The International Securities Lending Association
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ESMA
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

19 February 2015

Consultation on Technical Standards under the CSD Regulation

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.

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 borrow securities to enable them to fulfil their delivery obligations. Our interest in the CSDR is to try and ensure that implementing measures achieve the desired market settlement benefits without inadvertently discouraging investors from participating in securities lending. Investors consider securities lending to be an ancillary investment activity and there is evidence that in some circumstances applying costly settlement penalty regimes can actually serve to deter them from lending their securities.

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Executive Summary

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

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). There is substantial risk 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.

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 avoid widespread disruption to the markets. At very least implementation should not occur before the T2S system is operational and thought should be given to whether a phased approach from that time would be preferable.

Specifically regarding the measures proposed, we consider that further clarity is required regarding the exemption from buy-ins for short term SFTs which are conducted on an "open" basis (and which can be terminated at short notice by either party).

More clarity is required as to who should be responsible for buying in securities for failing transactions. We understand that market participants broadly favour that for OTC transactions, the trading parties should be responsible for executing buy-ins (or appointing agents for that purpose). We generally agree with this approach but would point out that most securities lending is undertaken by agents (such as custodian banks). These agents may not have the authority to undertake a buy-in and further thought will be required to establish effective mechanisms for buy-ins for failing returns of loans.

The use of trading venues for securities lending transactions is somewhat limited but market participants do agree loans through an automated program offered by EquiLend. Whilst EquiLend is treated for regulatory purposes as a MTF, its services are somewhat different to other providers that provide venues for the execution of buying and selling securities. We do not believe that EquiLend should have responsibility for the buy-in process for securities loans that are set up on its platform.

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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

Q7: What are your views on the proposed draft RTS related to the buy-in process?

In particular, what are your views on applying partial settlement at the end of the extension period? Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants?

What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?

Whilst we understand that the CSDR Level 1 text provides that mandatory buy-ins should be implemented we remain concerned that this system will be disruptive for the securities lending market. Whilst there are mandatory buy-in regimes elsewhere in the world, there are no mainstream markets that we are aware of where the buy-in may be applied to the securities lending transaction itself. (The buy-in occurs on the cash transaction which a lending transaction may support).

Investors engage in securities lending in order to generate low risk moderate returns. Such investors are typically pension funds, insurance companies, sovereign wealth funds and mutual funds who regard securities lending as an activity that is ancillary to their core investment objectives and activities. As such they are generally sensitive to the level of risk and cost involved in their lending programs and would not engage unless they were confident that the returns available compensated them adequately for these.

Unfortunately, whilst well intentioned, the settlement discipline measures included in the CSDR could be viewed as introducing a new "risk" to these investors that arises only because they participate in securities lending programs. That is the risk that they may be subject to a buy in or incur settlement penalties. Whilst it may be possible to reduce the likelihood of receiving a penalty or buy-in, some situations may be beyond the control of the lender. For example, where a borrower is unable to return a security, and this prevents the settlement of a market sale. In this example, provided the mechanisms for passing the consequences of penalties and costs down the chain operate effectively, the lender may not be exposed economically, however we are aware that a number of institutional investors will choose to avoid lending simply in order to avoid this situation completely.

Securities that are lent provide liquidity to markets, enabling firms to offer market making services and support trading opportunities. In essence, the vast majority of securities loans are completed to ensure the settlement of another transaction. In other words, securities lending helps to achieve higher rates of settlement efficiency within the system, however CSDR may act to deter institutions from lending.

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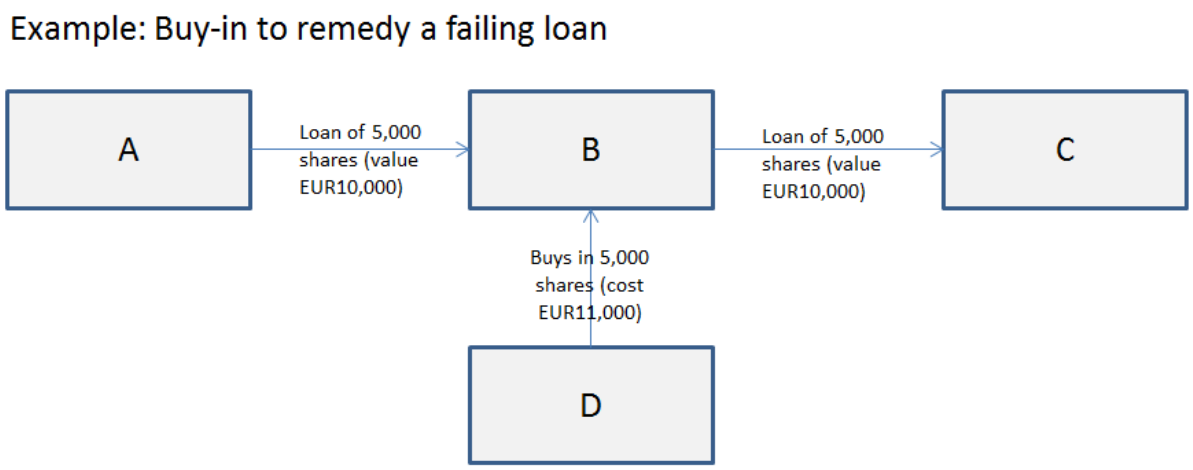
The problem of using buy-ins as a remedy for failing securities loans

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:-



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,

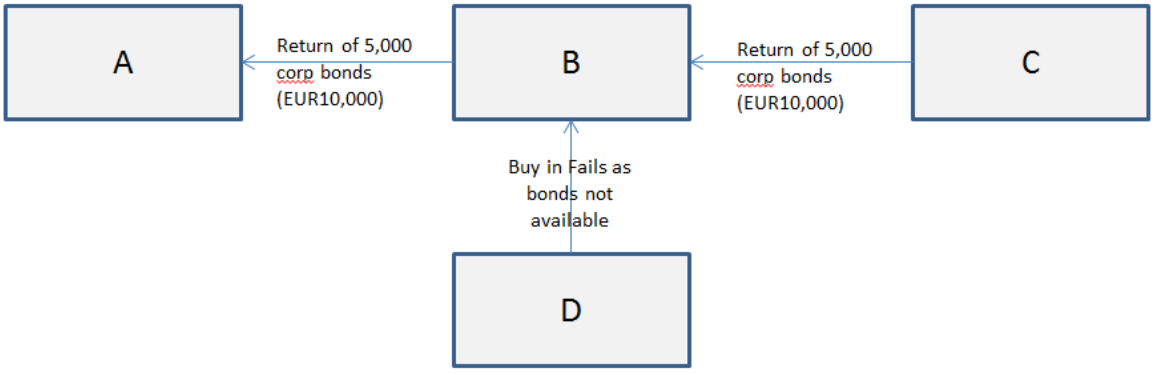
- B now owns 5000 shares it had no intention of buying. It must therefore sell the shares in the market to remove this unintended market exposure. Theoretically, it cannot sell the shares (as it has lent them to C) without either borrowing them from elsewhere or recalling them back from C. B had intended 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.

CSDR should clarify who has responsibility for executing the buy in.

Another point we would like to make in relation to the buy-in process is that more clarity is required as to who should be responsible for buying in securities for failing transactions. We understand that market participants broadly favour that for OTC transactions, the trading parties should be responsible for executing buy-ins (or appointing agents for that purpose). We generally agree with this approach but would point out that most securities lending is undertaken by agents (such as custodian banks) and that these agents may not have the authority to undertake a buy-in. As such further thought will be required to establish effective mechanisms for buy-ins for failing returns of loans where such agents are used.
Linked to this point, whilst the use of trading venues for securities lending transactions is somewhat limited, market participants do agree loans through an automated program offered by EquiLend. Whilst EquiLend is treated for regulatory purposes as a MTF, its services are somewhat different to other venues that provide for the execution of buying and selling securities. We do not believe that EquiLend should have responsibility for the buy-in process for securities loans that are set up on its platform.

Implementation of settlement discipline measures should not occur until after T2S is operational

Whilst we understand that the Level 1 text requires that buy-ins must occur we point out these complexities for their application to the securities lending market to illustrate why substantial time is needed to implement the buy-in framework and to enable more thinking by regulators, market participants and market infrastructures. We remain concerned that even then there could be material adverse impacts on the securities lending markets but believe that time to develop infrastructure, system and procedures will be helpful in mitigating some of these.

As a minimum, we believe that the buy-in regime should not be implemented ahead of the operation of T2S, and we believe that ESMA should consider whether there is scope for a phased approach, commencing with the most liquid securities first. This has the advantage of applying the regime to situations where it should be more within the powers of market participants to remedy fails before the buy-in is needed, and focuses the discipline regime on transactions that are likely to create the largest systemic risk (given volumes and trading sizes).

Q8: What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?

We note that the Level 1 text provides little flexibility in terms of the extension periods, but we broadly agree that the period for less liquid securities should be as long as possible. (Please note however that we believe it is important to consider a low or zero penalty rate for very illiquid securities which may not be available to borrow – please see our response to the Technical Advice Consultation). We do have concerns about the proposal to link the 4 or 7 day extension periods to the MiFID II definitions of liquid securities. Whilst this approach has the benefit of simplifying the approach (and we are generally supportive of keeping the settlement discipline procedures as simple as possible), we believe that this approach is overly simplistic for this purpose. We believe that there is a strong risk that many securities will be considered as liquid under MiFID II whilst in fact they are not at all liquid in terms of their availability to purchase or borrow at the point when needed.

The same considerations are true in relation to the buy-in timeframe.

Q9: What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?

Once again we note that the Level 1 text affords very little flexibility in terms of what types of operation could be considered as ineffective as regards buy-in. We believe that there is a strong case for exempting the open legs of all securities lending transactions however we note that this is unlikely to be possible and that only certain transactions for limited timeframes may be considered.

Whilst we support ESMA's proposals that the open legs of transactions which are for terms of 9, 15 or 22 days (liquid, illiquid and SME shares), we would also note that this adds complexity to the system which market participants and market infrastructures will need to manage. Not least we assume that it will be necessary for CSDs to be able to identify transactions for which buy-ins are considered to be ineffective.

A very important point that we wish to clarify is that securities lending (and repo) transactions that are entered into on an "open" basis (meaning that at the outset there is no fixed end date, but where either party to the transaction can elect to close the transaction at any time), should also be considered as falling into the category of those where buy-ins are ineffective. We believe that this would be completely consistent with ESMA's logic in terms of fixed duration transactions but would appreciate confirmation of this.