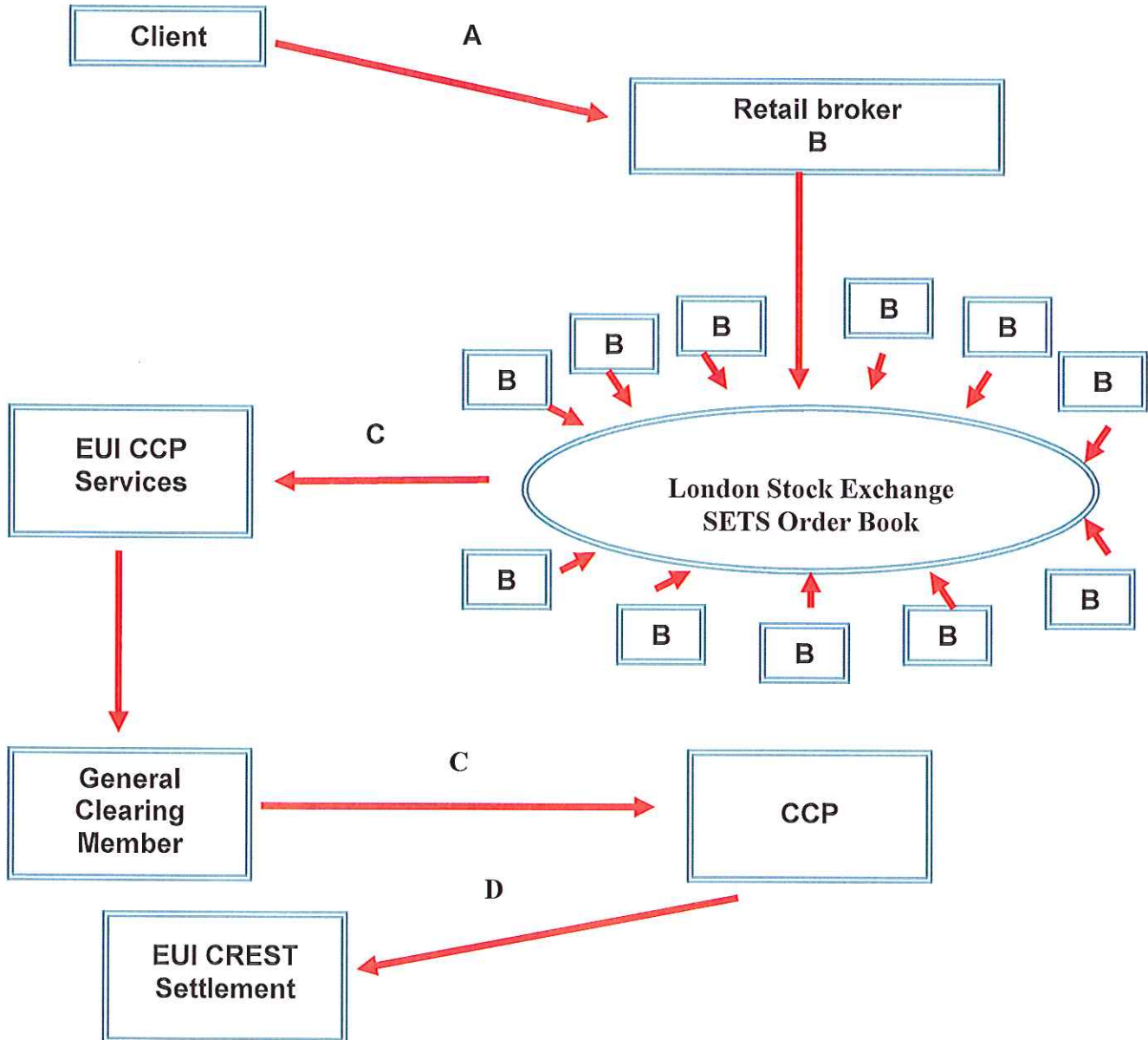
Diagram A: Broker executes trade via Retail Service Provider Model



- A - Retail client contacts broker by telephone or online to buy or sell
- B - Retail broker polls a range of RSPs for the best price and offers client the best available. Client confirms if he or she wishes to proceed.
- C - RSP sends trade report in respect of the trade to relevant execution venue
- D - Both retail broker and RSP settle transaction via Euroclear UK & Ireland' CREST settlement system and send EUI a transaction report.

Annex 2

Diagram B: Broker trades on Order Book



A - Retail client contacts broker by telephone or online to buy or sell

B - Retail broker places order on Order Book along with the many others that are there from other market counterparties.

C - Once order is "filled" it passes via Euroclear UK & Ireland's Central Counterparty service and a General Clearing Member - retail brokers are not members of the clearing house and have to use a GCM - to the Central Counterparty.

D - On settlement date, trade settles in EUI's CREST system. Trade reports and transactions reports are sent as per diagram A.