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EUROCLEAR S.A./N.V.  
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B-1210 BRUSSELS, BELGIUM

## Commission consultation on short selling

### Euroclear response

We are pleased to be given the opportunity to offer Euroclear's<sup>1</sup> views on the Commission's consultation on short selling. Euroclear is registered on the European Commission's register of interest representatives - ID number 88290282308-75.

As a market infrastructure service provider, Euroclear is supportive of measures that will increase financial stability, and of European harmonisation of such measures. While we are ready to accommodate specific practical needs in the area of short selling that will be agreed upon by regulators and the market players, we believe that settlement systems have very limited possibilities to detect and discourage any uncovered short sales activity, since by definition short selling is always a function of trading, not of the settlement process. Settlement systems do not know whether a failed settlement has failed because it is the consequence of a naked short sale by a trading counterparty. As a consequence, we are concerned about the Commission's approach as described in question 15 (related to uncovered short sales), specifically in relation to the potential future role of settlement institutions in this respect.

*(13) Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions could be put in place? If so please indicate which ones? Do you agree that arrangements other than formal agreements to borrow should be permitted if they ensure the shares are available for borrowing at settlement? If so, why?*

We would appreciate receiving some clarification on what is expected from the person that needs to demonstrate that it has an "other" borrowing arrangement in

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<sup>1</sup> The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the group comprises the international central securities depository Euroclear Bank, based in Brussels, as well as the national central securities depositories (CSDs) Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland and NCSD, the CSD for Finland and Sweden. Euroclear also owns EMXCo, the UK's leading provider of investment-fund order routing, and Xtrakter, which operates the TRAX trade matching system.



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place. More specifically, we would like to understand if such an arrangement can be a general arrangement (e.g. valid for a pre-defined set of transactions for an undetermined period) or if this would need to be an arrangement for a specific share, transaction or period. As an example, Euroclear Bank offers securities lending and borrowing services that are fully integrated within the settlement processing and that allow a client to agree upfront that securities are borrowed whenever there is a short-fall in its account (more details are given in the Annex). We would therefore, like to understand if such securities borrowing arrangements – that have proven very effective in reducing settlement fails - would fall within the criteria the Commission is proposing.

The Commission may want to refer to the ESCB/CESR Recommendations for Securities Settlement Systems – to which all Euroclear (I)CSDs are subject – which include a specific Recommendation (5) on Securities Lending and Borrowing that reads as follows: *Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for avoiding settlement failures and expediting the settlement of securities. Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.*

*(15) Do you agree with the proposal requiring buy in procedures for settlement failures due to short sales? If so, what is an appropriate base period that could be specified before buy in procedures are triggered (e.g. T + 4)? (18) What is the likely costs and impact of the different options on the functioning of financial markets?*

We are concerned that the proposed role of settlement systems in buy-in procedures would require substantial changes to the operational processes across trading, clearing and settlement venues, and in the role and responsibilities of settlement systems in particular.

The consultation document seems to start from the assumption that a settlement system would be able to identify which settlement fails are resulting from short selling. As a settlement system merely receives instructions for settlement from a trading venue, a central counterparty, the parties to the trade or their agents, it has no insight on the trading position on trade date of the person that entered into the trade. For transactions that are netted and cleared through a CCP, only a fraction are sent for settlement in the CSD after which only a further small percentage might end up in a settlement fail.



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The reason behind such settlement fail is not necessarily short selling. Settlement will take place if sufficient securities and cash are available in the counterparties' account on settlement date. If cash or securities are not available, this results in a settlement fail. The settlement system cannot identify the reason why cash or securities were not available at the time of settlement. It could be the result of operational errors such as wrong/late input or matching of instructions, back-to-back transactions in which one settlement fail gives rise to settlement fails in the whole back-to-back chain, etc. For cross-border transactions the difference in settlement cycles between the different CSDs can be a cause of settlement fails. As an indication of settlement fail rates, in Euroclear France and Nederland, between 2% and 3% of transactions that are sent for settlement in the CSD fail on intended settlement date.

Settlement systems are structured in order to mitigate risk wherever possible as indicated in the ESCB/CESR recommendations; they are not parties to the trade (like a CCP) and will therefore generally not have a role as a buy-in agent. To do so would require the CSD to take principal risk, changing its risk profile and increasing systemic risk. The parties to the trade would need to instruct and execute a buy-in themselves possibly under the rules of the trading platform on which the trade was conducted with the trading platform as principal. This occurs in some Member states today. If the CCP is a party to the trade, it could be given the role to instruct such buy-in. But, however structured, buying-in is no guarantee of the original failed transaction settling if the security to be bought-in cannot be sourced.

We understand that the Commission is also reflecting on imposing settlement fines (fees charged when settlement fails - a practice that is already in place in some Member States with the aim of improving settlement efficiency). We believe that such measures would not help to discourage short selling. Firstly, because even with such incentive regimes, settlement rates are never 100%. Secondly, because even where such regimes exist today, other additional measures have had to be taken by those authorities that have aimed to ban 'naked' short selling. Finally, such measures could, on the contrary, open the door to regulatory arbitrage if the proposed rules for uncovered short sales would be applicable only to transactions executed on trading venues, cleared through CCPs and settled in settlement systems. Setting short selling conditions or imposing a settlement discipline on transactions following the "traditional" market infrastructure route only could have as unintended consequence that short selling activities would move away from this infrastructure route.



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## **ANNEX – EUROCLEAR BANK SECURITIES LENDING AND BORROWING PROGRAMME**

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The scope of the Euroclear Bank Securities Lending and Borrowing programme is to enhance settlement efficiency by avoiding settlement fails. Within the context of its settlement system, Euroclear Bank offers a centralised Securities Lending and Borrowing Programme in both the batch and real-time processes for the benefit of Euroclear Participants. Loans are generated and may be reimbursed as a result of each securities lending and borrowing process. The integration of securities lending and borrowing into the securities settlement process allows for borrowing to correspond exactly to Borrowers' needs (subject to the availability of the corresponding pool of lendable securities) so as to avoid either over- or under borrowing. All securities made available by Lenders are aggregated into an anonymous "lending pool". There is no direct link between lenders and the borrowers. Each have a contractual relationship with Euroclear Bank. Upon signing the legal documentation with Euroclear they can opt to become either automatic or opportunity lenders and/or borrowers in the programme.

From a Borrower's point of view, the Programme allows them to acquire securities needed to settle transactions that would have otherwise failed for lack of securities. For Lenders, the Programme increases the yield of their portfolios, allowing them to retain the economic benefits of ownership on lent securities by keeping the collateral value for lent securities free of safekeeping fees to secure their credit arrangements.

Euroclear Bank guarantees Lenders the return of lent securities, the compensation after cash or non-cash distributions (such as interest, dividends and subscription rights paid by issuers on lent securities), or their cash equivalent, as well as the payment of the lending fees.