

ICMA EUROPEAN REPO COUNCIL

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Mr. Pascal Canfin
European Parliament
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Dear Mr. Canfin,

Article 13 of the proposed Short Selling Regulation

Introduction to repo and the ERC

The repo market is one of the largest and most active sectors in today's money markets. It provides an efficient source of money market funding for financial intermediaries while providing a secure home for liquid investments. In repo transactions securities are exchanged for cash with an agreement to repurchase the securities at a future date. Collateral is key to the proper functioning of repo markets. In the event of default, the collateral can be sold and exposure to the defaulting party can be netted off. This requires legally enforceable documentation. In the international market, this is provided by the ICMA Global Master Repurchase Agreement (GMRA).¹

It is worth noting that the advantage of repo for lenders is lower credit risk. Because repo is less risky, regulations such as the Basle Accords and CAD allow institutions lending through repo to hold less regulatory risk capital than unsecured lending. Moreover, both the UK Financial Services Authority (FSA) and the German Financial Supervisory Authority (BaFin) recognise the effect of the GMRA netting provisions for regulatory capital and large exposure requirements provided, inter alia, that a reasoned legal opinion has been obtained to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would find that, where a counterparty fails owing to default, bankruptcy, liquidation or any other similar circumstance, the regulated firm's claims and obligations pursuant to the GMRA would be limited to a net sum under the law of the relevant jurisdiction(s), and which meets certain other requirements. Accordingly, ICMA obtains and annually updates legal opinions on the GMRA from 62 jurisdictions worldwide. These opinions, made available to ICMA members, assist them in fulfilling these regulatory requirements.

¹ The GMRA is the most extensively used cross border repo master agreement and has reduced the risks associated with previously poorly documented repo transactions.

Repo is also crucially used by central banks as their principal tool in open market operations to control short-term interest rates. Repos are attractive as a monetary policy instrument because they carry a low credit risk while serving as a flexible instrument for liquidity management, which benefits the functioning of financial markets. Central banks are also able to act swiftly as lenders of last resort during periods of market turbulence by way of the repo market.²

The European Repo Council (ERC) was established by the International Capital Market Association (ICMA) in December 1999, to represent the repo community in Europe. It is composed of practitioners in the repo field, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately.

Concerns with Article 13

The ERC has been following the proposals set out in the draft Short Selling Regulation with considerable interest and Article 13 of that proposal in particular. We feel that the aims of this Article, namely to enhance settlement discipline, are laudable and necessary but the methods currently being suggested to effect this legislative outcome need to be adjusted in order to make the provisions workable. Article 13, as drafted by the European Commission, suggests that the buy-in or penalty should be imposed at the trading venue level. However, we feel that for the repo market this is not ideal and instead penalties and buy-ins should be imposed at the last point in the chain – i.e. settlement venues - otherwise trading will be distorted. The underlying concerns are as follows:

- (1) Article 13 would require trading venues to “buy-in” securities following a failed trade. This implies that trading venues are able to access the full range of securities. However, this is not the case; trading venues do not have access to the full pool of securities – they merely bring together buyers and sellers seeking to execute a trade. Likewise, central counterparties are not in a position to access pools of securities on demand as they only bring counterparties together. Securities may trade on a number of trading venues or be settled by more than one CCP.
- (2) Under Article 13(1)(b) the trading venue would be required to pay cash compensation to the buyer based on the value of the shares or the debt to be delivered at the delivery date plus an amount for any losses incurred by the buyer. Calculating the value of the position of the failed trade and the lost profits of the buyer (in order to determine the appropriate level of compensation) may be difficult and possibly contentious. A strong argument can be made that these are not functions that a trading venue should be carrying out and instead these responsibilities are better carried out at the settlement level.
- (3) There does not appear to be any countervailing provision to ensure that a trading venue or central counterparty does not buy-in securities in a way that is anti-competitive. By this we mean that the securities to be bought in should be obtained in a competitive market environment. Moreover, the buying in of securities should not be done in such a way that imposes excessively high buy-in rates or penalties.
- (4) Article 13(1)(a) provides that, in the case of a failure to deliver securities, procedures are to be triggered four days after trade date or six days after trade date in the case of market makers. A different buy-in period for different market participants would be problematic as

² The ERC has published a White Paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This paper sets out in greater detail what the repo market is and its benefits and is attached, together with a supplementary Annex.

it would create a regulatory asymmetry. For example, if Bank A is designated as a Market Maker and is subject to a six day buy-in rather than the standard four day buy-in (which Bank B is subject to) and Bank B is being failed into by Bank A, then it is possible that Bank B will be forced to buy-in before Bank A does.

- (5) A mandatory buy-in deadline as proposed in Article 13 would serve to reduce liquidity in the repo market and increase the costs to market participants. It would also dramatically alter the current position in the repo market where it is up to market participants to determine how they deal with a fail, in accordance with their contractually agreed terms under the GMRA. Under Article 13, making the buy-in a certainty and having a very short exercise period would increase costs which would result in either a widening of spreads or some repo market participants deciding to exit the business.
- (6) Article 13 is also based on an underlying assumption that trading venues/central counterparties can buy-in securities where sellers cannot. This, in turn, is based on an assumption that the problem is naked short-selling – i.e. that the reason for delivery fails is due to an unwillingness by the failing party deliver the securities rather than an inability to do so. If the securities lending market is illiquid, then formal buy-in mechanisms of the sort suggested by Art.13 (at trading venue level) will lead to the problem of unpredictable and potentially enormous borrowing fees that deter trading and reduce market liquidity.

We also note the recent European Parliament Draft Report (published November 24th) which recommends additionally that an investment firm which executes orders on behalf of clients in those instruments outside a trading venue shall ensure that it or the central securities depository that provides settlement services has procedures in place which comply with the requirements of Art. 13. However, we would like to bring to your attention the fact that there are a number of provisions that already govern market practice in this area. For example, the GMRA, which is a bi-laterally negotiated agreement, contains provisions regarding events of default, one of which concerns the failure to deliver purchased securities on the purchase date or the failure to deliver equivalent securities on the repurchase date. The two ICSDs also have provisions in place that facilitate the buy-in of securities in the event of delivery failure. We would urge that any buy-in provision in the Short Selling Regulation be drawn up in such a way as not to undermine the legal certainty currently provided by existing mechanisms.

We feel that buy-in procedures need to be based on a sound legal basis as is the case with Europe's two ICSDs. This practice should be extended to the national CSDs. Buy-in rules need to be harmonised across the EU (and beyond) in a way that avoids any race to the bottom. We recommend that a link be created in the forthcoming regulatory initiative re (I)CSDs, to article 13 which could set out in greater detail further amendments to make clear that that arrangements should be in place between the central counterparty, clearing house or settlement system and custodians on behalf of all actors in the respective markets to provide securities for the purposes of buy-ins. The buy-in of securities should crucially be carried out in a way that takes into account a competitive market environment. We would also urge that the buy-in process needs to take into account the practicalities of the repo market in market segments where liquidity is limited. Accordingly, the buy-in process should not be a proscriptive mandatory 5 days but more flexible for delivery, such as notice date +10. Whilst more liquid instruments may indeed be sourced in a notification +5 period, many counterparties/clients will need an extended period to close out onward repo/lending or engage in borrowing and bond management to source the bought in positions. Without allowing for such flexibility, the risk is that a series of buy-ins could be triggered at the wholesale level, which would lead to additional layers of risk, when the focus should instead be in the closure of the existing position.

In recognition of the fact that there is a lot of work underway that needs to proceed from a well informed appreciation of a number of elements of the repo market's operation and infrastructure, the ERC Committee recently commissioned Mr. Richard Comotto to produce an ERC White Paper on the working of the repo market. The White Paper covers a wide range of repo market topics, including specials, shorts and fails. With respect to the latter it examines both normal resolution mechanisms and the extra problems associated with low/negative interest rate environments. It then goes on to describe market infrastructures, highlighting those features which are desirable for these to be robust. Existing problems are highlighted, along with possible solutions and recommendations. A copy of the ERC White Paper and additional supplementary Annex is attached for your reference.

The ERC appreciate the valuable contribution made by the European Parliament's examination of the issues related to short selling. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'De Vidts', with a long horizontal line extending to the right.

Godfried De Vidts
Chairman
ICMA European Repo Council