

An Introduction to Securities Lending (*Australia*)

Commissioned by: -

Australian Securities Lending Association Limited

This is the Australian adaptation
of “An Introduction to Securities Lending”,
focused on the United Kingdom market,
written by Mark C. Faulkner,
managing director and co-founder of Spitalfields Advisors Limited,
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The Australian adaptation was prepared by
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Australian Foreword

Original UK Publication

“An Introduction to Securities Lending (Australia)” is the Australian adaptation of a UK publication, focused on the UK markets, entitled “An Introduction to Securities Lending” ©Mark C Faulkner, 2004 (the “**Original UK Publication**”).

The Original UK Publication, which may be downloaded at www.spitalfieldsadvisors.com, was commissioned by the UK Securities Lending and Repo Committee, the International Securities Lending Association, the London Stock Exchange, the London Investment Banking Association, the British Bankers’ Association and the UK Association of Corporate Treasurers and was welcomed by the National Association of Pension Funds and the Association of British Insurers. It was first published in 2004.

As stated on page 1 of the Original UK Publication, it was the intention of the commissioning parties and Mr Faulkner that the Original UK Publication be freely available and as widely distributed as possible. With that objective in mind, the copyright holder in the Original UK Publication (Mark C Faulkner) gave his permission for all or parts of that publication to be reproduced, stored in a retrieval system, transmitted in any form or by any means (electronic, mechanical, photocopying, recording or otherwise) without his prior permission.

However, the granting of that permission was only for the English language and was conditional upon the insertion of the following accreditation:

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This Publication

This adaptation was prepared, with Mr Faulkner’s permission, by John C King, Partner, Mallesons Stephen Jaques, Sydney, at the request of the Australian Securities Lending Association Limited.

Appendix 2 of the Original UK Publication (headed “Terms of Reference of the SLRC” [ie the UK Stock Lending and Repo Committee]) has been replaced by an *Australian Supplement*.

Otherwise, apart from minor cosmetic changes, the text in the Executive Summary, Chapters 1 to 6 and part 1 of each of Appendices 1, 3 and 4 is the same as the text in the corresponding sections of the Original UK Publication, except that:

- some references to UK corporate law, other UK regulatory matters, the UK Stock Borrowing and Lending Code, and UK tax and stamp duty, which are irrelevant in an Australian context, have been modified (so as to confine their relevance to the UK) or omitted;
- cross references to the Australian Supplement have been added;
- certain minor modifications have been made to recognise things such as the different stock exchanges, regulatory, corporate law and tax regimes, and currencies used in

the two jurisdictions (where practicable, such modifications are shown inside square brackets, as in “[]”); and

- in some instances, additional paragraph numbering and headings have been incorporated into the text, principally to facilitate cross-referencing.

ASLA

The Australian Securities Lending Association ("**ASLA**") was formed in August 1991, in response to a perceived need among industry participants for unified representation in regulatory and other issues relevant to its members.

In addition to ASLA's role of assisting regulatory development, the Association also promotes standardization throughout the industry in terms of documentation and market practice. It commissioned the drafting of the first standard Australian Master Securities Lending Agreement (1997) and accompanying User's Guide and the November 2003 update and accompanying User's Guide, as well as this publication.

ASLA is active in the future development of the Securities Lending industry in Australia. Its regular meetings provide a forum for the dissemination of information and the interchange of ideas and responses to market changes.

ASLA membership is open to all industry & non-industry participants. Its current 33 members represent Investment Banks, Custodian & Commercial Banks, Brokers, Legal firms and IT providers.

Its website is www.asla.com.au

John King,
1 August 2005.

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Disclaimers

The views expressed in the Original UK Publication are those of its author, Mark C Faulkner.

Any different or additional views expressed in this publication are those of John C King.

Care has been taken, both in the Original UK Publication and in this publication, to try to ensure that the contents of the publication are accurate and any commentary is reasonable. However, none of Mr Faulkner, any commissioning body relating to the Original UK Publication, ASLA, Mr King or Mallesons Stephen Jaques accepts any responsibility for any errors or omissions or for any opinions, or for any loss suffered by any person, arising from acting or refraining from acting as a result of any material in, or any error in or omission from, this publication.

In particular:

- (a) *It is necessary for readers of this publication to determine in each case its relevance or otherwise to the particular circumstances applicable in that case. Readers should be aware that securities lending can raise complex Australian and foreign legal, regulatory, tax and other issues.*
- (b) *This publication is not intended to constitute, and should not be treated as constituting, legal, regulatory, tax or other advice or information on which a reader may rely in implementing an actual transaction. It is therefore strongly recommended that readers should seek expert Australian (and, if appropriate) foreign legal, regulatory (including in relation to licensing, conduct and disclosure obligations), tax and any other professional advice that they think appropriate in respect of any transaction, prior to entering into that transaction.*
- (c) *Accordingly, none of Mr Faulkner, any commissioning body relating to the Original UK Publication, ASLA, the member organisations and representatives of ASLA, Mr King or Mallesons Stephen Jaques accepts any responsibility for any use to which this publication is put.*

About the Authors

1 *From the Original UK Publication*

Mark C Faulkner

Mark Faulkner is Managing Director and co-founder of Spitalfields Advisors Limited (“Spitalfields Advisors”). Spitalfields Advisors is an independent specialist consultancy firm and its focus is upon the provision of consultancy services to institutions active, or considering becoming active, in the securities finance markets, particularly beneficial owners. Spitalfields Advisors assists institutions embarking on securities lending reviews and also analyses existing programmes and suggests opportunities for improvement.

Mark is also the Chief Executive Officer of Data Explorers Limited. The company provides clients with insights into comparative risk and performance measurement using proprietary Risk Explorer and Performance Explorer services. Data Explorers also conducts a wide range of quantitative research projects and benchmarking exercises on behalf of customers. The Index Explorer service highlights the potential impact of securities lending upon market prices and corporate governance.

After graduating from the London School of Economics, Mark Faulkner has spent the majority of his career specialising in International Securities Finance. Since 1987, he has held management responsibility at L.M. (Moneybrokers) Ltd., Goldman Sachs, Lehman Brothers and more recently at Securities Finance International Limited.

Whilst occupying these different posts he has gained experience as lender, borrower, conduit borrower and prime broker. During his career he has worked closely with the UK Inland Revenue and has represented firms at the Securities Lending and Repo Committee and The London Stock Exchange's securities lending committees. Being an independent advisor since 1995 has provided Mark with a unique insight into the operation of the securities financing market.

Mark lives with Jude and their son Archie in Canonbury, London.

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www.spitalfieldsadvisors.com

2 *For this Australian adaptation of the Original UK Publication*

John C King

John King has been a Partner in the Sydney office of Mallesons Stephen Jaques since 1979. He specialises in taxation. From 1986 to 1988, he was the resident partner in the firm's then New York representative office.

John's practice concentrates on the taxation aspects of Financial Services and Capital Markets transactions and products (including securities lending and repos, other equity, debt, hybrid, swap, option and other derivative products, and prime brokerage arrangements), floats, and corporate and business acquisitions and disposals. He also advises on the tax aspects of inbound foreign investment, trusts and partnerships. Most of his work is not of a public nature.

For more than 15 years, he has advised extensively in relation to securities lending and repo transactions. At the request of ASLA, he drafted the original 1997 Australian Master Securities Lending Agreement and accompanying User's Guide and the November 2003 update and accompanying User's Guide. He has also drafted submissions which resulted in the amendment of Federal income tax and State stamp duty Bills or Acts and Australian Taxation Office rulings affecting securities lending and repo transactions, among others.

In 1996 he was named as one of the top 10 tax advisers in Australia in an independent survey of the leading tax advisers in the Asia-Pacific region (International Tax Review, May 1996). He is included as a leading individual adviser in the Euromoney "2002 Guide to the World's Leading Tax Advisers", in the Tax section of the Who's Who Legal 2002 and 2003 "International Who's Who of Business Lawyers" and in the Third and Fourth (2004) editions of its "International Who's Who of Corporate Tax Lawyers", and in the Tax section in the Chambers Global "World's Leading Lawyers" 2001-2002, 2002-2003, and 2003. He is also included as a highly recommended Australian individual adviser in the Tax section in the Ninth edition (2003) of the Practical Law Company "Global Counsel 3000" and in its successor publication "PLC Which lawyer? Yearbook 2005", and in the "AsiaLaw Leading Lawyers 2005".

John is a graduate in Arts, and Laws (with Honours), of the University of Sydney and also holds a Master of Laws degree from the University of London (where he was enrolled at the London School of Economics).

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Acknowledgements

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He would like to express his gratitude for their assistance, encouragement and support.

2 For this Australian adaption of the Original UK Publication

In recent years, and also while preparing this publication, Mr King received invaluable assistance from:

David Strong, Director, Merrill Lynch Equities (Australia) Limited, the former chairman (2000 to 2005) of ASLA, and

Guy Caruana, Vice President, Equity Finance, Citigroup Global Markets Pty Ltd, and the current chairman of ASLA.

He would also like to acknowledge the assistance of his colleagues Edward Kerr and Mark McFarlane, who reviewed and commented on parts of earlier drafts of this publication.

Introduction

The Original UK Publication was commissioned by the UK Securities Lending and Repo Committee.

The UK Securities Lending and Repo Committee brings together market practitioners, the UK authorities and infrastructure providers, with the Bank of England chairing and providing administrative support.

In the Foreword to the Original UK Publication, David Rule, from the Bank of England and the Chairman of the UK Securities Lending and Repo Committee, wrote:

“Securities lending provides liquidity to equity, bond and money markets, placing it at the heart of today's financial system. This increase in liquidity reduces the cost of trading, increasing market efficiency and benefiting all. Securities lending markets allow market participants to sell securities that they do not own in the confidence that they can be borrowed prior to settlement. They are also used for financing, through lending of securities against cash, forming an important part of the money markets. The ability to lend and borrow securities freely underpins the services that securities dealers offer their customers and the trading strategies of dealers, hedge funds and other asset managers. On the lending side, securities lending forms a growing part of the revenue of institutional investors, custodian banks and the prime brokerage arms of investment banks.”

The same comments apply equally in Australia.

As in the case of the Original UK Publication, this Australian adaptation aims to describe the relevant Australian markets. Its intended audience includes market practitioners and others with some interest in securities lending, including trustees of superannuation or other funds that already lend their securities or might consider doing so, managers of companies whose securities are lent, financial journalists, the authorities and other interested parties.

John King,
1 August 2005.

Executive Summary

[Except as noted or referred to below, the comments in this Executive Summary are equally applicable in Australia.]

1 Overview

Securities lending – the temporary transfer of securities, usually on a collateralised basis – is a major and growing activity, providing significant benefits for issuers, investors and traders alike. These are likely to include improved market liquidity, more efficient settlement, tighter dealer prices and perhaps a reduction in the cost of capital.

The scale of securities lending globally is difficult to determine accurately, as it is an “over the counter” rather than an exchange-traded market. However, it is safe to say that the balance of securities on loan globally exceeds £1 trillion.

[See also paragraphs 1.9 to 1.10 of the Australian Supplement.]

2 What is securities lending?

Securities lending describes the common market practice by which securities are transferred temporarily from one party (the lender) to another (the borrower) with the borrower obliged to return them (or equivalent securities) either on demand or at the end of any agreed term. However, the word ‘lending’ is in some ways misleading. Under English [and Australian] law, the transaction is in fact an absolute transfer of title (as in a sale) against an undertaking to return equivalent securities. Usually the borrower will collateralise the transaction with cash or other securities of equal or greater value than the lent securities, in order to protect the lender against counterparty credit risk.

Some important consequences arise from the nature of securities lending transactions:

- Under English [and Australian] law, absolute title over both lent and collateral securities passes between the parties. Therefore, all these securities can be sold outright or on-lent, which is commonplace and an intrinsic part of the functioning of the market.
- The borrower is entitled to the economic benefits of owning the lent securities (e.g. dividends), but the agreement with the lender will oblige it to make (‘manufacture’) equivalent payments back to the lender.
- A lender of equities no longer owns them and has no entitlement to vote. But it is still exposed to price movements on them, since effectively the borrower can return them at a pre-agreed price. Lenders typically reserve the right to recall equivalent securities from the borrower, and will exercise this option if they wish to vote. Borrowing securities for the specific purpose of influencing a shareholder vote is not regarded as acceptable market practice in the UK.

3 Different types of securities lending transactions

Most securities loans are collateralised, either with other securities or with cash deposits.

Where lenders take securities as collateral, they are paid a specific fee by the borrower.

By contrast, where they are given cash as collateral, they pay the borrower interest but at a rate (the rebate rate) that is lower than market rates, so that the lender can reinvest the cash and make a return (ie the spread).

Pricing is negotiated between the parties and would typically take into account factors such as supply and demand for the particular securities, collateral flexibility, [in the UK, but usually not in Australia] the size of any manufactured dividend, and the likelihood of the lender recalling the securities early.

[As regards typical borrowing fees in Australia, see paragraph 2.19 of the Australian Supplement.]

As well as securities lending, sale and repurchase (repo) and buy-sell back transactions are used for the temporary transfer of securities against cash. In general, securities lending is more likely to be motivated by the desire to borrow specific securities and repo and buy-sell backs by the desire to borrow cash – but this boundary is fuzzy. For example, reinvestment of cash collateral has been an integral part of the securities lending business for many years, particularly in the United States, with reinvestment opportunities often driving the underlying securities lending transactions.

4 Lenders and intermediaries

The supply of securities into the lending market comes mainly from the portfolios of beneficial owners, such as pension and other funds and insurance companies. Underlying demand to borrow securities begins largely with the trading activities of dealers and hedge funds.

In the middle are a number of intermediaries. The importance of intermediaries in the market partly reflects the fact that securities lending is a secondary activity for many of the beneficial owners and underlying borrowers. But intermediaries provide valuable services, such as credit enhancement and the provision of liquidity, by being willing to borrow securities at call while lending them for term. They also benefit from economies of scale, including the significant investment in technology required to run a modern operation.

Intermediaries include custodian banks and asset managers lending securities as agents on behalf of beneficial owners, alongside the other services provided to these clients. Some specialist securities lending agents have also emerged in the UK. Agents agree to split securities lending revenues with lenders and may offer indemnities against certain risks, such as borrower default.

Another category of intermediary is dealers trading as principals. Dealers intermediate between lenders and borrowers, as well as using the market to finance their own wider securities trading activities. They may seek returns by taking collateral, counterparty credit or liquidity risk – for example, by lending securities to a client for a period while borrowing them on an open basis, with a risk of early recall by the lender. Through their prime brokerage operations, they also meet the needs of hedge funds. Borrowing of securities to finance their positions has grown rapidly.

For beneficial owners, there are a number of different possible routes to the market. These include using an agent (custodian bank, asset manager or a specialist) to manage a lending programme, auctioning a portfolio to borrowers directly, selecting one principal borrower, establishing an ‘in-house’ operation and lending directly, or some combination of these strategies.

5 The borrowing motivation

The most common reason to borrow securities is to cover a short position – using the borrowed securities to settle an outright sale. But this is rarely a simple speculative bet that the value of a security will fall, so that the borrower can buy it more cheaply at the maturity of the loan. More commonly, the short position is part of a larger trading strategy, typically designed to profit from perceived pricing discrepancies between related securities. For example:

- Convertible bond arbitrage: buying a convertible bond and simultaneously selling the underlying equity short.
- ‘Pairs’ trading: seeking to identify two companies, with similar characteristics, whose equity securities are currently trading at a price relationship that is out of line with the historical trading range. The apparently undervalued security is bought, while the apparently overvalued security is sold short.
- Merger arbitrage: for example, selling short the equities of a company making a takeover bid against a long position in those of the potential acquisition company.
- Index arbitrage: selling short the constituent securities of an equity price index [e.g. ASX 200] against a long position in the corresponding index future [e.g. ASX 200 contract on the SFE].

Short positions also arise as a result of failed settlement (with some securities settlement systems arranging for automatic lending of securities to prevent chains of failed trades) and where dealers need to borrow securities in order to fill customer buy orders in securities where they quote two-way prices.

Not all securities lending is motivated by short selling. Financing drives many transactions – the lender is seeking to borrow cash against the lent securities, whether using repo, buy/sell backs or cash-collateralised securities lending.

Another large class of transactions not involving a short is motivated by lending to transfer ownership temporarily to the advantage of both lender and borrower. For example:

- Where a lender would be subject to withholding tax on dividends or interest but some potential borrowers are not. Subject to the possible application of any relevant specific or general anti-avoidance tax provisions or principles, the borrower receives the dividend free of tax and shares some of the benefit with the lender in the form of a larger fee or larger manufactured dividend.
- Where, under a Dividend Reinvestment Plan (“**DRP**”), an issuer offers shareholders the choice of receiving a dividend in cash or reinvesting it in additional securities (scrip) at a discount to the market price, but some funds are unable to take the more attractive scrip alternative for one reason or another (e.g. in the case of index trackers, because their holdings would become larger than permitted under investment guidelines). The borrower chooses the scrip dividend alternative and probably sells the securities in the market [often under a programmed selling strategy], while at the same time making a manufactured cash payment to the lender (funded either from its own cash reserves or from the proceeds of sale of the DRP shares). Again, the return is shared with the lender through a larger fee or [in the UK, but not in Australia] larger manufactured dividend.

6 Trading and settlement

The securities lending market is a hybrid between a relationship-based market and an open, traded market. Historically, transactions were negotiated by telephone but increasingly securities are broadcast as available at particular rates using email or other electronic platforms.

Loans may be either for a specified term or, more commonly, open to recall, because lenders typically wish to preserve the flexibility for fund managers to be able to sell at any time.

Settlement occurs on a shorter time frame than outright transactions, so that securities can be borrowed to cover a sale.

In most settlement systems [but contrast Australia, where delivery versus payment (“**DvP**”) transactions are possible and the norm] securities loans are settled as “free of payment” deliveries and the collateral taken is settled quite separately, possibly in a different payment or settlement system and maybe a different country and time zone. This can give rise to “daylight exposure”, a period when the lent securities have been delivered but the collateral securities have not yet been received. To avoid this exposure some lenders insist on pre-collateralisation, so transferring the exposure to the borrower.

[See paragraphs 4.6 to 4.9 of the Australian Supplement.]

7 Stamp Duty and GST

[See paragraphs 7.1 to 7.5 of the Australian Supplement.]

8 Corporations Act

[See paragraphs 4.17 to 4.21 of the Australian Supplement.]

9 Transparency in the market

[See paragraph 4.22 of the Australian Supplement.]

10 Risks and risk management

When taking cash as collateral A lender taking cash as collateral pays rebate interest to the securities borrower. So the cash must be reinvested by the lender at a higher rate in order to make any net return on the collateral aspect of the transaction. Expected returns can be increased by reinvesting in assets with more credit risk or longer maturity in relation to the likely term of the loan, with a risk of loss if market interest rates rise. Many of the large securities lending losses over the years have been associated with re-investment of cash collateral.

Transaction collateralised with other securities Apart from the risk of errors, systems failures and fraud always present in any market, problems arise on the default of a borrower. The lender must then sell its collateral in the market in order to raise the funds to replace the lent securities. It will lose money if the value of the collateral securities falls relative to that of the lent securities. Generally, the risk of loss is greater:

- if it takes longer to close out these positions,
- if the collateral or lent securities are wrongly valued,
- if the markets for these securities are illiquid, and

- if the market prices of the lent and collateral securities do not tend to move together.

11 Regulation

[See paragraphs 5.39-5.75 of the Australian Supplement.]

12 Stock Borrowing and Lending Code

In the UK, in addition to the prudential standards set by the FSA, market participants have drawn up a Stock Borrowing and Lending Code which UK-based market participants observe as a matter of good practice. In the UK, the Code does not in any way replace the FSA's or other authorities' regulatory requirements, nor is it intended to override the internal rules of settlement systems as regards borrowing or lending transactions.

[See paragraphs 5.76 and 5.77 of the Australian Supplement.]

13 Frequently asked questions

Many questions are asked about the securities lending industry. Chapter 6 (Frequently Asked Questions) responds to many of these, grouped into: legal; dividends and coupons; collateral and risk management; operational and logistical; corporate governance; and lending options for beneficial owners.

14 Glossary

Finally, every market has its own jargon and securities lending is no exception. *Appendix 3* is a glossary of terms.

15 Concluding comments

Securities lending is too significant to ignore, touching the interests of securities investors, companies that issue securities, market intermediaries and the authorities. It is also too central to the efficient running of the modern financial markets to be misunderstood. This publication is intended to provide an authoritative introduction to the modern industry[, with an emphasis in this adaptation on the modern securities lending industry in Australia].

Chapter 1: What is securities lending?

[Except as noted or referred to below, or in part 1 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

1 History

Securities lending began as an informal practice among brokers who had insufficient share certificates to settle their sold bargains, commonly because their selling clients had mislaid their certificates or just not provided them to the broker by the settlement date of the transaction. Once the broker had received the certificates, they would be passed on to the lending broker. This informal business arrangement was subject to no formal agreement and there was no exchange of collateral.

Appendix 1 contains a short history of historical developments since then.

Securities lending is now an important and significant business and describes the common market practice whereby securities are temporarily transferred by one party (the lender) to another (the borrower). The borrower is obliged to return equivalent securities to the lender, either on demand, or at the end of any agreed term. For the period of the loan, the lender is secured by acceptable assets delivered by the borrower to the lender as collateral.

Under English [and Australian] law, absolute title to the securities “lent” passes to the “borrower”, who is obliged to return “equivalent securities.” Similarly the lender receives absolute title to the assets received as collateral from the borrower, and is obliged to return “equivalent collateral.”

Securities lending today plays a major part in the efficient functioning of the securities markets worldwide. Yet it remains poorly understood by many of those outside the market.

2 Definitions

In some ways, the term “securities lending” is misleading and factually incorrect. Under English [and Australian] law and in many other jurisdictions, the transaction commonly referred to as “securities lending” is, in fact...

“a disposal (or sale) of securities linked to the subsequent reacquisition of equivalent securities by means of an agreement.”

Such transactions are collateralised and the “rental fee” charged, along with all other aspects of the transaction, are dealt with under the terms agreed between the parties. It is entirely possible and very commonplace that securities are borrowed [or collateral securities are received] and then sold or on-lent.

There are some consequences arising from this clarification:

- (a) Absolute title over both the securities on loan and the collateral received passes between the parties.
- (b) The economic benefits associated with ownership e.g. dividends, coupons etc. are “manufactured” back to the lender, meaning that the borrower is entitled to these benefits as owner of the securities but is under a contractual obligation to make equivalent payments to the lender.

- (c) A lender of equities surrenders its rights of ownership e.g. voting. Should the lender wish to vote on securities on loan, it has the contractual right to recall equivalent securities from the borrower.

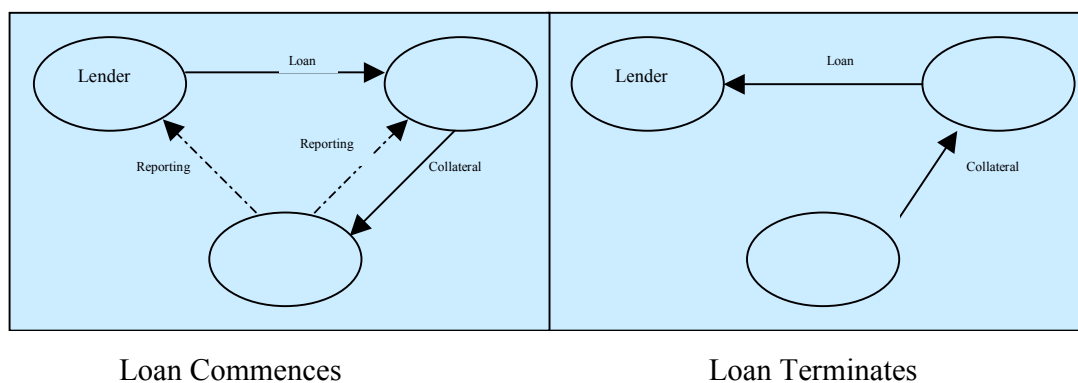
[See paragraphs 1.1 to 1.4 of the Australian Supplement.]

3 Different types of securities loan transactions

Most securities loans in today's markets are made against collateral in order to protect the lender against the possible default of the borrower. This collateral can be either cash or other securities/other assets.

(a) Transactions collateralised with other securities/other assets

Diagram 1



Non-cash collateral would typically be drawn from the following collateral types:

- Government Bonds
 - Issued by G7, G10 or Non-G7 governments.
- Corporate Bonds
 - Various credit ratings.
- Convertible Bonds
 - Matched or unmatched to the securities being lent.
- Equities
 - Of specified Indices.
- Letters of Credit
 - From banks of a specified credit quality.
- Certificates of Deposit
 - Drawn on institutions of a specified credit quality.

- Delivery By Value (“DBVs”)¹
 - Concentrated or Unconcentrated.
 - Of a certain asset class.
- Warrants
 - Matched or unmatched to the securities being lent.
- Other money market instruments.

The eligible collateral will be agreed between the parties, as will other key factors including:

- Notional Limits
 - The absolute value of any asset to be accepted as collateral.
- Initial margin
 - The margin required at the outset of a transaction.
- Maintenance margin
 - The minimum margin level [usually expressed as a percentage of the current market value, from time to time, of the borrowed securities] to be maintained throughout the transaction.
- Concentration limits
 - The maximum percentage of any issue to be acceptable e.g. less than 5% of daily traded volume.
 - The maximum percentage of collateral pool that can be taken against the same issuer i.e. the cumulative effect where collateral in the form of letters of credit, CD, equity, bond and convertible may be issued by the same firm.

The example in the above diagram shows collateral being held by a Triparty Agent. This specialist agent (typically a large custodian bank or International Central Securities Depository) will receive only eligible collateral from the borrower and hold it in a segregated account to the order of the lender. The Triparty Agent will mark this collateral to market, with information distributed to both lender and borrower. Typically the borrower pays a fee to the Triparty agent.

There is debate within the industry as to whether lenders that are flexible in the range of non-cash collateral they are willing to receive are appropriately rewarded with higher fees. Some argue that they are, others claim that the fees remain largely static but that borrowers are more prepared to deal with a flexible lender and therefore balances and overall revenue rise.

Box 1 below indicates how the specific separate securities lending fee is calculated for a securities lending transaction secured by non-cash collateral.

¹ See glossary for an explanation of DBVs.

Box 1: Cash flows on a securities loan against collateral other than cash

The return to a lender of securities against collateral other than cash derives from the fee charged to the borrower. A cash flow of this transaction reads as follows:

Transaction date	13 th June 2003
Settlement date	16 th June 2003
Term	Open
Security	XYZ Limited
Security price	£10.00 per share
Quantity	100,000 shares
Loan Value	£1,000,000.00
Lending fee	50 basis points (100ths of 1 per cent)
Collateral	UK FTSE 100 Concentrated DBVs
Margin Required	5%
Collateral required	£1,050,000.00 in DBVs
Daily Lending Income	$£1,000,000.00 \times 0.005 \times (1/365) = £13.70$

Should the above transaction remain outstanding for one month and be returned on 16th July 2003 there will be two flows of revenue from the borrower to the lender.

On 30th June fees of £191.80 ($£13.70 \times 14$ days)

On 31st July fees of £219.20 ($£13.70 \times 16$ days)

Thus total revenue = £411.00 against which one has to offset the cost of settling the transactions (loan and collateral).

NB for purposes of clarity, the example assumes that the value of the security on loan has remained constant when in reality the price would change daily, resulting in a mark to market event, different fees chargeable per day and changes in the value of the collateral required. Open loan transactions can also be re-rated or have their fee changed should market circumstance alter. It is assumed that this did not happen either.

The agreement on a fee is reached between the parties and would typically take into account the following factors:

- Demand and supply:
 - The less of a security available, other things being equal, the higher the fee a lender can obtain.
- Collateral flexibility:
 - See above – the cost to a borrower of giving different types of collateral varies significantly, so that they might be more willing to pay a higher fee if the lender is more flexible.

- The size of the manufactured dividend required to compensate the lender for the post-tax dividend payment that it would have received had it not lent the security.²

[See paragraphs 2.20, 3.5, 7.18-7.30 and 7.31-7.50 of the Australian Supplement.]

- The term of a transaction
 - Securities lending transactions can be either open to recalls or for a specified term – there is much debate about whether there should be a premium or a discount paid for certainty. If a lender can guarantee a recall-free loan, then a premium will be forthcoming. One of the attractions of repo and swaps is the transactional certainty on offer from a counterparty.
- Certainty
 - As Chapter 3 explains, there are trading and arbitrage opportunities, the profitability of which revolves around the making of specific decisions. If a lender can guarantee a certain course of action, this may mean it can negotiate a higher fee.

Given the above factors, the following table (Table 1) shows the range of lending fees observed for different asset classes in the UK market in December 2003. The majority of transactions are concluded at the lower end of the ranges quoted.

Table 1

Asset Class	Typical Fee Range (basis points per annum)
UK FTSE 100 equities	6 - 200
UK FTSE 250 equities	10 - 400
Index Linked Gilts	6 - 43
Non- index Linked Gilts	3 – 13
UK Corporate bonds (Investment grade)	5 - 75
UK Corporate bonds (Sub-investment grade)	20 - 100

Source: - www.performanceexplorer.com

(b) Transaction Collateralised with Cash

Cash collateral is, and has been for many years, an integral part of the securities lending business, particularly in the United States [and also in Australia]. The lines between two distinct activities:

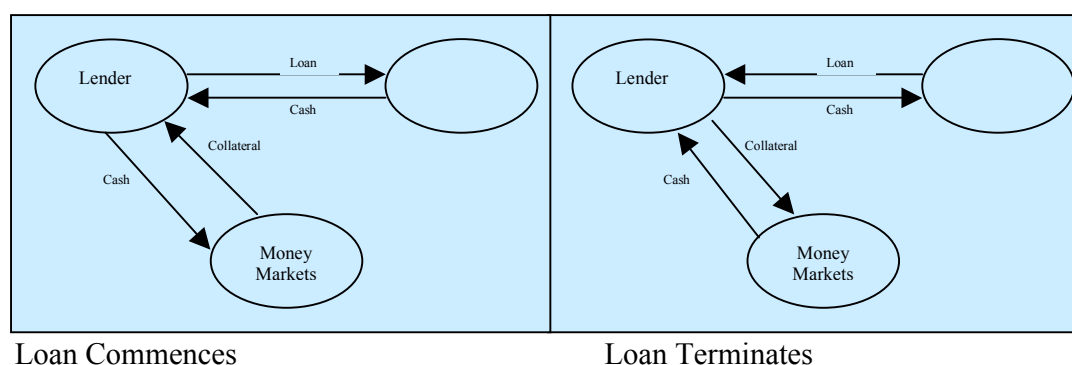
- Securities lending; and

² See Chapter 3 of the Original UK Publication for an explanation of how securities lending in the UK can be motivated by the different tax status of borrowers and lenders.

- Cash re-investment;

have become blurred and, to many US investment institutions, securities lending is virtually synonymous with cash re-investment. This is much less the case outside the United States, but consolidation of the custody business and the important role of US custodian banks in the market means that this practice is becoming more prevalent. The importance of this point lies in the very different risk profiles of these increasingly inter-twined activities.

Diagram 2



The revenue generated from cash-collateralised securities lending transactions is derived in a different manner from that in a non-cash transaction. It is made from the difference or “spread” between interest rates that are paid and received by the lender (see Box 2).

Box 2: Cash flows on a securities loan collateralised with cash [references to \$ are to US\$]

Transaction date	13 th June 2003
Settlement date	16 th June 2003
Term	Open
Security	XYZ Limited
Security price	£10.00 per share
Quantity	100,000 shares
Loan Value	£1,000,000.00
Rebate Rate	80 basis points
Collateral	USD cash
Margin Required	5%
Collateral required	\$1,718,850.00 (£1,050,000.00 X 1.67*)
Reinvestment rate	130 basis points
Daily Lending Income	\$23.87 or £14.58 (\$1,718,850.00 X 0.005 X (1/360))

FX Rate assumed of £1.00 = US\$1.637

Should the above transaction remain outstanding for one month and be returned on 16th July 2003 there will be two flows of cash from the lender to the borrower. These are based upon the cash collateral and the profitability of the lender comes from the 50 basis points spread between the re-investment rate and the rebate rate.

$$\$1,718,850 \times 0.008 \times (1/360) = \$38.20$$

Payments to the borrower: -

On 30th June \$534.80 (\$38.20 X 14 days)

On 31st July \$611.20 (\$38.20 X 16 days)

The lenders profit will typically be taken as follows: -

On 30th June £204.12 (£14.58 X 14 days)

On 31st July £233.28 (£14.58 X 16 days)

Thus total revenue = £437.40 against which one has to offset the cost of settling the transactions (loan and collateral).

NB for purposes of clarity, this example assumes that the value of the security on loan has remained constant for the duration of the above transaction. This is most unlikely and typically the price would change daily, resulting in a mark to market and in changes to the value of the collateral required. Open loan transactions can also be re-rated or have their rebate changed should market circumstances alter. It is assumed that this did not happen either.

The marginal increase in daily profitability associated with the cash transaction at a 50 bps spread compared to the non-cash transaction of 50 bps is due to the fact that the cash spread is earned on the collateral which has a 5% margin and the fact that the USD interest rate convention is 360 days and not 365 days as in the United Kingdom.

Re-investment guidelines are typically communicated by the beneficial owner to their lending agent in words. Some typical guidelines might be as follows:

Conservative

- Overnight G7 Government Bond repo fund.
- Maximum effective duration of 1 day.
- Floating-rate notes and derivatives are not permissible.
- Restricted to overnight repo agreements.

Quite Conservative

- AAA rated Government Bond repo fund.
- Maximum average maturity of 90 days.
- Maximum remaining maturity of any instrument is 13 months.

Quite Flexible

- Maximum effective duration of 120 days.
- Maximum remaining effective maturity of 2 years.
- Floating-rate notes and eligible derivatives are permissible.
- Credit quality: Short-term ratings: A1/P1, long-term ratings: A-/A3 or better.

Flexible

- Maximum effective duration of 120 days.
- Maximum remaining effective maturity of 5 years.
- Floating-rate notes and eligible derivatives are permissible.
- Credit quality: Short-term ratings: A1/P1, long-term ratings: A-/A3 or better.

Some securities lending agents offer bespoke re-investment guidelines whilst others offer re-investment pools.

4 Other transaction types

Securities lending is part of a larger set of inter-linked securities financing markets. These transactions are often used as alternative ways of achieving similar economic outcomes, although the legal form and accounting and tax treatments can differ. The other transactions include:

(a) Sale and repurchase agreements

Sale and repurchase agreements (or “repos”) involve one party agreeing to sell securities to another against a transfer of cash, with a simultaneous agreement to repurchase the same securities (or equivalent securities) at a specific price on an agreed later date in the future. It is common for the terms ‘seller’ and ‘buyer’ to replace the securities lending terms ‘lender’ and ‘borrower’. Most repos are governed by a master agreement called the TBMA/ISMA Global Master Repurchase Agreement (GMRA)³.

Repos occur for two principal reasons, either to transfer ownership of a particular security between the parties or to facilitate collateralised cash loans or funding transactions.

The bulk of bond lending and bond financing is conducted by repo and there is a growing equity repo market. An annex can be added to the GMRA to facilitate the conduct of equity repo transactions.

In substance or economically, repos are much like securities loans collateralised against cash, with the income being factored into an interest rate that is implicit in the pricing of the second leg of the transaction.

- At the beginning of a transaction, under the first leg, securities are valued and sold at the prevailing ‘dirty’ market price (i.e. including any coupon that has accrued).
- [Importantly, as in the case of a normal securities lending transaction, if the record date for a distribution on the purchased securities occurs during the term of the repo, the buyer must separately pay to the seller an amount equal to that distribution, on the relevant distribution payment date.]
- Under the second leg, at termination, the securities are resold at a predetermined price equal to the original sale price together with interest at a previously agreed rate known as the repo rate.

³ The Public Securities Association (“PSA”) is now called the Bond Market Association (“BMA”) and is a US trade association, The International Securities Market Association (“ISMA”) is the self-regulatory organisation and trade association for the international securities market.

Relevantly:

- In securities-driven transactions (i.e. where the motivation is not simply financing), the repo rate is typically set at rates lower than prevailing money market rates, to reward the “lender”, who will invest the funds in the money markets and thereby seek a return or spread. The “lender” often receives a margin by pricing the securities above their market level.
- In cash-driven transactions, the repurchase price will typically be agreed at a level close to current money market yields, as this is a financing, rather than a security-specific transaction. The right to substitute repoed securities as collateral is agreed by the parties at the outset. A margin is often provided to the cash “lender”, by reducing the value of the transferred securities by an agreed ‘haircut’ or discount.

(b) Buy/sell backs

Buy/sell backs are similar in economic terms to repos, being structured as a spot sale of securities and a simultaneous forward purchase of equivalent securities, with the purchase for a future settlement date. The price of the forward purchase is typically calculated and agreed by reference to market repo rates.

The purchaser of the securities receives absolute title to the securities.

However, importantly [and in contrast to a repo]:

- The purchaser retains any accrued interest and coupon payments during the life of the transaction [and does not have to make any corresponding payments to the seller].
- Consequently, the price of the forward contract takes account of any coupons received by the purchaser [ie the repurchase price under the second leg is reduced to take account of the value of any coupons received and retained by the purchaser].

Buy/sell back transactions are normally conducted for financing purposes and involve fixed income securities. Typically, a cash borrower does not have the right to substitute collateral. Until 1996, the bulk of buy/sell back transactions took place outside of a formal legal framework, with contract notes being the only form of record. In 1995, the GMRA was amended to incorporate an annex that dealt explicitly with buy/sell backs. Most buy/sell backs [including in Australia] are now governed by this agreement.

The table below (Table 2) compares the three main forms of collateralised securities loan transaction.

Table 2

Characteristic	Securities lending		Repo		Buy/Sell back
	Cash collateral	Securities/ other non-cash collateral	Specific securities (securities-driven)	General Collateral (cash-driven)	
Formal method of Exchange	Sale with agreement to make subsequent reacquisition of equivalent securities	Sale with agreement to make subsequent reacquisition of equivalent securities	Sale and repurchase under terms of master agreement	Sale and repurchase under terms of master agreement	Sale and repurchase
Form of Exchange	Securities Vs cash	Securities Vs collateral (n.b. often free of payment but sometimes delivery versus delivery)	Securities Vs cash (n.b. often delivery versus payment)	Cash Vs securities (n.b. often delivery versus payment)	Cash Vs securities (n.b. often delivery versus payment)
Collateral type	Cash	Securities (bonds and equities), letters of Credit, DBVs, CDs	Cash	General collateral (bonds) or acceptable collateral as defined by buyer	Typically Bonds
Return is paid to the supplier of	Cash collateral	Loan securities (not collateral securities)	Cash	Cash	Cash
Return payable as	Rebate interest (i.e. return paid on cash lower than comparable cash market interest rates)	Fee e.g. standard fees for FTSE 100 stocks are about 6-8 basis points (i.e. 0.06-0.08% pa).	Quoted as repo rate, paid as interest on the cash collateral (lower than general collateral repo rate)	Quoted as repo rate, paid as interest on the cash	Quoted as repo rate, paid through the price differential between sale price and repurchase price
Initial margin	Yes	Yes	Yes	Yes	Possible
Variation margin	Yes	Yes	Yes	Yes	No (only possible through close out and Repricing)
Over-collateralisation	Yes (in favour of the securities lender)	Yes (in favour of the securities lender)	No	Possible (if any, in favour of the cash provider)	Possible (if any, in favour of the cash provider)
Collateral Substitution	Yes (determined by borrower)	Yes (determined by borrower)	No	Yes (determined by the original seller)	No (only possible through close out and Repricing)
Dividends and Coupons	Manufactured to the lender	Manufactured to the lender	Paid to the original seller	Paid to the original seller	No formal obligation to return income, - normally factored in the buy-back price.
Legal set off in event of default	Yes	Yes	Yes	Yes	No
Maturity	Open or term	Open or term	Open or term	Open or term	Term only
Typical asset type	Bonds and equities	Bonds and equities	Mainly bonds, equities possible	Mainly bonds, equities possible	Almost entirely bonds
Motivation	Security specific dominant	Security specific	Security specific	Financing	Financing dominant
Payment	Monthly in arrears	Monthly in arrears	At maturity	At maturity	At maturity

5 Generally

[See paragraphs 1.5 and 1.9 to 1.10 of the Australian Supplement.]

Chapter 2: Lenders and intermediaries

[Except as noted or referred to below, or in part 2 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

The securities lending market involves various types of specialist intermediaries, which take principal and/or agency roles. These intermediaries separate the underlying owners of securities – typically, large pension[, superannuation] or other funds and insurance companies – from the eventual borrowers of securities, whose typical motivations are described in chapter 4.

A Intermediaries

1 Agent Intermediaries

Securities lending is increasingly becoming a volume business and the economies of scale offered by agents that pool together the securities of different clients enable smaller owners of assets to participate in the market. The costs associated with running an efficient securities lending operation are beyond many smaller funds, for which this is a peripheral activity. Asset managers and custodian banks have added securities lending to the other services they offer to owners of securities portfolios; while third party lenders specialise in providing securities lending services.

Owners and agents “split” revenues from securities lending at commercial rates. The split will be determined by many factors, including the service level and provision of any risk mitigation by the agent, such as an indemnity. Securities lending is often part of a much bigger relationship [e.g. a custodian/client relationship] and therefore the split negotiation can become part of a bundled approach to the pricing of a wide range of services.

(a) Asset Managers

It can be argued that securities lending is an asset management activity – a point that is easily understood in considering the re-investment of cash collateral. Particularly in Europe, where custodian banks were perhaps slower to take up the opportunity to lend than in the United States, many asset managers run significant securities lending operations.

What was once a back office, low profile activity is now a front office growth area for many asset managers. The relationship that the asset managers have with their underlying clients puts them in a strong position to participate.

(b) Custodian banks

The history of securities lending is inextricably linked with the custodian banks [see “The 1970s” in part 1 in Appendix 1]. Once they recognised the potential to act as agent intermediaries and began marketing the service to their customers, they were able to mobilise large pools of securities available for lending. This in turn spurred the growth of the market.

Most large custodians have added securities lending to their core custody businesses. Their advantages include: the existing banking relationship with their customers; their investment in technology and global coverage of markets, arising from their custody businesses; the ability to pool assets from many smaller underlying funds, insulating borrowers from the administrative inconvenience of dealing with many small funds and providing borrowers with protection from recalls; and experience in developing, as well as developed, markets.

Being banks, they also have the capability to provide indemnities and manage cash collateral efficiently – two critical factors for many underlying clients.

Custody is so competitive a business that, for many providers, it is a loss making activity. However, it enables the custodians to provide a range of additional services to their client base. These may include:

- Foreign exchange, trade execution, securities lending and fund accounting.

(c) Third party Agents

Advances in technology and operational efficiency have made it possible to separate administration of securities lending from the provision of basic custody services. Consequently, a number of specialist third-party agency lenders have established themselves in the UK as an alternative to the custodian banks.

Their market share in the UK is currently growing from a relatively small base level. Their focus on securities lending and their ability to deploy new technology without reference to legacy systems can give them flexibility.

(d) Generally

[See paragraph 2.5 of the Australian Supplement.]

2 Principal Intermediaries

(a) Introduction

There are three broad categories of principal intermediary:

- Broker dealers, specialist intermediaries and prime brokers. [Each of these three categories is discussed further under separate sub-headings (e) to (g) below.]

In contrast to the agent intermediaries discussed in part 1 above, they can assume principal risk, offer credit intermediation and take positions in the securities that they borrow. Distinctions between the three categories are blurred. Many firms would be in all three.

In recent years securities lending markets have been liberalised to a significant extent, so that there is little general restriction on who can borrow and lend securities.

Lending can, in principle, take place directly between beneficial owners and the eventual borrowers. But, typically a number of layers of intermediary are involved.

(b) Value added by principal intermediaries

What value do the intermediaries add?

(i) Credit intermediation service

A beneficial owner may well be an insurance company or a pension [or superannuation] scheme, while the ultimate borrower could be a hedge fund. Institutions will often be reluctant to take on credit exposures to borrowers that are not well recognised and regulated, and that do not have a good credit rating, which would exclude most hedge funds. In these circumstances, the principal intermediary (often acting as prime broker)

performs a credit intermediation service in taking a principal position between the lending institution and the hedge fund.

(ii) Taking on liquidity risk

A further role of the intermediaries is to take on liquidity risk. Typically, they will borrow from institutions on an open basis – giving the institutions the option to recall the underlying securities either if they want to sell them or for other reasons – whilst lending to clients on a term basis, giving the clients certainty that they will be able to cover their short positions.

(iii) Matching supply and demand

In many cases, as well as servicing the needs of their own proprietary traders, principal intermediaries provide a service to the market in matching the supply of beneficial owners with large stable portfolios to those with significant borrowing demand. They also distribute securities to a wider range of borrowers than underlying lenders, which may not have the resources to deal with a large number of counterparties.

(c) How principal intermediaries mitigate their liquidity risk

These activities leave principal intermediaries exposed to liquidity risk if lenders recall securities that have been on lent to borrowers on a term basis.

Some ways they use to mitigate this risk include:

- Accessing in-house inventory, where appropriate:
 - Proprietary trading positions can be a stable source of lending supply.
 - If the long position is associated with a long term derivatives transaction.
 - Efficient inventory management is seen as critical.
 - Many securities lending desks act as central clearers of inventory within their organisations, only borrowing when netting of in house positions is complete.
 - This requires a significant technological investment.
 - Accessing inventory from investor affiliates, where regulations permit.
- Bidding for exclusive and certain access to inventory.

(d) How principal intermediaries have addressed their demand dependency

On the demand side, intermediaries have historically been dependent upon hedge funds or proprietary traders that make trading decisions.

But some organisations have addressed this demand dependency. A growing number of securities lending businesses at the investment bank intermediaries have either developed “trading” capabilities within their lending or financing departments, or entered into joint ventures either with other departments or even in some cases their hedge fund customers. The rationale behind

this development is that the financing component of certain trading strategies is so significant that, without the loan, there is no trade.

(e) Broker dealers

Broker dealers borrow securities for a wide range of reasons:

- Market making.
- To support proprietary trading.
- On behalf of clients.

Many broker dealers combine their securities lending activities with their prime brokerage operation (the business of servicing the broad requirements of hedge funds and other alternative investment managers). This can bring significant efficiency and cost benefits. Typically, within broker dealers the fixed income and equity divisions duplicate their lending and financing activities.

(f) Specialist intermediaries

Historically, regulatory controls on participation in stock lending markets meant there were many intermediaries worldwide. Some specialised in intermediating between stock lenders and market makers in particular e.g. UK Stock Exchange Money Brokers (“SEMB”). With the deregulation of stock lending markets, these niches have disappeared in many cases.

Some of the specialists are now part of larger financial organisations. Others have moved to parent companies that have allowed them to expand the range of their activities into proprietary trading.

(g) Prime brokers

Prime brokers service the needs of hedge funds and other alternative investment managers. The business was once viewed, simplistically, as the provision of six distinct services, although many others, such as capital introduction, risk management, fund accounting and start up assistance, have now been added:

Table 3

Profitable activities	Part of the cost of being in business
Securities lending	Clearance
Leverage of financing provision	Custody
Trade execution	Reporting

Securities lending is one of the central components of a successful prime brokerage operation, with its significance depending on the strategies of the hedge funds for which the prime broker acts. Two strategies that are heavily dependent on securities borrowing are long/short equity and convertible bond arbitrage.

The cost associated with the establishment of a full service prime broker is very significant and the incumbent providers have a significant advantage and historical inertia on their side. Some of the newer entrants have been using total return swaps, contracts for difference and other derivative transaction types to offer what has become known as “synthetic prime brokerage.” Again, securities lending remains a key component of the service, as the prime broker will still need to borrow securities in order to hedge the derivatives positions entered into with the hedge funds: for example, to cover short positions. But it is internalised within the prime broker and less obvious to the client.

B Beneficial owners

Those beneficial owners with securities portfolios of sufficient size to make securities lending worthwhile include:

- Pension funds, insurance and assurance companies, mutual funds/unit trusts and endowments

When considering whether and how to lend securities, beneficial owners need first to consider the characteristics of their organisations and portfolio (see parts 1 and 2 below). Then they need to consider the various possible routes to the securities lending market (see part 3 below).

1 Organisation Characteristics

(a) Management Motivation

Some owners lend securities solely to offset custody and administrative costs. Others are seeking more significant revenue.

(b) Technology investment

Lenders vary in their willingness to invest in technological infrastructure to support securities lending.

(c) Credit risk appetite

The securities lending market contains organisations with a wide range of credit quality and collateral capabilities. A cautious approach to counterparty selection (AAA only) and restrictive collateral guidelines (G7 Bonds) will limit lending volumes.

2 Portfolio Characteristics

(a) Size

Other things being equal, borrowers prefer large portfolios.

(b) Holdings Size

Loan transactions generally exceed US\$250,000. Lesser holdings are of limited appeal to direct borrowers. Holdings under US\$250,000 are probably best deployed through an agency programme, where they can be pooled with other inventory.

(c) Investment Strategy

Active investment strategies increase the likelihood of recalls, thereby reducing the inventory's attractiveness as against passive portfolios.

(d) Diversification

Borrowers want portfolios where they need liquidity. A global portfolio offers the greatest chance of generating a fit. That being said, there are markets that are particularly in demand from time to time, and there are certain borrowers with a geographic or asset class focus.

(e) Tax Jurisdiction and Position

Borrowers are responsible for "making good" any benefits of share ownership (excluding voting rights) as if the securities had not been lent. They must "manufacture" (i.e., pay) the economic value of dividends to the lender. In the UK [but not normally in Australia], an institution's tax position compared to that of other possible lenders is an important consideration. In the UK, if the cost of manufacturing dividends or coupons to a lender is low, then its assets will be in greater demand.

(f) Inventory Attractiveness

"Hot" securities are those in high demand, whilst general collateral or general collateral securities are those that are commonly available. Needless to say, the "hotter" the portfolio, the higher the returns to lending.

3 The possible routes to the securities lending market

Having examined (in parts 1 and 2 above) the organisation and portfolio characteristics of the beneficial owner, what are the various possible routes to market?

(a) Using an Asset Manager as Agent

Having selected an asset manager, a beneficial owner may find that they are operating a securities lending programme. This route poses few barriers to getting started quickly.

(b) Using a Global/Domestic Custodian as Agent

This is the least demanding option for a beneficial owner, especially a new one. They will already have made a major decision to select an appropriate custodian. This route also poses few barriers to getting started quickly.

(c) Appointing a Third-Party Specialist as Agent

A beneficial owner, having decided to outsource, but not wishing to use its asset manager(s) or custodian(s), may appoint a third-party specialist. This route may mean getting to know and understand a new provider prior to getting started. The opportunity cost of any delay needs to be factored into the decision.

(d) Auctioning a Portfolio to Borrowers

There is a demand from borrowers for specific portfolios for which they will bid guaranteed returns in return for receiving exclusive access. There are several different permutations of this auctioning route:

- Do-it-yourself auctions.
- Assisted Auctions
 - Agent assistance.
 - Consultancy assistance.
 - Specialist “auctioneer” assistance.

This is not a new phenomenon, but one that has gained a higher profile in the UK in recent years. A key issue for the beneficial owner considering this option is the level of operational support that the auctioned portfolio will require and who will provide it.

(e) Selecting one Principal Borrower

Many borrowers act effectively as wholesale intermediaries and have developed global franchises using their expertise and capital to generate spreads between two principals that remain unknown to one another. These principal intermediaries are sometimes separately incorporated organisations, but, more frequently, parts of larger bank, broker-dealer or investment banking groups. Acting as principal allows these intermediaries to deal with organisations that the typical beneficial owner may choose to avoid for credit reasons, e.g. hedge funds.

(f) Lending Directly to Proprietary Principals

Normally, after a period of activity in the lending market using one of the above options, a beneficial owner that is large enough in their own right may wish to explore the possibility of establishing a business “in house” and lending directly to a selection of principal borrowers that are the final end-users of their securities. The proprietary borrowers include broker-dealers, market makers and hedge funds. Some have global borrowing needs, while others are more regionally focused.

(g) Choosing Some Combination of the Above

Just as there is no one right lending method, nor are the options outlined above mutually exclusive. Deciding not to lend one portfolio does not preclude the lending of another, just as lending in one country does not necessitate lending in all. Choosing a wholesale intermediary that happens to be a custodian in the United States and Canada does not mean that a lender cannot lend Asian assets through a third-party specialist and European assets directly to a panel of proprietary borrowers.

C Generally

[See Part 2 of the Australian Supplement.]

Chapter 3: The borrowing motivation

[Except as noted or referred to below, or in part 3 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

1 Introduction

One of the central questions that is commonly asked by issuers and investors alike is “why does the borrower borrow my securities?” Before considering this point (see part 3 below), let us examine why issuers might care.

2 Issuers

If securities were not issued, they could not be lent. Behind this simple tautology lies an important point. When Initial Public Offerings are frequent and corporate merger and acquisition activity is high, the securities lending business benefits. In the early 2000s, the fall in the level of such activity depressed demand to borrow securities, leading to:

- A depressed equity securities lending market:
 - Fewer trading opportunities.
 - Less demand.
 - Fewer ‘specials’.
- Issuer concern about the role of securities lending:
 - Is it linked in any way to the decline in the value of a company’s shares?
 - Should securities lending be discouraged?

How many times does an issuer discussing a specific corporate event stop to consider the impact that issuance of a convertible bond, or the adoption of a dividend re-investment plan, might have upon their share trading activity, with specific reference to the securities lending market?

There is a significant amount of information available on the ‘long’ side of the market, and correspondingly little on the short side. Securities lending activity is not synonymous with short selling. But it is often, but not always, used to finance short sales (see part 3 below) and might be a reasonable and practical proxy for the scale of short selling activity in the absence of full short sale disclosure. It is natural that issuers would want to understand how and why their securities are traded.

3 Reasons to borrow

Borrowers, acting as principal, have no obligation to tell the lenders or their agents why they are borrowing securities. In fact, they may well not know themselves, as they may be on- lending the securities to proprietary traders or hedge funds that do not share their trading strategies openly. Some prime brokers are deliberately vague when borrowing securities, as they wish to protect their underlying hedge fund customer’s trading strategy and motivation.

This chapter explains some of the more common reasons behind the borrowing of securities. In general, these can be grouped into:

- (1) borrowing to cover a short position (settlement coverage, naked shorting, market making, arbitrage trading);
- (2) borrowing as part of a financing transaction motivated by the desire to lend cash; and
- (3) borrowing to transfer ownership temporarily to the advantage of both lender and borrower (tax arbitrage [if available], dividend re-investment plan arbitrage).

We will discuss each reason in turn.

[See also, generally, Part 3 of the Australian Supplement.]

(1) Borrowing to cover short positions

(a) Settlement Coverage

Looking back at the history of securities lending [see *Appendix I*], this borrowing motivation played a significant part in the development of the market. Going back a decade or so, most securities lending businesses in the UK were located in the back office of their organisations and not properly recognised as businesses in their own right. Particularly for less liquid securities – such as corporate bonds and equities with a limited free float – settlement coverage remains a significant part of the demand to borrow.

The ability to borrow to avoid settlement failure is vital to ensure efficient settlement and has encouraged many securities depositories into the automated lending business, meaning that they remunerate customers for making available their securities to be lent by the depository automatically in order to avert any settlement failures.

(b) Naked Shorting

Naked shorting can be defined as borrowing securities in order to sell them, in the expectation that equivalent securities can be bought back subsequently at a lower price, in order to return those equivalent securities to the lender. Naked shorting is a directional strategy, speculating that prices will fall, rather than part of a wider trading strategy, usually involving a corresponding long position in another related security.

Naked shorting is a high-risk strategy. Although some funds specialise in taking short positions in the shares of companies they judge to be overvalued, naked shorting in the UK is a relatively small and probably declining reason for borrowing securities.

(c) Market Making

Market makers play a central role in the provision of two-way price liquidity in many securities markets around the world. They need to be able to borrow securities in order to settle ‘buy orders’ from customers and to make tight two-way prices.

The ability to make markets in illiquid small capitalisation securities is sometimes hampered by a lack of access to borrowing, and some of the specialists in these less liquid securities have put in place special arrangements to enable them to gain access to securities. These include guaranteed exclusive bids with securities lenders.

The character of borrowing is typically short term for an unknown period of time. The need to know that a loan is available tends to mean that the level of communication between market makers and the securities lending business has to be highly automated. A market maker that goes short and then finds that there is no loan available would have to buy that security back to flatten its book.

[See paragraph 3.2 of the Australian Supplement.]

(d) Arbitrage Trading

Securities are often borrowed to cover a short position in one security, taken to hedge a long position in another security, as part of an 'arbitrage' strategy. Some of the more common arbitrage transactions that involve securities lending are described below.

(i) Convertible bond arbitrage

Convertible bond arbitrage involves buying a convertible bond and simultaneously selling the underlying equity short, borrowing the shares to cover the short position (see Box 3 below). Leverage can be deployed to increase the return in such a transaction. Prime brokers are particularly keen on hedge funds that engage in convertible bond arbitrage, as they offer scope for several revenue sources:

- Securities lending revenues.
- Provision of leverage.
- Execution of the convertible bond.
- Execution of the equity.

Box 3: Worked example of convertible bond arbitrage [references to \$ are to US\$]

Long Side

- 5% XYZ Limited convertible bond
- Maturing in one year at US\$1,000
- Exchangeable into 100 non-dividend-paying shares
- Stock currently trading at US\$10 per share

Short side

- A short position of 50 underlying shares at \$10 per share

Pricing inefficiencies between these two related securities can create arbitrage opportunities whether the underlying share price rises or falls. In general, however, the trade will be more profitable if the implied volatility of the share price rises, increasing the value of the call option embedded in the convertible bond.

Unless the issuer defaults, convertible bonds can only fall in value as low as their "investment value" -- the value of the same company bond if it were not convertible. In this case, the investment value is assumed to be US\$920.

Bondholders can purchase protection against issuer default using credit default swaps but this element of the transaction is not covered in this example. To keep the example simple, it is also assumed that the convertible trades with a 'delta' of one to the stock (i.e. that the prices of the convertible bond and the share change at the same rate).

A transaction such as the one outlined above would have the following return dynamics:

No change in share price:

Interest payments on \$1,000 convertible bond (5%)	\$50
Interest earned on \$500 short sale proceeds (1.5%)	\$7.50
Fees paid to lender of shares (0.25% per annum)	(\$1.50)
Net cash flow	\$56.00
Annual Return	<u>5.6%</u>

25% rise in share price:

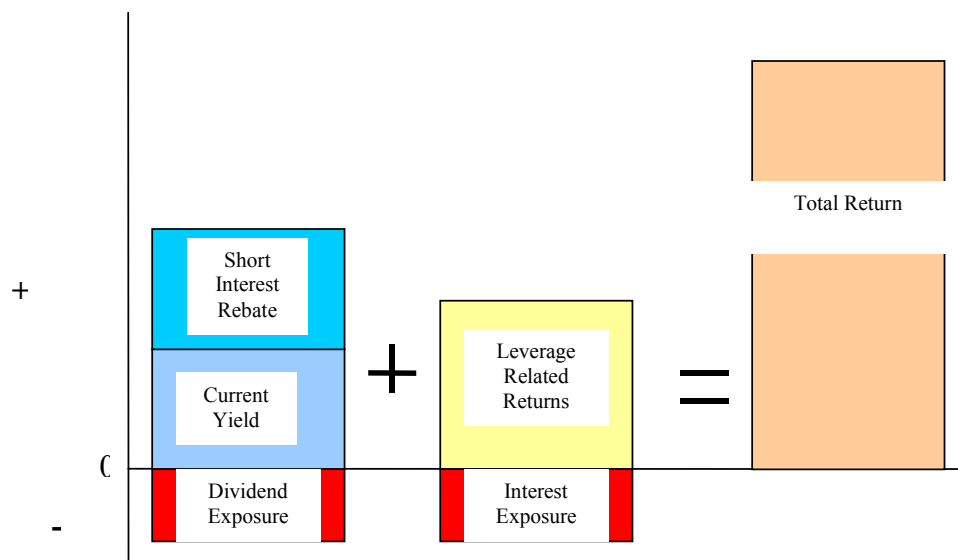
Gain on convertible bond	\$250.00
Loss on shorted stock (50 shares @ \$2.50/share)	(\$125.00)
Interest from convertible bond	\$50.00
Interest earned on short sale proceeds	\$7.50
Fees paid to lender of shares	(\$1.50)
Net trading gains and cash flow	\$181.00
Annual Return	<u>18.10%</u>

25% fall in share price:

Loss on convertible bond (only falling as low as "investment value")	(\$80.00)
Gain on shorted stock (50 shares @ \$2.50/share)	\$125.00
Interest from convertible bond	\$50.00
Interest earned on short sale proceeds	\$7.50
Fees paid to lender of shares	(\$1.50)
Net cash flow	\$101.00
Annual Return	<u>10.10</u>

Diagram 3

Components of Return

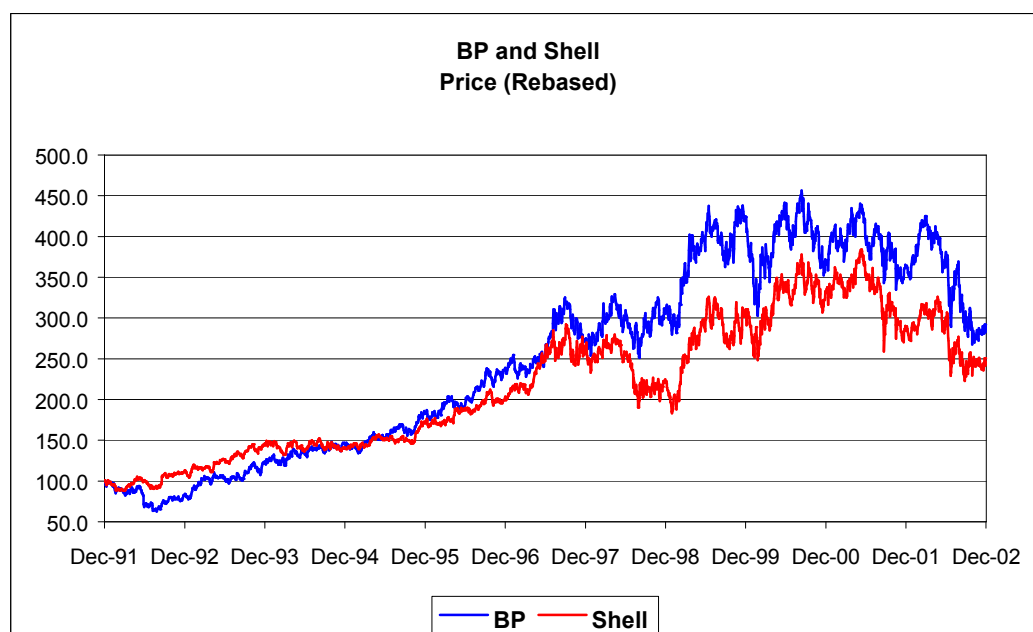


(ii) Pairs trading or relative value 'arbitrage'

This is an investment strategy which seeks to identify two companies, with similar characteristics, whose equity securities are currently trading at a price relationship that is out of line with their historical trading range. The strategy entails buying the apparently undervalued security while selling the apparently overvalued security short, borrowing the latter security to cover the short position.

Focussing on securities in the same sector or industry should normally reduce the risk of this strategy. The following chart shows how Shell and BP have traded in the UK since 1991. At times it would have been possible to buy one share and sell the other, awaiting price realignment.

Diagram 4



(iii) Index Arbitrage

In this context, arbitrage refers to the simultaneous purchase and sale of the same commodity or stock in two different markets in order to profit from price discrepancies between the markets.

In the stock market, an arbitrage opportunity arises when the same security trades at different prices in different markets. In such a situation, investors buy the security in one market at a lower price and sell it in another for more, capitalising on the difference. However, such an opportunity vanishes quickly as investors rush in to take advantage of this price difference.

The same principle can be applied to index futures. Being a derivative product, index futures derive their value from securities that constitute the index. At the same time, the value of index futures is linked to the stock index value, through the opportunity cost of funds (borrowing/lending cost) required to play the market.

Stock index-arbitrage involves buying (selling) a basket of stocks and selling (buying) futures when mispricing is perceived to occur.

When is an arbitrage possible? Either:

- Where the current index futures price (FC) is not equal to the index value (IC) plus the difference between the risk free interest (RF) and dividends (D) obtainable over the life of the contract; or
- whenever the following is not true: $FC = IC + (RF - D)$.

Whenever the actual futures price moves away from the above calculated value, i.e. when either $FC > IC + (RF - D)$ or $F < IC + (RF - D)$, arbitrage opportunities exist. The difference between the current theoretical actual cost and the futures price is called the basis! It is this difference that creates an arbitrage opportunity.

When $FC > IC + (RF - D)$, a trader can profit from taking the following action:

- Buying a portfolio which is identical to the index value.
- Selling index futures.

When $FC < IC + (RF - D)$, a trader can profit from taking the following action:

- Going short (selling) a portfolio which is identical to the index value.
- Buying index futures.

It is here that securities lending plays its role. The ability of a borrower to source a complete portfolio of all the stocks in an index, properly weighted, that will accurately track the performance of the index is a big advantage. Incomplete indices or unbalanced indices open up the possibility of tracking error, whereby the performance of the short cash portfolio deviates from that of the index.

The ability to borrow securities that have a cheaper manufactured dividend obligation [if available] is an advantage too. One of the problem areas is when a component(s) of the index is in

high demand ('trading special') and the cost of borrowing rises, thereby reducing the profitability of the transaction. The ability to borrow for a fixed term basis is also an advantage.

From a UK point of view, the best sources of securities to support this type of transaction are passive index tracking funds incorporated in countries that suffer a significant withholding tax. [In Australia, borrowing Australian securities from such funds could attract specific or general tax anti-avoidance provisions: *see paragraphs 7.18-7.30 and 7.31-7.50 of the Australian Supplement.*]

Once established, the stock index arbitrage can generate profits should the price of the index and the underlying securities move in either direction. The arbitrage opportunity is often short-lived, as positions are taken and the price adjusts. The margins in these transactions can be thin and they are often done in large sizes.

(2) Financing

As broker dealers build derivative, prime brokerage and customer margin business, they hold an increasing inventory of securities that requires financing.

This type of activity is high volume and takes place between two counterparties that have the following coincidence of wants:

- One has cash that they would like to invest on a secured basis and pick up yield.
- The other has inventory that needs to be financed.

In the case of bonds, the typical financing transaction is a repo or buy/sell back. But, for equities, securities lending and equity repo transactions are used.

In the UK, triparty agents are often involved in such financing transactions, as they can reduce operational costs for the cash lender and they have the settlement capabilities the cash borrower needs to substitute securities collateral as their inventory changes.

(3) Temporary transfers of ownership

(a) Tax Arbitrage

Tax driven trading [if available] is an example of securities lending as a means of exchange.

Markets that have historically provided the largest opportunities for tax arbitrage include those with significant tax credits that are not available to all investors, such as Italy, Germany and France.

The different tax positions of investors around the world have opened up opportunities for borrowers to use securities lending transactions, in effect, to exchange assets temporarily for the mutual benefit of purchaser, borrower and lender. If tax driven trading is available, the lender's reward comes in one of two ways: either a higher fee for lending, if they require a lower manufactured dividend; or a higher manufactured dividend than the post-tax dividend that they would normally receive (quoted as an "all in rate").

For example, an offshore [e.g. outside the European Union] lender that would normally receive 75% of a German dividend and suffer 25% withholding tax (with no possibility to reclaim) could lend the security to a borrower that, in turn, could sell it to a German investor able to obtain a tax credit rather than suffer withholding tax. If the offshore lender claimed from the borrower 95% of

the dividend that it would otherwise have received, it would be making a significant pick-up (20% of the dividend yield), whilst the borrower might make a spread between 95% and whatever the German investor was bidding. The terms of these trades vary significantly and rates are calculated accordingly.

[See paragraph 3.5 of the Australian Supplement.]

(b) Dividend Re-investment Plan Arbitrage

Many issuers of securities create an arbitrage opportunity when, under a dividend re-investment plan (DRP), they offer shareholders the choice of taking a dividend or re-investing in additional securities at a discounted price.

Income or index tracking funds that cannot deviate from recognised securities weightings may have to choose to take the cash option and forgo the opportunity to take the discounted re-investment opportunity.

[Alternatively, foreign securities laws (e.g. in the US) may effectively prevent non-resident registered holders from being invited to participate in the DRP, unless the issuer takes special steps to comply with those securities laws, which it may be unwilling to do.]

One way that holders who, for one reason or another, are unable or unwilling to participate in the DRP can share in the potential profitability of this opportunity is to lend securities to borrowers that then take the following action:

- Borrow as many guaranteed cash shares as possible as cheaply as possible.
- Tender the borrowed securities to receive the new discounted shares [ie elect to participate in the DRP].
- Sell the new shares to realise the “profit” between the discounted share price and the market price. [Often, programmed selling shares in the issuer can lock in a fixed profit approximately equal to the discount.]
- Return the shares and manufacture the cash dividend to the lender.

[See paragraph 3.3 of the Australian Supplement.]

Chapter 4: Market mechanics

[Except as noted or referred to below, or in part 4 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

1 Introduction

This section outlines the detailed processes in the life of a securities loan including:

- Negotiation of loan deals.
- Confirmations.
- Term of loan.
- Term trades.
- Putting securities “on hold”.
- Settlements including how loans are settled and settlement concerns.
- Termination of loans.
- Redelivery, failed trades and legal remedies.
- Corporate actions and voting.
- Reporting of transactions.
- Tax arrangements.

We will discuss each of these processes in turn.

2 Loan negotiation

Historically, securities loans in the UK were typically negotiated between counterparties (whose credit departments have approved one another) on the telephone, with written or electronic confirmations being sent subsequently. Normally the borrower initiates the call to the lender, with a borrowing requirement. However pro-active lenders may also offer out securities that they know are in demand in the market to their approved counterparties. Particularly if one borrower returns a security and the lender is still lending it to others in the market, the lender will contact the borrower to see if it wishes to borrow additional securities.

Today, there is an increasing amount of bilateral and multilateral automated lending whereby securities are broadcast as available at particular rates by using email or other electronic means. Where lending terms are agreeable, automatic matching can take place.

An example of an electronic platform for negotiating equity securities lending transactions is EquiLend, which began operations in 2002 and is backed by a consortium of financial institutions. EquiLend’s stated objective is to:

“...Provide the securities lending industry with the technology to streamline and automate transactions between borrowing and lending institutions and ... introduce a set of common protocols. EquiLend will connect borrowers and lenders through a common, standards-based global equity lending platform enabling them to transact with increased efficiency and speed, and reduced cost and risk.”

EquiLend is not alone in this market; for example, SecFinex offers similar services in Europe.

[See paragraphs 4.1 to 4.3 of the Australian Supplement.]

3 Confirmations

Written or electronic confirmations are issued, whenever possible on the day of the trade, so that any queries by the other party can be raised in a timely manner. Material changes during the life of the transaction are agreed between the parties and may also be confirmed if either party wishes it. Examples of material changes are collateral adjustments or collateral substitutions.

The parties agree who will take responsibility for issuing loan confirmations that would normally include the following information:

- Contract and settlement dates.
- Details of loaned securities.
- Lender and borrower (and any underlying principal).
- Acceptable collateral and margin percentages.
- Term and rates.
- Lender's and borrower's bank and settlement account details.

4 Term of loan and selling securities while on loan

Loans may either be for a specified term or open. Open loans are trades with no fixed maturity date. It is more usual for securities loans to be open or “at call”, especially for equities, because lenders typically wish to preserve the flexibility for fund managers to be able to sell at any time. Open loans can remain on loan for a long period. [But, in relation to Australian lenders, *see paragraphs 4.4 and 4.5 of the Australian Supplement.*]

Lenders are able to sell securities despite their being on open loan, because they can usually be recalled from the borrower for return within the settlement period of the particular market concerned.

5 Term trades – fixed or indicative?

The general description “term trade” is used in the UK to describe differing arrangements in the securities lending market. The parties need to agree whether the term of a loan is fixed for a definite period or whether the duration is merely indicative and therefore the securities are callable.

If fixed, there is no obligation on the lender to accept the earlier return of the securities. Neither does the borrower need to return the securities early if requested by the lender. Accordingly, securities subject to a fixed loan should not be sold by the lender while on loan.

Where the term discussed is intended to be indicative, in the UK it usually means that the borrower has a long term need for the securities but the lender is unable to fix for term and retains the right to recall the securities if necessary.

6 Putting securities “on hold” (also known as “Icing”)

Putting securities “on hold” (referred to in the UK market as “icing” securities) is the practice whereby the lender will reserve securities at the request of a borrower against the borrower’s anticipated need to borrow those securities at a future date. This occurs where the borrower needs to be sure that the securities will be available before committing to a trade that will require such securities to be borrowed.

While particular arrangements can be agreed between the parties, it is normal in the UK for any price quoted to be purely indicative, and for securities to be held to the following business day. The arrangement can be rolled over by contacting the holder before 9am, or otherwise it terminates.

Key aspects of these UK arrangements are that the lender does not receive a fee for reserving the securities and they are generally open to challenge by another borrower making a firm bid. In this case the first borrower would have 30 minutes to decide whether to take the securities at that time or to release them.

7 “Pay to hold” arrangements

Variations on this theme are “pay to hold” arrangements where the lender does receive a fee for putting the securities on hold. As such, they constitute a contractual agreement and are not open to challenge by other borrowers.

8 How are loans settled?

(a) Generally

Securities lenders need to settle transactions on a shorter timeframe than the customary settlement period for that market. Settlement will normally be through the lender’s custodian bank and this is likely to apply irrespective of whether the lender is conducting the operation or delegating to an agent. The lender will want to agree a schedule of guaranteed settlement times for its securities lending markets with its custodians. Prompt settlement information is of crucial importance for the efficient monitoring and control of a lending programme, with reports needed for both loans and collateral.

In most settlement systems securities loans are settled as “free of payment” deliveries and the collateral taken is settled quite separately, possibly in a different payment or settlement system and maybe a different country and time zone e.g. lending UK equities against collateral provided in a European International Central Securities Depository or US dollar cash collateral paid in New York. This can give rise to what is known in the market as “daylight exposure”, a period when the loan is not covered as the lent securities have been delivered but the collateral securities have not yet been received. To avoid this exposure, some lenders insist on pre-collateralisation, so transferring the exposure to the borrower.

(b) UK CREST settlement facility for stock lending

The CREST system for settling UK and Irish securities is an exception to the normal practice, as collateral is available within the system. This enables loans to be settled against cash intra-day and

for the cash to be exchanged, if desired, at the end of the settlement day for a package of DBV securities overnight. The process can be reversed and repeated the next day.

CREST also has specific settlement arrangements for stock loans, requiring the independent input of instructions by both parties, which must complete a number of matching fields, including the amount and currency of any cash collateral, together with the percentage value of applicable loan margin. Loans may be affected against sterling, euro or dollar consideration or made free of payment.

Immediately after the settlement of the loan, CREST automatically creates a pre-matched stock loan return transaction with an intended settlement date of the next business day. The return is prevented from settling until the borrower intervenes to raise the settlement priority of the transaction. The stock lender may freeze the transaction in order to prevent the stock from returning.

CREST provides full revaluation facilities for all securities out on loan. On the original creation of the return and every night that the loan is open thereafter, it is marked-to market against the prevailing CREST offer price. Any deficit or surplus of cash collateral of a stock loan return arising from price fluctuations is corrected by CREST which automatically generates payment instructions between the parties and simultaneously alters the value of the return consideration. Users may opt out of the revaluation process by completing the relevant field of the loan transaction, or by settling loans on a free of payment basis.

(c) Australian settlement facilities

[See paragraphs 4.6 to 4.9 of the Australian Supplement.]

9 Termination of the loan

Open loans may be terminated by the borrower returning securities or by the lender recalling them. The borrower will normally return borrowed securities when it has filled its short position. A borrower will sometimes refinance its loan positions by borrowing more cheaply elsewhere and returning securities to the original lender. The borrower may, however, give the original lender the opportunity to reduce the rate being charged on the loan before borrowing elsewhere.

10 Redelivery, failed trades and legal remedies

When deciding in which markets and in what size to lend, securities lenders will consider how certain they can be of having their securities returned in a timely manner when called, and what remedies are available under the legal agreement in the event of a failed return.

Procedures to be followed in the event of a failed redelivery are usually covered in legal agreements or otherwise agreed between the parties at the outset of the relationship. Financial redress may be available to the lender if the borrower fails to redeliver loaned securities or collateral on the intended settlement date. Costs that would be typically covered include:

- Direct interest, overdraft and similar costs and expenses incurred.
- Costs reasonably and properly incurred as a result of the borrower's failure to meet its sale or delivery obligations.

- Total costs and expenses reasonably incurred by the lender as a result of a ‘buy-in’ (i.e. where the lender purchases securities in the open market following the borrower’s failure to return them).

Costs that would usually be excluded are those arising from the transferee’s negligence or wilful default and any indirect or consequential losses.

An example of an indirect or consequential loss is when the non-return of loaned securities causes an onward trade for a larger amount to fail. The norm is for only that proportion of the total costs relating to the securities or collateral that the transferor has failed to return to be claimed. It is good practice, where possible, to consider ‘shaping’ or ‘partialling’ the larger transaction (i.e. breaking it up into a number of smaller amounts for settlement purposes) so as to avoid the possibility of the whole transaction failing, if the transferor cannot redeliver the loaned securities or collateral on the intended settlement date.

11 Corporate actions and votes

The basic premise underlying securities lending is to make the lender whole for any corporate action event, such as a dividend, rights or bonus issue, by putting the borrower under a contractual obligation to make equivalent payments to the lender, e.g. ‘manufacturing’ dividends.

However, a shareholder’s right to vote as part owner of a company cannot be manufactured. When securities are lent, legal ownership and the right to vote in shareholder meetings passes to the borrower, which will often sell the securities on into the secondary market. Where lenders have the right to recall securities, they can use this option to restore their holdings and voting rights, with the onus on the borrower to find the securities, including through borrowing or purchasing them in the market, if necessary.

Borrowing securities in order to build up a holding in a company with the deliberate purpose of influencing a shareholder vote is not illegal in the UK [or in Australia] as it is in the United States. However, institutional lenders have recently become more aware of this possibility, which is not a use of securities borrowing that most market participants would accept as legitimate.

In the UK, the National Association of Pension Funds and other bodies representing institutional investors in the United Kingdom and elsewhere are currently developing a “Code of Best Practice for Stock Lending” for long-term investors that is intended to address these concerns. [There is no similar development in Australia.]

12 Reporting of transactions *in Australia*

(1) Australian Stock Exchange reporting by member firms

[See paragraphs 4.10 to 4.16 of the Australian Supplement.]

(2) Corporations Act

[See paragraphs 4.17 to 4.21 of the Australian Supplement.]

(3) Transparency in the Australian market

[See paragraph 4.22 of the Australian Supplement.]

(4) Takeovers Panel

[See paragraphs 4.23 and 4.24 of the Australian Supplement.]

13 Tax arrangements

[See Part 7 and especially paragraphs 7.33-7.36 of the Australian Supplement.]

Chapter 5: Risks, regulation and market oversight

[Except as noted or referred to below, or in part 5 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

1 Introduction

This chapter describes the main financial risks in securities lending, and how lenders typically manage them. It is not a comprehensive description of the various operational, legal, market and credit risks to which market participants can be exposed. Readers seeking a fuller analysis are referred to the relevant sections of, for example, ‘Securities Lending Transactions: Market Development and Implications’ (BIS/IOSCO, 1999).

Financial risks in securities lending are primarily managed through the use of collateral and netting:

- As described in chapter 1, collateral can be in the form of securities or cash.
- The market value of the collateral is typically greater than that of the lent portfolio. This margin is intended to protect the lender from loss and reflect the practical costs of collateral liquidation and repurchase of the lent portfolio in the event of default.
- Any profits made in the repurchase of the lent portfolio are normally returned to the borrower’s liquidator. Losses incurred are borne by the lender, with recourse to the borrower’s liquidator along with other creditors.

2 Risks and risk management

[See also paragraphs 5.1 to 5.31 of the Australian Supplement.]

(1) When taking cash as collateral

Cash can be highly appropriate collateral. However, the lender needs to decide how best to utilise this form of collateral. As described in Chapter 1, a lender taking cash as collateral pays rebate interest to the securities borrower, so the cash must be reinvested at a higher rate to make any net return on the collateral aspect of the transaction. This means the lender needs to decide on an appropriate risk: return trade-off. In simple terms, expected returns can be increased by reinvesting in assets with more credit risk – with a risk of loss in the event of defaults – or longer maturity in relation to the likely term of the loan – with a risk of loss if market interest rates rise. Many of the large securities lending losses over the years have been associated with re-investment of cash collateral.

Typically, lenders delegate reinvestment to their agents, (e.g. custodian banks). They specify re-investment guidelines, such as those set out in Chapter 1. There is a move towards more quantitative risk-based approaches; often specifying the ‘value-at-risk’ in relation to the different expected returns earned from alternative reinvestment profiles. Agents do not usually offer an indemnity against losses on re-investment activity, so that the lender retains all of the risk while their agent is paid part of the return.

(2) When transactions are collateralised with other securities

Apart from the risk of errors, systems failures and fraud always present in any market, problems arise on the default of a borrower. In such an event, the lender will then seek to sell the collateral securities, in order to raise the funds to replace the lent securities. There are some key elements that influence the degree of this risk:

Reaction and Legal Risk. If a lender experiences delays in either selling the collateral securities or repurchasing the lent securities, it runs a greater risk that the value of the collateral will fall below that of the loan. Typically, the longer the delay, the larger the risk.

Misprice Risk. The lender will be exposed if either collateral securities have been over-valued or lent securities under-valued, because the prices used to mark-to-market differ from prices that can actually be traded in the secondary market. One example is using mid rather than bid prices for collateral. For illiquid securities, obtaining a reliable price source is particularly important.

Liquidity Risk – Illiquid securities are more likely to be realised at a lower price than the valuation used. Valuation haircuts are used to address this risk (i.e. collateral is valued at, for example, 98% or 95% of the current market value). The size of the ‘haircuts’ might depend upon:

- the proportion of the security issue held in the portfolio - the larger the position, the greater the haircut;
- the average daily traded volume of the security - the lower the volume, the greater the haircut; and
- the volatility of the security - the higher the volatility, the greater the haircut.

Congruency of Collateral and Lent Portfolios (Mismatch Risk) - If the lent and collateral portfolios were identical, then there would be no market risk. In practice, of course, the lent and collateral portfolios are often very different. The lender’s risk is that the market value of the lent securities increases but that of the collateral securities falls, before rebalancing can be effected. Provided the counterparty has not defaulted, the lender will be able to call for additional collateral on any adverse collateral/loan price movements. However, following default, it will be exposed until it has been able to sell the collateral and replace the lent securities. The size of mismatch risk depends on the expected co-variance of the value of the collateral and lent securities – the risk will be greater if the value of the collateral is more variable, if the value of the lent securities is more variable or if their values do not tend to move together, so that the expected correlation between changes in their value is low. For example, in deciding whether to hold Australian government securities or Australian equities to collateralise a loan of Commonwealth Bank of Australia Ltd (CBA) shares, a lender would have to judge whether the greater expected correlation between the value of the Australian equities and the CBA shares reduced mismatch risk by more than the lower expected volatility in the value of the government securities.

Many agent intermediaries will offer beneficial owners protection against these risks by agreeing to return (buy-in) lent securities immediately for their clients following a fail, taking on the risk that the value of the collateral on liquidation is lower.

Box 4: A worked example: Securities lending against the collateral of other securities

This example illustrates one approach to estimating the risk exposure to a lender taking securities as collateral.

Table 4A: Summary of ABC's Lent and Collateral Position with Borrower 1

Asset Class	Loan Inventory (£m)	No. of Loan Positions	Collateral Inventory (£m)	No. of Collateral Positions	Gross Margin (£m)
Total	550.0	43	575.0	10	25.0
FTSE 100	100.0	5	75.0	2	-25
FTSE 250	200.0	10			-200
UK 20-Year Bonds			300.0	5	300
UK Cash			100.0		100
US Equities	100.0	15			-100
Japan Equities	50.0	3			-50
Malaysian Equities	100.0	10			-100
US Long Bonds			100.0	3	100

Assume that the lender ABC has loaned Borrower 1 a range of equities in the UK, US, Japanese and Malaysian markets. Collateral is mainly in the form of UK gilts at various maturities, sterling cash deposits and US long-dated Treasury bonds. The gross margin is £25m or 4.5% of loan inventory.

Table 4B: Data used to drive the analysis

Currency Base: GBP											
Asset Class	Ave Daily Liq (£m)	Asset Risk	Avg Stock RRisk (%p.a.)	Correlation Assumptions							
				FTSE 100	FTSE 250	UK 20-Year Bonds	UK Cash	US Equities	Japanese Equities	Malaysian Equities	US Long Bonds
FTSE 100	5.80	18%	20%	1.00	0.93	0.38	-0.01	0.70	0.31	0.64	0.26
FTSE 250	1.00	20%	30%	0.93	1.00	0.30	-0.09	0.65	0.37	0.61	0.23
UK 20-Year Bonds	20.00	9%	3%	0.38	0.30	1.00	-0.02	0.09	0.12	0.08	0.12
UK Cash		1%	3%	-0.01	-0.09	-0.02	1.00	-0.04	-0.09	-0.07	-0.02
US Equities	9.40	20%	24%	0.70	0.65	0.09	-0.04	1.00	0.26	0.64	0.68
Japanese Equities	1.40	25%	22%	0.31	0.37	0.12	-0.09	0.26	1.00	0.30	0.13
Malaysian Equities	0.90	34%	29%	0.64	0.61	0.08	-0.07	0.64	0.30	1.00	0.39
US Long Bonds	20.00	14%	5%	0.26	0.23	0.12	-0.02	0.68	0.13	0.39	1.00

Table 4B shows the type of data on which a detailed analysis might be based: the average daily liquidity in each asset class, the volatility of each asset class, the average residual risk on particular securities within each asset class and a matrix of correlations between various asset classes.

Step 1: Realistic Valuations

The first consideration is whether the valuation prices are fair. Assuming the portfolios have been conservatively valued at bid and offer (not mid) prices, then the lender might require some adjustment to reflect concentration and price volatility of the different assets. For example, in the case of the sterling cash collateral, the haircut might be negligible. But for the Malaysian equity portfolio, a high adjustment might be sought on the assumption that it would probably cost more than £100m to buy back this part of the lent portfolio. Required haircuts might be based on the average daily liquidity for the asset class, the price volatility of the asset class and the residual risk on individual securities, taken from table 4B.

Table 4C: Adjusted Collateral and Lent Portfolio Values

Asset Class	Adjusted Loan Inventory (£m)	Adjusted Collateral Inventory (£m)	Net Margin (£m)
Total	557.1	573.3	16.2
FTSE 100	100.7	73.8	-26.9
FTSE 250	203.8		-203.8
UK 20-Year Bonds		299.7	299.7
UK Cash		100.0	100.0
US Equities	100.2		-100.2
Japan Equities	51.0		-51.0
Malaysian Equities	101.4		-101.4
US Long Bonds		99.8	99.8

Table 4C shows how needed haircuts could affect the valuation. For example, the lent Malaysian equities have been revised upwards to £101.4m. This reflects the lower liquidity and higher volatility of the Malaysian equities, which outweigh the risk reduction brought by diversifying the risk on the lent portfolio. The lender's margin has thus effectively been reduced from £25m to £16.2m or 2.9%.

Step 2: Risk Calculation (Post – Default)

Using the adjusted portfolios, the lender can then calculate the risk of a collateral shortfall should the borrower default. Broadly, this will need to take into account the volatility of each asset class, the correlation between them and the residual risk of securities within them to derive a range of possible scenarios from which probabilities of loss and the most likely size of losses on default can be estimated. Assuming that the lender can realise its collateral and replace its lent securities in a reaction time of twenty days, table 4D shows these results for the portfolio, together with some sensitivity analysis in case market volatility and liquidity changed significantly. By increasing the volatility assumption or reducing the liquidity assumption, the probability and scale of expected losses increase.

Table 4D: Risk Analysis for Borrower 1 under different assumptions

Scenario	Probability of Loss on Default	Expected Loss on Default (£m)
Base Case	26%	4.0
Asset Risk increased by 50%	33%	8
Reduce Liquidity by 50%	31%	5.1

The final sensitivity is reaction time, and table 4E shows how the probability and expected size of losses decrease if the lender can realise the collateral and replace the lent securities more quickly.

The framework can be used to understand how possible changes in ABC's programme with Borrower 1 might affect the risks. Table 4E summarises some of the possible changes that could be made, in each case leaving the base case portfolio unchanged in other respects.

Table 4E: Risk Analysis for Borrower 1 under different Lending Policies

Policy	Probability of Loss on Default	Expected Loss on Default (£m)
Base Case Portfolios	26%	4.0
Reaction Time = 10 days	19%	1.8
Reaction Time = 3 days	5%	0.2
Half the Concentration (i.e. double the number of securities lent and collateral)	20%	2.7
£10m more in Cash Collateral	15%	1.9
No Malaysian Lending & reduction in Cash Collateral	17%	1.7
Matched Collateral/Lent Exposure & Concentration + Residual Collateral in Cash	14%	0.7

3 Netting

Netting (set off) is an important element of risk management, given that market participants will often have many outstanding trades with a counterparty. If there is an event of default, then the various standard industry master agreements for securities lending provide for the parties' various obligations under different securities lending transactions governed by a master agreement to be accelerated, i.e. payments become due at current market values. But, instead of requiring the parties to deliver securities or collateral on each of their outstanding transactions gross, their respective obligations are valued (i.e. given a cash value), the value of the obligations owed by one party is set off against the value of the obligations owed by the other party, and it is the net balance that is then due in cash.

This netting mechanism is a crucial part of the agreement. That is why there is so much legal focus on it: for example, the need to obtain legal opinions about the effectiveness of netting provisions in jurisdictions of overseas counterparties, particularly in the event of a counterparty's insolvency.

That is also why regulators of financial firms typically expect there to be legal opinions on the robustness of netting arrangements before they are willing to recognise the value of collateral in reducing counterparty credit exposures for capital adequacy purposes. In the United Kingdom, SLRC has a netting sub-group, which monitors an exercise to gather opinions on the legal basis for netting in different jurisdictions on behalf of subscribing banks.

[See paragraphs 5.32 to 5.41 of the Australian Supplement.]

4 Regulation

[See paragraphs 5.42-5.75 of the Australian Supplement.]

5 UK Stock Borrowing and Lending Code

In the UK, in addition to the essentially prudential standards set by the FSA, market participants have drawn up a code, the Stock Borrowing and Lending Code, which UK-based market participants in the stock borrowing and lending markets of both UK domestic and overseas securities observe as a matter of *good practice*. The Code covers matters such as agents, brokers, the legal agreement used, custody, margin, default and close out, and confirmations. The Code was derived from current practices observed by leading participants in the stock borrowing /

lending market and is kept under regular review. The Code does not in any way replace the FSA's or other authorities' regulatory requirements; and it is not intended to override the internal rules of settlement systems as regards borrowing or lending transactions. Work is currently in progress to produce a UK Annex to the Code that will consider specific aspects of UK law and practices in the equity stock lending market. The Code is available at the Bank of England's website at www.bankofengland.co.uk/markets/stockborrowing.pdf.

[See paragraphs 5.76 and 5.77 of the Australian Supplement.]

6 No Australian equivalent to the UK Securities Lending and Repo Committee

The UK Stock Borrowing and Lending Code was produced by the UK Securities Lending and Repo Committee (SLRC). The SLRC is a UK-based committee of market practitioners, together with bodies such as CRESTCo, the United Kingdom Debt Management Office, the Inland Revenue, the London Clearing House, the London Stock Exchange and the FSA. It provides a forum in which structural (including legal, regulatory, trading, clearing and settlement infrastructure, tax, market practice and disclosure) developments in the stock lending and repo markets can be discussed, and recommendations made, by practitioners, infrastructure providers and the UK authorities. It also co-ordinates the development of gilt repo and equity repo codes; produces and updates the Gilts Annex to the ISMA/ TBMA Global Master Repurchase Agreement (GMRA); keeps under review the other legal agreements used in the stock lending and repo markets; and maintains a sub-group on legal netting. It liaises with similar market bodies and trade organisations covering the repo and securities and other financial markets, both in London and other financial centres. Minutes of SLRC meetings are available on the Bank of England's website, at www.bankofengland.co.uk/markets/slrc/htm. Its terms of reference are shown in appendix 2 to the UK Publication.

In the UK, the work of the SLRC complements the work of the various market associations, including in the securities lending field the International Securities Lending Association (ISLA). The objectives of ISLA include representing the common interests of securities lenders and to assist in the orderly, efficient and competitive development of the securities lending market. ISLA has helped to produce standard market agreements, including the Overseas Securities Lending Agreement (OSLA 1995 version), the Master Equity and Fixed Interest Securities Lending Agreement (MEFISLA 1999 version) and the Global Master Securities Lending Agreement (GMSLA May 2000).

[There is no Australian equivalent to the SLRC.]

Chapter 6: Frequently asked questions

[Except as noted or referred to below, or in part 6 of the Australian Supplement, the comments in this Chapter are equally applicable in Australia.]

The securities lending business is seen by many non-practitioners as difficult to understand and there are many questions asked. Here are answers to some of those questions, grouped under the following headings:

- A. Legal.
- B. Dividends and Coupons.
- C. Collateral and Risk Management.
- D. Operational and Logistical.
- E. Corporate Governance.
- F. The various lending options for beneficial owners.

A. Legal

1 What do people mean when they talk of transfer of title?

The contractual arrangements provide for ownership of the securities lent to pass from the lender to the borrower.

A moment's thought about one of the principal motivations for borrowing and lending securities will make the necessity for this clear. Say the borrower needs to borrow securities to cover a short position i.e. to fulfil a contract it has entered into to sell the relevant kind of securities. Obviously, the buyer is expecting the borrower to pass its ownership on settlement of that sale, as is normal in a sale. If the borrower cannot do that, the borrower will not be able to fulfil its contract with that purchaser. In order to enable it to do this, the borrower obtains title from the lender and then passes it on to the purchaser.

2 What does this mean for the lender?

The lender needs to be aware that it will be transferring ownership of the securities and of the various consequences that flow from this.

First, any transfer taxes applicable to a transfer of securities will be relevant, unless an exemption applies. This will typically be an issue for the borrower on the initial leg of the transaction. But the lender should recognise that the return leg of the transaction (i.e. what happens at the end of the loan) involves a transfer of securities from the borrower to the lender, and so transfer taxes may also be relevant then (again unless there is an exemption). [However, there should be no stamp duty or GST transfer taxes in respect of Australian equity or debt securities.]

Second, the transfer of the lent securities is in legal terms a disposal of them, and the lender needs to establish whether such a disposal will have any consequences. Again this is usually a tax question e.g. are there tax consequences for the lender in disposing of the lent securities? *[See paragraphs 7.8 to 7.14 of the Australian Supplement.]*

Third, and very importantly, the obligation of the borrower on the return leg of the transaction is an obligation to transfer equivalent securities back to the lender, not the original securities. The borrower does not hold the securities in trust or in custody for the account of the lender. The lender has no right to, or ownership of, securities that are in the hands of the borrower (and, given that the borrower will often have sold the securities, it is unlikely that the securities will be in the borrower's hands).

Fourth, as the lender will cease to be the owner, it will no longer be entitled to income on the securities, notice or benefit of corporate actions, or any voting rights in respect of the securities. The standard documentation sets out contractual mechanisms for putting the owner in a comparable economic position vis-à-vis income and corporate actions (although these can raise their own tax issues). Voting rights are transferred and the lender must recall equivalent securities from the borrower in order to vote. *[See paragraph 6.1 of the Australian Supplement.]*

3 *Why is it called securities lending when there is transfer of title?*

Because commercially or economically people think of it as lending the borrower the use of the securities. Legally this is not what it is at all, but economically and possibly for other purposes such as accounting or capital requirements, it is comparable to a loan.

4 *Does it mean that the lender gets exactly the same securities back?*

The borrower's obligation is to return 'equivalent securities', ie from the same securities issue, with the same International Securities Identification Number (ISIN). Often it will have sold the original lent securities holding and will borrow or purchase securities in the market to fulfil its obligation to the lender.

5 *Does the lender have a pledge over the collateral?*

Under standard market agreements and English [and Australian] law, there is also usually a transfer of title to the collateral. If the collateral is cash, all that means is that there is a cash payment by the borrower to the lender's bank account. If the collateral is securities, there is a transfer of title of those securities to the lender.

So, many of the same questions arise for borrowers in relation to collateral securities as arise for lenders in relation to lent securities.

6 *Why are there so many different agreements?*

Historically the different tax treatment of securities lending in different jurisdictions has driven the need in the UK for different agreements (like OSLA - the Overseas Securities Lender's Agreement, MEFISLA - the Master Equity and Fixed Income Stock Lending Agreement, and so on). Following certain UK tax changes, it has generally become possible in the UK to use a single document: the GMSLA (the Global Master Securities Lending Agreement) consolidates the various UK historical documents.

[See paragraph 6.2 of the Australian Supplement.]

7 *If the securities lending is carried out under English Law, but your custodian appoints a sub-custodian in another country, or lends to an entity in another country, which does not recognise English Law, what happens when something goes wrong?*

Simplifying a bit, there are three elements in the application of law to a securities lending transaction:

- the first is the contractual law;
- the second is the home country law applying to each of the two parties; and
- the third is the law applying to the place where the securities are held.

The contractual law is that which applies to the legal agreement between the parties, which sets out the contractual terms relating to the lending transaction. Most UK lending agreements are in practice subject to English law, so that any disputes can be settled in the courts of England.

Where a party incorporated in England proposes to conduct a securities lending transaction with a party incorporated in another country, the former party will need to check, normally by obtaining a legal opinion, that the home country law of the other party will allow the contract to be given effect in accordance with its terms. This opinion will normally focus in particular on the close out and netting (set-off) provisions of the legal agreement that apply in insolvency. Those provisions help to ensure that one party is able to close out immediately existing transactions in the event of a default by the other party; and, by netting the amounts in respect of securities lending transactions due, the net sum due by one to the other should be relatively small (see the section on netting in Chapter 5). This, together with the collateralisation and margin arrangements, should keep the risks in conducting such business to acceptable levels.

As regards the law relating to where the securities are held, securities borrowers need to be certain that they have good title to the securities. There is a potential for conflicts of laws or legal uncertainty with respect to good title. The traditional rule for determining the validity of a disposition of securities is to look at the law of the place where the securities are located [the *lex sitae* / *lex situs* principle]. This is, however, difficult to apply with a position where securities are held through a number of intermediaries. The generally preferred approach now is to look to the location of the intermediary maintaining the account to which the securities are credited (the ‘PRIMA’ principle). The EU Collateral Directive, as implemented in EU member states, applies the PRIMA principle; and there are plans to extend it further through the Hague Convention. Parties should therefore seek to be satisfied that the law applying to the intermediary is satisfactory.’

[See paragraph 6.3 of the Australian Supplement.]

B. Dividends and Coupons

1 *What happens if the lender has lent a stock over the dividend period?*

The “borrower” of stock makes good to the lender the dividend amount that the lender would have received had it not lent the stock in the first place. This amount is the gross dividend, less any withholding tax that the lender would usually incur.

[See paragraph 6.4 of the Australian Supplement.]

2 *Does the lender still receive the dividend or coupon payment?*

No, the lender receives a “manufactured” dividend or coupon rather than the dividend or coupon itself.

3 *Does the lender still receive the (manufactured) dividend or coupon payment on the due date?*

Yes, the lender’s account should be credited on the due date by the borrower, even if the borrower has not actually received it.

4 *What happens if the lender has loaned a stock over a scrip dividend record date – does it get the relevant cash or stock on the pay date?*

The lender should tell your borrower which it would like to receive in advance. Again, the borrower must manufacture the cash or stock for the lender even if it is receiving the other.

5 *Who organises that?*

It is between the borrower and the lender or its designated agent or custodian.

6 *Why do lenders get higher loan rates if they take cash for a scrip dividend?*

Usually there is a financial incentive offered by a company to shareholders that take scrip rather than cash. Therefore the borrower can take scrip, sell it to give additional income over the cash amount of the dividend, and may share this, or some of this, with the lender.

[See paragraph 6.5 of the Australian Supplement.]

C. Collateral and Risk Management

1 *What is collateral?*

Financial instruments [or cash or an L/C] given by borrowers to lenders to protect the lenders against default over the term of the loan. Collateral securities are usually marked to market every day, with borrowers required to maintain collateral with a market value at least equal to the market value of the loaned securities plus some agreed margin haircut.

2 *What is a haircut?*

Haircut or margin is the extra collateral that a borrower provides in order to mitigate any adverse movements in the value of the loan and value of collateral between the mark to market date and the value of liquidated collateral and repurchased loan securities on the default date.

3 *How often is the collateral valued?*

Usually every day, as with the loaned securities, but can be more frequent in exceptional circumstances

4 *Is the collateral held in the lender’s name or its agent’s name?*

It should be held in the lender’s name, but can be held by an agent to the lender’s order, if so desired.

- 5 *Is collateral valued at the individual client level or does the custodian value it at a summed level and then allocate the collateral amongst its clients?*

Again, this can be done either way as desired by lenders and agents.

- 6 *What happens if the borrower defaults?*

The lender liquidates the collateral and repurchases the loaned (lost) securities. Any excess should be returned to the borrower or liquidator. Any shortfall should be claimed from the borrower or liquidator.

- 7 *How do lenders get their securities back? How long does it take?*

Within the usual settlement cycle for the securities in question, after they have been repurchased.

- 8 *Who liquidates the collateral?*

Lenders or their agents (if they use them).

- 9 *How do lenders ensure that the liquidation of the collateral is done at market rates?*

In a similar manner as they might check on any sales made in the usual course of business. Some agents will indemnify lenders against borrower default, in which case they will return the loaned assets and deal with liquidating the collateral themselves.

- 10 *What happens if market prices rise between the borrower defaulting and cash being made available following the liquidation of the collateral?*

Any shortfall should be claimed from the borrower or its liquidator in insolvency. N.B. In the UK, up to a 48-hour window is available under the OSLA, MEFISLA and GESLA (see the glossary for definitions) depending on whether default takes place within or outside normal business hours. This is extended to 5 days in the new GMSLA.

[See paragraph 6.6 of the Australian Supplement.]

- 11 *What happens if the markets move such that the collateral held is less than the required collateral amount?*

Any shortfall should be claimed from the borrower or its liquidator in insolvency; otherwise more collateral should be sought. If markets are particularly volatile, then intra-day marking to market may be appropriate.

- 12 *How often is the collateral topped up (i.e. marked to market and margin called)?*

Usually every day, as required.

- 13 *Are the collateral securities and the securities on loan valued at the same time/prices/frequency?*

Not always, as the collateral and loan securities might be located in different markets and time-zones. Otherwise both valuations should be made at least daily.

14 *Is accrued interest included in the calculations of market value for collateral, loan and fees?*

In the UK, the GMSLA provides for the valuation of both securities and collateral to include:

- accrued income;
- dividend or interest payments declared but not yet due by the issuer; and
- dividends paid in the form of securities;

but not other rights and assets arising from the securities or collateral.

[See paragraph 6.7 of the Australian Supplement.]

15 *What happens if a borrower doesn't return a stock when called or at maturity?*

The lender may decide to expedite a "buy-in", whereby it purchases the unreturned stock in the market and invoice the borrower for any costs.

[See paragraph 6.8 of the Australian Supplement.]

16 *Who would pay the overdraft fees if a lender's fund manager had sold stock and the lender had failed to settle the trade because the borrower hadn't returned the stock?*

The lender may claim against the borrower for any costs incurred. However it should be noted that consequential loss might not be covered. Where the borrower's failure to redeliver securities to the lender causes a larger onward transaction to fail, the norm is for the lender to claim only that proportion of the costs that relate directly to the loaned securities.

17 *What is cash re-investment?*

In many cases, particularly in the United States [and also in Australia - *see paragraphs 2.17(a) and (b) of the Australian Supplement*], stock is loaned against cash collateral. In such cases, rather than the borrower paying a fee, it receives a rebate (e.g. 0.4%) being the interest rate payable on the cash (e.g. 1%) less the fee (e.g. 0.6%). In such situations the lender, or their agent, has cash and an obligation to pay this rebate to the borrower. The lender therefore reinvests the cash to receive an interest rate (e.g. 1.1%), so that the lender receives the fee plus any reinvestment pick-up (e.g. 0.1%) or less any reinvestment shortfall.

The reinvestment market in the US is aptly described as 'the tail that wags the dog'. The pursuit of income in a fairly mature lending market for US securities means that reinvestment opportunities frequently drive loan transactions that are little more than a method of raising cash.

18 *What are the risks attached to cash re-investment?*

There is the chance that the reinvestment rate achieved is less than the rebate rate. This usually happens more in rising interest rate environments if the interest rate with the borrower is the overnight rate fixed daily and reinvestments are fixed out in time (e.g. one month). So, if short-term rates rise in the time that the reinvestment is fixed, the lender can lose.

Also, reinvestments are sometimes made into investments of lower credit quality, to achieve returns. If this instrument should no longer pay interest or be downgraded by rating agencies, it is likely to fall in value. Most reinvestment of US\$ cash collateral is made into US Treasury or US

Agency mortgage-backed securities, in which cases custodian/banks will usually indemnify lenders in the case of default.

[See paragraphs 5.24 to 5.28 of the Australian Supplement.]

19 *What happens if the assets being held as collateral become worthless?*

So long as the borrower has not defaulted too, they will substitute, or top-up, collateral to the agreed level, in the course of the mark to market process.

20 *What happens if the assets on loan become worthless?*

The borrower will ask for collateral back to the agreed level, in the course of the mark to market process.

21 *What is an indemnity?*

In substance (though not in form or legal effect), it is a kind of insurance policy offered to lenders to mitigate risks associated with lending. One of the most commonly offered indemnities is against borrower default. Usually, like insurance policies, they cover specific events and are not a catchall. So, as with insurance policies, read the small print!

22 *Who offers them?*

Usually custodian banks offer indemnities to their lending customers. Third-Party Agents obtain them from insurance companies.

23 *What strings are attached?*

Lenders may be asked to split revenue differently, reflecting the value of the indemnity.

24 *How important is it to create a set of lending/collateral guidelines before starting to lend, rather than accepting the standard terms/guidelines.*

For a new lender, an agent's standard terms/guidelines are probably a good place to start. The next step is to consider what is and is not appropriate to accept, from a risk perspective. It is the client's prerogative to alter these guidelines as they see fit.

D. Operational and Logistical

1 *What is the difference between overnight and term loans?*

Most loans are on an "open" or overnight basis. In certain cases lenders are prepared to guarantee that they will hold the assets over a longer period, but this is fairly rare in the UK. In such cases, the borrower has certainty that lent securities will not get recalled inside the term of the loan. It is more usual that a hedge fund borrower will obtain term loans from an investment bank, which will have multiple lenders, so that, if one should recall, they can borrow from another.

2 *How long are term loans usually on loan for?*

In the UK, a month would be a typical period, but it depends on the nature of the trade underlying the need to borrow.

[See paragraph 6.9 of the Australian Supplement.]

3 *How long does it take to recall a stock?*

Recalling should be exactly like buying. If a lender gives the instruction by the appropriate deadline, then it should receive the stock back within the usual settlement cycle of the market in question.

E. Corporate Governance

1 *Can lenders vote in an AGM/EGM whilst stock is on loan?*

No. Stock lending is in one sense a misnomer: it involves the transfer of title, including voting rights; indeed securities are often borrowed in order to settle an outright sale, so that the securities pass onto another outright owner. But borrowers have a contractual obligation to return equivalent securities to lenders on demand. Lenders therefore treat securities loans as temporary transactions, which do not affect their desired holding in a stock. In the case of votes, lenders have the choice whether to recall 'equivalent securities' in order to vote their entire 'desired holding', or to leave stock on loan, forgoing the right to vote. (Although, this does not mean that votes are necessarily 'lost' in aggregate, as the new owner may choose to vote.) If they select to leave the stock on loan, they have no means of controlling or knowing how the current owner might vote. This choice boils down to whether the benefits of voting are greater than those of lending. It is worth noting that returns to lending often increase around key corporate actions. Investors make their own choices.

2 *If not, can lenders recall stock to vote, and does this affect their reputation as lenders?*

It is quite common that lenders retain a buffer when lending stock, so they can always go to or vote in an AGM/EGM whilst stock is on loan. However, if they wish to vote all their holding, they must recall the lent securities. If a borrower is still holding the stock (i.e. it has not yet been used to fulfil short-sale obligations), lenders may ask them to vote the stock on their behalf.

3 *Is it acceptable to borrow stock in order to accumulate a large temporary holding in order to influence a vote?*

In the UK, borrowing stock for the purpose of accumulating a temporary holding in order to influence a vote is not a practice that most market participants regard as acceptable.

[See paragraph 3.4 of the Australian Supplement.]

F. The various lending options for beneficial owners

1 *Will lenders be able to lend more stocks from a portfolio that has very little trading/turnover, rather than a very actively traded portfolio?*

Yes, as greater certainty about the stability of the loan is a critical factor for all borrowers.

2 *How do custodians decide whose stock they lend if they have many clients that hold a particular stock?*

They have allocation algorithms, but no two seem to be the same.

3 *What is an exclusive lending relationship?*

Where a lender makes available all, or segments of, his assets to a particular borrower or borrowers exclusively.

4 *How is this different to going via a custodian?*

It can indeed be done via a custodian, which will do all the necessary administration etc. A custodian will usually parcel out loans to borrowers on a stock-by-stock basis, with the “algorithm” making the allocations between lenders.

5 *How long do exclusive arrangements normally last?*

In the UK, a year.

6 *How does the custodian make money from securities lending?*

Mostly they split the income between lenders and themselves, but percentages vary.

7 *What are the normal fees that they charge?*

In the UK, usually the lender gets between 60% and 80%, but there are agreements outside this range.

[See paragraph 6.10 of the Australian Supplement.]

Appendix 1: Short History of Securities Lending

1 Globally

Securities lending began with the development of securities trading markets. For example, in the UK market from the 19th century, specialist intermediaries sourced gilts for the jobbers or market makers. Collateral, typically non-cash, passed between the parties at the end of the trading day and offered protection for the lenders. A two-tier market soon developed. There was a security-specific or “special” market and a more generic financing or “general” market. Much of the borrowing facilitated a practice called “bond washing,” whereby tax advantages were exchanged between parties around record and ex-dividend dates. This was the precursor of tax arbitrage.

(a) The 1960s

As the UK and US securities trading markets developed, so too did the securities lending markets. Here are some of the key developments from the 1960s:

- The first formal equity lending transactions took place in the City of London.
- An active inter-dealer market developed in the US (back office to back office).
- The increase in general, and particularly block, trading volume in the US equity markets, but with the settlement system remaining based on paper shares certificates, led to large backlogs of settlement fails with back offices borrowing securities for settlement cover.,
- US Treasury bond financing expanded– hitherto the US market had focused on equities.

(b) The 1970s

In the 1970s the US market developed and assumed much of the shape that would be recognised today. The UK market would not develop a recognisable form until deregulation following Big Bang in the 1980s. Here are some of the key developments from the 1970s:

- The Depository Trust Company (DTC) reduced settlement related demand but facilitated an increase rise in trading activity.
- Trading demand from arbitrageurs increased. Strategies included:
 - Convertible bond arbitrage.
 - Tax Arbitrage.
 - Initial Public Offering (IPO)-related trading.
- The US custodian banks began to lend securities on behalf of their clients:
 - Endowments.
 - Insurance Companies.
 - Pension Funds (amendments to ERISA legislation in 1981 permitted lending in accordance with guidelines).

- Treasury dealers began ‘matched book’ repo trading – generating borrowing demand.
- The US Treasury bond repo market became a key part of the money markets.
- The non-cash “bonds borrow” market promoted the broker-to-bank business:
 - Cash collateral was a problem for banks wishing to avoid capital charges.
 - Using long inventory saved the borrowers money.
 - Using non-cash collateral reduced their balance sheet when compared to cash.
- The use of derivatives and leverage in transactions expanded because returns could be increased and banks were willing to extend the necessary finance.
- The creation of “finders” - specialists that lacked capital but had significant relationships and could find the securities that you needed.
- The first cross border or international securities lending transactions took place:
 - Typically offshore from the US or the UK.
 - Initially experienced traders using trading techniques that had been proven over time in their local markets initiated these transactions.
 - Several key advantages such as time zone, and a high concentration of international fund management expertise, put the United Kingdom at the centre of international securities lending.

(c) The 1980s

Key developments included:

- International and cross border securities lending grew rapidly, driven partly by the international expansion of the US broker dealers and custodian banks.
- Institutional lending of overseas securities increased because US and UK lenders were willing to expand their programmes from being domestic only.
- Increases in the debt of most G10 governments encouraged the growth of government bond lending and repo markets.
- Trading demand continued to grow, driven by a variety of strategies:
 - The international derivatives markets expanded, with many derivatives hedging strategies requiring short coverage e.g. index arbitrage.
 - Tax arbitrage – the tax anomalies available to exploit internationally were numerous.
 - Hedge Funds were established in significant numbers.
- Some institutional lenders began to enter into exclusive lending relationships with borrowers.

- Securities settlement systems introduced book entry settlement and were able to process increased volumes:
 - The Group of 30 report by an international group of experts stated that securities lending should be encouraged as a means to expedite efficient settlement.
- On May 17 1982, Drysdale Securities, a minor bond dealer, collapsed. Drysdale had over \$2 billion in US Treasury loans outstanding when it defaulted. Institutional supply temporarily dried up following the Drysdale affair, particularly via the custodians, due to legal uncertainties. The US Government Securities Act of 1986 followed and other changes included the BMA developing a standard contract, specification of collateral margins, collateralisation of accrued interest and disclosure of borrowers and lenders by custodian banks.
- In the autumn of 1988 Robert Maxwell authorised securities lending transactions from the Mirror Group Newspaper pension fund. It was not until after his death on 5th November 1991 that the consequences of these and subsequent transactions became apparent to the authorities, the market and the pensioners. As the Department of Trade and Industry (“DTI”) puts it in a chronology of events on www.dti.gov.uk:

“From November 1988, Mr Robert Maxwell therefore began to make use of the more marketable blue chip shares held by the pension funds and First Tokyo Index Trust as collateral for bank borrowings to the private side; this was described as 'stock lending' to make it appear to be the legitimate practice of lending securities to market makers as part of ordinary share dealing activities. Cash continued to be borrowed from the pension funds by the private side without providing any collateral to the pension funds for these loans.”

(d) The 1990s

Securities lending volumes again increased sharply in most markets throughout the decade. Key developments included:

- Growing demand to borrow securities to support hedging and trading strategies:
 - Technological advances, including computer processing power, access to real time price information and automated trade execution made possible new trading strategies, such as statistical arbitrage.
 - Further rapid growth in hedge fund assets under management, despite a pause following the collapse of Long Term Capital Management in 1999.
 - Investment banks developed global prime brokerage operations to support the activities of hedge fund clients, including securities lending and financing.
- The removal of many regulatory, tax and structural barriers to securities lending throughout the world. Some of the major changes and developments in the repo market were driven by the removal of specific legal or regulatory barriers e.g.:
 - 1993 French repo.
 - 1996 Japanese repo.

- 1996 UK repo.
- 1997 Italian buy-sell back.
- 1998 Swiss repo.
- In 1994 the sharp increase in US short-term interest rates led to losses for many securities lenders that had taken US dollar cash as collateral and were re-investing it in a variety of money market instruments. In many cases their agents, typically custodian banks, compensated their underlying clients for these losses even though they were not legally obliged to do so. Lessons included improved risk management procedures, better documentation and clear re-investment guidelines.
- During the Asian crisis in 1997-98, the authorities in a number of countries imposed restrictions on short selling, drawing a link with currency speculation e.g. Malaysia in August 1997 and Thailand in August 1997.

(e) 2000 and beyond

Trends include:

- The market becoming more segmented:
 - Specialist regional players developing.
 - Outsourcing developing e.g. third party securities lending agents.
- Tax arbitrage opportunities disappearing as tax harmonisation occurs.
- Continuing deregulation and tax changes making possible the establishment of new securities lending markets e.g. in Brazil, India, Korea, Taiwan.
- New transaction types:
 - Equity repo - much more accepted and widespread than in 1990s.
 - Contracts for Differences (“CFDs”).
 - Total return Swaps.
- Fewer Initial Public Offering (“IPO”) and Mergers and Acquisition (“M&A”) opportunities in 2002 and 2003 with fewer ‘hot’ stocks. The rate of growth of equity stock lending slowed but the development of traded credit and corporate bond markets encouraged growth in the fixed income part of the business.

2 Australia

[See paragraphs 1.6 to 1.8 of the Australian Supplement.]

Appendix 2: *Australian Supplement*

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[Parts 1 to 6 below contain comments referable to Chapters 1 to 6, respectively, in the main text and should be regarded as supplemental to the corresponding Chapter in the main text.]

Introduction

This is the Australian Supplement to *An Introduction to Securities Lending (Australia)*.

For the Australian institutional investor (such as a pension or superannuation fund, an insurance company, public unit trust or other kind of mutual fund, and some government bodies), securities lending is viewed widely as a natural adjunct and value-added service to the custody service provided by custody banks.

Although the incremental income typically is relatively small (though it can be significant in absolute terms), it offers the opportunity to the investor, *with limited risk*, to earn some incremental income and thereby effectively reduce their net custody fees. This is particularly relevant for a large portfolio, because it enables the institution effectively to provide a greater return for its clients. As the IOSCO/CPSS Report noted (page 19), this can be important in a field as highly competitive as funds management, where very small differences in performance can affect performance ranking significantly.

The principal focus of this Australian Supplement is on the lending by an institutional investor of its *Australian* equity securities, which typically must be executed in Australia. (Different legal, practical, documentary and tax issues are, or at least can be, involved in the “lending” of debt securities.) However, several observations are made regarding the lending by Australian owners of *overseas* equity securities and of domestic debt securities.

This Australian Supplement also highlights the differences between principal and agency programmes operated by a custodian bank in an Australian context.

This Australian Supplement covers the following topics (with **Parts 1 to 6 of this Australian Supplement corresponding to Chapters 1 to 6 in the main text in this publication, *An Introduction to Securities Lending (Australia)***):

- 1 Securities lending *in Australia*.
- 2 *Australian* lenders and intermediaries.
- 3 The borrowing motivation *in Australia*.
- 4 *Australian* market mechanics.
- 5 Risks, regulation and market oversight *in Australia*.
- 6 Frequently asked questions *in Australia*.
- 7 *Australian* taxation issues.
- 8 Concluding comments.

1 Securities lending in Australia

[The comment in this Part 1 are supplemental to those in Chapter 1 of the main text.]

(1) What is “securities lending” in Australia?

1.1 In Australia, under Australian law, as in the UK, under English law:

- (a) “Securities lending” arrangements arise when a longer term holder of securities agrees to provide them to a borrower for a period.
- (b) The borrower is contractually obliged to return, at the end of the period, replacement securities which are equivalent in number and type to the original securities.
- (c) Consequently, at the end of the period, after the return of the replacement securities, the lender retains exactly the same portfolio as before.
- (d) For that reason, the arrangement is viewed in substance, or economically, as a “loan” of the relevant securities, even though, legally, under the terms of the relevant master agreement, the lender actually transfers absolute ownership of the original securities to the borrower and is only entitled to receive identical or equivalent securities in return. (This transfer of absolute ownership enables the borrower to sell or otherwise deal with the securities.)
- (e) During the period of the “loan”, the lender has contractual rights similar to those that it would have had if it had retained ownership of the original securities, namely the right to receive from the borrower the equivalent of all dividends (or, in the case of debt securities, interest) and other distributions or rights (if any) in respect of the securities which are paid or arise during the period of the loan.
- (f) However, in the case of equity securities the lender does not retain any voting rights. Generally, if the lender wishes to exercise voting rights, it must recall the stock.

(2) What is the true legal character of a securities lending transaction in Australia?

1.2 In Australia, as in the UK, the terms “lending” and “borrowing” describe the substance of a securities lending arrangement, but incorrectly describe its legal effect under the terms of the relevant master agreement (in Australia, usually the AMSLA, together with any amendments that parties may agree in a particular case). In Australia, as in the UK:

- (a) the first leg involves an outright disposition of absolute ownership of the securities by the lender; and
- (b) contemporaneously, the borrower in effect enters into a deferred forward sale agreement for *equivalent* (but not necessarily the original) securities.

1.3 Thus, there is no “lending” of the original securities by the lender. (Despite this, the Australian market continues to use “lending” terminology, which is likewise adopted and used in this Australian Supplement.) In technical legal parlance, most arrangements are what were known as *mutuums* under Roman law.

1.4 Likewise, in the case of Australian collateral securities:

- (a) Effectively, there is a separate securities lending transaction in respect of those collateral securities, contemporaneous with the loan of the principal securities.
- (b) The main differences are:
 - (i) The provider of the collateral securities cannot recall them unless it provides substitute collateral.
 - (ii) In certain circumstance, the recipient of the collateral securities may not be obliged to gross up any manufactured payments (ie Manufactured Dividends (defined in Part 1 of Appendix 3), in the case of equity collateral securities, or analogous payments, in the case of other collateral securities such as bonds) for any tax payable in respect of that manufactured payment while the collateral securities are held by that recipient (see, for example, clause 6.7 of the AMSLA; contrast clause 9.7(a) of the AMSLA in relation to manufactured payments in respect of the lent securities).

(3) *What types of securities are loaned in Australia?*

1.5 Securities lending in Australian typically involves any of the following types of securities:

- (a) the top 200 Australian equities and those securities with an associated derivative instrument; and
- (b) Government, Semi-Government and corporate bonds and inscribed stock. (For largely historical and also systems reasons, such securities usually are dealt with by reciprocal purchase agreements, or “repos”, (and similar transactions known as buy/sell agreements) under an agreement such as the BMA/ISMA Global Master Repurchase Agreement (“GMRA”), whose legal effect is different from a securities lending agreement.)

(4) *History of securities lending in Australia*

1.6 Domestic securities lending developed in the 1970s and 1980s, principally to prevent failed trades.

1.7 It increased rapidly in the early 1990s, initially because of the rapid expansion of derivatives trading and later because of the tax arbitrage opportunities opened up by tax changes which took effect in August 1991, until they were curtailed by specific anti-avoidance amendments in 1996 and 1997.

1.8 Securities lending practices have now reached a mature and sophisticated level.

(5) *What is the size of the Australian securities lending market?*

1.9 The size of the securities lending market in Australia is uncertain. This is principally because (as will be seen in Part 5 of this Australian Supplement) in practice securities lending transactions are not reported in Australia, irrespective of the purpose of the borrowing.

- 1.10 The demand for equity securities lending dropped substantially after the May 1997 Federal Budget effectively removed the opportunity for tax arbitrage, but in 1999 the IOSC/CPSS Report estimated that the daily turnover in equities securities lending in Australia was A\$550+ million.

2 Australian lenders and intermediaries

[The comments in this Part 2 are supplemental to those in Chapter 2 of the main text.]

(1) Who loans securities in Australia, and why?

- 2.1 Generally in Australia, as in the UK, institutions lend their securities to increase portfolio returns.
- 2.2 That is, lenders obtain an additional return in the form of the fees earned (or equivalent interest rate spread), on top of the distributions and other returns (if any) normally derived from the security itself.
- 2.3 However, it is necessary to distinguish the different circumstances of:
 - (a) overseas institutions (for whom interest (and, in the case of equity securities, dividend) withholding tax are relevant);
 - (b) Australian institutions (for whom, in the case of equity securities, franking credits are relevant); and
 - (c) local nominees and custodians, either as a principal or as agents for local and overseas clients.
- 2.4 A more detailed discussion of Australian taxation issues relevant to those overseas and Australian institutions is contained in Part 6 of this Australian Supplement.

(2) What types of securities lending programmes are there in Australia, and what role do intermediaries play?

- 2.5 In Australia, as in the UK, a lender can run its own programme provided it can itself source sufficient demand. Several of the biggest institutions do so. However, most institutions in Australia use an intermediary to avoid the expense, administrative and operational difficulties and the credit and other risks of running their own programmes. As indicated below, the leading intermediaries for institutional investors, in terms of market share, traditionally have been the custodian banks. So far, no specialist third-party agency lenders have established a meaningful presence in Australia.
- 2.6 In Australia, as in the UK, there are two types of securities lending programmes offered by custodians:
 - (a) *Principal programme*

Many institutions find it convenient to lend securities to an intermediary principal (eg a custodian bank), who then onlends to many more counterparties. This saves administration and, importantly (as will be seen), limits credit risks to the principal.

However, in Australia, if the principal is a custodian bank, that risk usually is uncollateralised.

(b) *Agency programme (with or without indemnification)*

Many other institutions choose to enter into an agency programme with an intermediary (usually a custodian), who then deals directly with a large but limited number of end borrowers. This involves extra administration and wider credit and other risks.

On the other hand, most (but not all) of these risks are collateralised and some may be the subject of indemnification by the agent. The three main types of collateral are:

- (i) cash (usually in the same currency in which the borrowed securities are traded on the principal stock exchange on which they are quoted, or in which they are denominated);
- (ii) securities (such as bonds or equities); and
- (iii) only occasionally, irrevocable standby letters of credit.

(3) ***What is a typical “principal” programme in Australia?***

2.7 In a typical Australian *principal* programme:

- (a) The custodian bank will borrow securities from the client as a principal and, accordingly, will have a personal obligation and liability to return equivalent securities, as well as to perform its other obligations under the agreement.
- (b) Accordingly, the client has counterparty credit risk exposure to the custodian bank.
- (c) The custodian bank typically does not provide any collateral to the client (which the client would then have to manage, or which the custodian would have to manage on behalf of the client). Accordingly, the client’s counterparty credit risk exposure is unsecured. However, this may be quite acceptable in practice if the credit rating of the custodian bank is regarded as sufficient. The exposure of the client to the custodian bank appears similar to that arising if the client simply had deposited cash with the custodian bank, subject only to any priority afforded to deposit liabilities of the bank (under section 13A(3) of the Banking Act 1959).
- (d) However, when the custodian on-lends the securities as principal to a third party, invariably it will do so only to a select number of counterparties of requisite credit-worthiness, subject to credit limits and on terms which involve the third party providing collateral and variation margin, as described below under the heading “What are the common features of principal and agency programmes in Australia?”

In this way the custodian bank performs a credit intermediation service, as well as the other services described in part A2(b) of Chapter 2.

(4) *What is a typical “agency” programme in Australia?*

2.8 In a typical Australian *agency* programme:

- (a) The custodian bank will lend securities as agent for the client. Under the terms of the agency agreement:
 - (i) the potential third party borrowers usually are named in a list which initially is provided to the client and from time to time is updated; and
 - (ii) the custodian bank must receive and hold acceptable collateral of a certain minimum value, which normally is marked to market on a daily basis.
- (b) As the primary legal relationship of the lender in relation to the securities lending transaction is with each of the borrowers (and not with the agent), the lender has counterparty credit exposure to each borrower. Accordingly, as indicated in more detail in part 5 below, the lender has to consider initially and then periodically review the credit worthiness of each potential borrower on the agent’s list and set any exposure limits.
- (c) For similar reasons, the lender has to consider initially and then review periodically acceptable collateral and, in particular, its re-investment of cash collateral risk (which invariably is not indemnified by the agent). The collateral risks are described in more detail in part 5 (see especially paragraphs 5.24 to 5.28) below and in part 2 (see especially part 2(2)) in Chapter 5.
- (d) The lender must also:
 - (i) assess, perhaps with the help of an external rating agency, (or rely on the agent’s assessment of) the creditworthiness of any bank whose letter of credit is permitted as acceptable collateral by the agent, unless the lender indicates otherwise; and
 - (ii) consider the lender’s other exposures (if any) to every permitted L/C issuing bank and whether the lender wishes to impose limits on the L/C exposure to any such bank and, if so, advise the agent accordingly.

(Normally the agent will accept an L/C issued by a bank only if the bank has a certain minimum credit rating and require the issue of a substitute L/C by another approved issuing bank if the rating of the first issuing bank is downgraded to below the minimum level. The agent also normally has in place other procedures to try to avoid an over-concentration with, or an excessive exposure to, any individual issuing bank.)

- (e) An agency programme may also be a partly indemnified one. The IOSCO/CPPS Report (page 56) says that “market participants acting as agents need to clearly specify the risks covered by any such [indemnification] provisions”. Therefore, the lender needs to understand clearly who will ultimately bear all the risks and, in particular, what risks are not covered by any indemnification. See further part 2 in Chapter 5.

(5) *What are the common features of principal and agency programmes in Australia?*

2.9 In Australia, as in the UK, the custodian typically will:

- (a) prior to transacting:
 - (i) review potential borrowers and determine acceptable borrowers and any applicable credit or other limits;
 - (ii) negotiate a master agreement with each acceptable borrower;
 - (iii) identify and agree available securities; and
 - (iv) identify acceptable collateral and (in the case where the collateral can take the form of an L/C) determine acceptable L/C issuing banks and any applicable credit or other limits;
- (b) periodically:
 - (i) review and update acceptability of borrowers and any applicable credit or other limits;
 - (ii) review and update available securities; and
 - (iii) review and update acceptable collateral and acceptable L/C issuing banks and relevant limits; and
- (c) in transactions:
 - (i) arrange trades;
 - (ii) issue instructions to settle;
 - (iii) (if applicable) provide collateral management services (including receiving, investing, returning; mark-to-market valuation of securities on loan and (if applicable) collateral; and (if applicable) calling for, receiving and returning variation margin);
 - (iv) collect and credit income equivalent, or “manufactured” income, payments;
 - (v) (if applicable) collect and wholly or partially remit income on collateral; and
 - (vi) in the case of equity securities, monitor other corporate actions.

(6) *Some comparisons between a principal and an agency programme in Australia?*

2.10 In Australia, generally, a custodian that operates an *agency* programme will do so primarily for its own reasons - ie because of the potentially adverse balance sheet and capital adequacy implications for the custodian of operating a *principal* programme. In other words, the choice by the custodian bank to offer an agency programme is not

primarily driven by client needs. However, typically, all loans in an agency programme are required to be adequately collateralised.

- 2.11 On the other hand, lending to a custodian as a *principal* intermediary is typically uncollateralised. This does involve the concentration of credit risk in a sole counterparty. However, the client may be happy with the credit rating of the custodian. And a principal programme avoids the need for the lender to:
- (a) evaluate and rely on (or at least on the agent's assessment of) the creditworthiness of all the counterparties on the agent's list of potential counterparties (many, or at least some, of whom may not be well known to the lender) and set appropriate exposure limits (if any);
 - (b) determine (or at least rely on the agent's assessment of) acceptable collateral;
 - (c) evaluate and rely on (or at least rely on the agent's assessment of) the credit worthiness of any L/C issuing bank and set any exposure limits; and
 - (d) investigate and comprehend the extent of its re investment of its unindemnified cash collateral risk and the extent of any indemnification by the agent of other risks.
- 2.12 In Australia, the choice between a principal and an agency programme depends on who the lender's custodian bank is (and its preference or willingness to offer one kind of programme rather than the other) and the lender's level of comfort with the programme offered by that custodian.

(7) *What are typical collateral arrangements in Australia?*

- 2.13 As indicated above, in any principal programme with a custodian bank in Australia, normally collateral is not provided by the custodian bank.
- 2.14 In any agency programme, the borrower provides the lender (or the lender's agent) with collateral (either cash or acceptable non-cash collateral securities) for the term of the loan, to secure the performance of its obligation to return the replacement securities. The three main types of collateral are cash, securities and irrevocable standby letters of credit ("L/Cs").
- 2.15 The administrative burdens involved in a direct lender receiving collateral has lead to the development of triparty arrangements, in which a third party effectively takes on the back office role. However, they are still in their early stages of achieving wide ranging acceptability.

(8) *What are typical fee arrangements in Australia?*

- 2.16 In Australia, as in the UK, the lender earns a fee for the use of the borrowed securities.
- 2.17 In the typical Australian *agency* programme:
- (a) Where cash collateral is provided by the borrower under a "borrow vs cash" ("BvC") arrangement, usually no separate fee is payable. Instead, the interest rate which the lender of the securities pays to the borrower on the cash collateral put up by the borrower (generally called the "rebate") is a normal market rate less an

agreed spread. The spread is equivalent to the fee which the lender would otherwise earn (see (b) and (c) below).

- (b) Where cash collateral is provided by the borrower under a so-called “pool” arrangement (either under a “borrow vs cash pool” (“**BvCP**”) arrangement, where only cash collateral can be provided, or under a “borrow vs pool” (“**BvP**”) arrangement, where cash and/or agreed securities can be provided), a separate borrow fee, calculated usually on a daily basis by reference to the market value of the borrowed securities, is payable by the borrower to the lender.
- (c) Similarly, where an irrevocable standby letter of credit is provided, a separate fee, calculated usually on a daily basis by reference to the market value of the borrowed securities, is payable by the borrower to the lender.

2.18 In the typical Australian *principal* programme (where collateral normally is not provided by the borrower custodian bank), normally the borrower pays just a separate agreed fee to the lender (similar to 2.17(b) and (c) above).

2.19 In Australia, currently indicative fees for borrowing range between:

- (a) for ASX 200 equities: anywhere between 25 and 400 basis points per annum, depending on supply and demand, but the fees in a particular case can also be outside this range; and
- (b) for Commonwealth Government securities: between 5 and 50 basis points per annum.

(9) *What are typical arrangements for distributions and other entitlements in Australia?*

2.20 In Australia, as in the UK, the borrower compensates the lender for distributions (eg dividends or, in the case of debt securities, interest) and other rights (if any) that may accrue on the borrowed securities during the term of the loan. The compensation payments are sometimes called “manufactured” payments (being the term originally used in the UK). The Australian tax attributes of the manufactured payments are explained in Parts 7(5) and 7(6) of this Australian Supplement.

3 The borrowing motivation in Australia

[The comments in this Part 3 are supplemental to those in Chapter 3 of the main text.]

(1) Is securities lending in Australia “securities-driven” or “cash-driven”?

3.1 In Australia, in practice, as in the UK, there are two broad distinct drivers for a securities lending transaction:

- (a) The principal type of transaction is a “securities-driven” one, where the borrowing motivation is paramount. This is where the borrower of the securities wants to obtain temporary access to the specific securities. These types of transactions typically are highly intermediated, as the securities lenders usually must rely only on the intermediary to source the demand for the securities. The leading intermediaries for institutional investors, in terms of market share, traditionally have been the custodian banks. ***This Australian Supplement focuses solely on these types of “securities-driven” securities lending transactions.***
- (b) Another type of transaction, much less common in Australia, is a “cash-driven” one, where the lending motivation is paramount:
 - (i) This is usually where the securities lender simply wants to borrow cash and to use the relevant securities as collateral for the transaction. This is one of the types of transactions discussed in part 3(2) of Chapter 3. In this type of transaction, the securities borrower is not seeking to obtain access to any particular securities and, within certain defined categories, generally will permit the securities lender to choose the securities to be provided. The potential advantage to the securities lender is that it may be able to borrow cash at a cheaper rate than under a conventional secured loan facility. ***This Australian Supplement does not deal with any particular issues connected with this type of “cash-driven” securities lending transaction.***
 - (ii) A related type of transaction, also discussed in part 3(2) of Chapter 3, is where the borrower simply has cash that it would like to effectively lend out on a fully secured basis, in order to earn yield. ***This Australian supplement also does not deal with any issues that might be particular to that type of “cash-driven” securities lending transaction.***

(2) Who borrows securities in Australia, and why?

3.2 As in the UK, most borrowing in Australia is for the following purpose:

- *Market making/trading*

Market makers (such as investment banks and broker-dealers, including prime brokers) are the largest borrowers of securities in Australia and are responsible for the majority of securities lending transactions in Australia.

These traders sell securities for a variety of reasons, most of which are hedging related eg index/physical arbitrage, option or warrant hedging, other derivatives, as well as outright short selling - ie for the reasons outlined in part 3(1) of Chapter 3.

Securities loans drawn down by market makers and traders are typified as being larger in volume and, in the case of equity securities, can be of longer duration. For lenders, these loans represent the greatest opportunity to maximise profit, by minimising associated administrative costs.

3.3 As in the UK, another purpose in Australia is:

- *Temporary transfer of ownership: DRP Arbitrage*

Part 3(3)(b) in Chapter 3 referred to DRP arbitrage.

This too was very common in Australia for many years.

However, the profits to be made from such transactions shrank (and therefore the prevalence diminished) as the typical percentage discount diminished or was eliminated.

3.4 In Australia, borrowing of securities may also occur for one or more of several purposes in addition to those referred to in part 3 of Chapter 3.

- *Margin requirements*

There are borrowers who need to meet margin requirements in respect of other transactions and can do this more cheaply by borrowing securities rather than depositing cash. This type of transaction typically occurs in the Australian equity options market, where lodging certain transferable securities is an accepted alternative to deposits of cash margins.

- *To exercise equity voting rights*

There have been several instances overseas where a borrower apparently just wanted to be able to exercise the voting rights referable to the borrowed equity securities at an important general meeting of the relevant company. The best known of these involved the UK company British Land in June 2002: see the article entitled “Getting the Vote Out” in the International Securities Finance magazine, June 2003, at pages 34-36. An analogous situation occurred in Australia in relation to the 2002 election for directors of Coles Myer Limited and in 2005 in relation to the control of General Property Trust.

3.5 Part 3(3)(a) in Chapter 3 referred to Tax Arbitrage.

- *Temporary transfer of ownership: Tax Arbitrage: no longer prevalent in Australia*

In Australia, especially since 1996 and 1997, specific and general tax anti-avoidance provisions referred to in part 7 of this Australian Supplement have effectively curtailed any blatant attempt to engage in tax arbitrage regarding Australian securities.

4 Australian market mechanics

[The comments in this Part 4 are supplemental to those in Chapter 4 of the main text.]

(1) Loan negotiation (see part 2 in Chapter 4)

- 4.1 Currently, there is no automated electronic platform for negotiating securities lending transactions, such as EquiLend or SecFinex, in use in Australia.
- 4.2 In Australia, all transactions are entered into under, and governed by, a master agreement between the counterparties.
- 4.3 In Australia, the standard industry document is the Australian Master Securities Lending Agreement (AMSLA), prepared by Mallesons Stephen Jaques for the Australian Securities Lending Association (ASLA). The latest version is the November 2003 version, as published in the 28 November 2003 Update 8 of the Australian Financial Markets Association's On-Line Guide to OTC Documents. It can be used for debt, as well as equity, securities.

(2) Term of Loan (see part 4 in Chapter 4)

- 4.4 Generally, for local tax reasons, an Australian lender will insist on the second leg (ie the return of equivalent securities) taking place within 12 months of the settlement date under the first leg of the relevant securities lending transaction. This is to preserve non-recognition treatment for those two legs, as far as the lender is concerned, under section 26BC(3)(a), (4) and (6) of the Income Tax Assessment Act 1936.
- 4.5 However, so long as the necessary equivalent securities have been transferred to the lender or its custodian within that period, they can be relent immediately, including to the same borrower.

(3) How are loans settled in Australia? (see part 8 in Chapter 4)

(a) Equity Securities

- 4.6 The Australian Stock Exchange's CHESS system permits loans of listed securities and returns of equivalent listed securities to be settled either on a delivery-versus-payment ("DvP") basis (the payment can be set at zero), in a manner similar to a sale, (these only settle once a day) or on a free of payment basis (these settle on demand, outside certain times (currently outside between 10.30am and about 2pm)). Typically, in the case of a free of payment demand transfer, cash will move via a totally separate transaction on Austraclear later in the business day.
- 4.7 However, unlike CREST, CHESS does not provide any revaluation facilities for securities out on loan. Instead, counterparties keep their own daily records of securities on loan, the mark to market valuation of those securities, and required collateral movements and agree those collateral movements with each other each business day morning.]

(b) Debt securities

- 4.8 Commonwealth Government debt securities are now held in the Austraclear system (prior to February 2002, these securities were held in the Reserve Bank of Australia's RITS system). Most State Government, semi-government and corporate debt securities are also held in the Austraclear system.

- 4.9 Debt securities held in the Austraclear system can be transferred on a DvP basis. Delivery of the debt security occurs in the Austraclear system with simultaneous payment occurring through a link between Austraclear and the Reserve Bank of Australia's real time gross settlement system (RITS).

(4) Reporting of transactions in listed equities in Australia (see part 12(1) in Chapter 4)

(a) No stamp duty reporting

- 4.10 Prior to the abolition in 2001 of all State and Territory stamp duties on sales and other transfers of Australian listed shares, transfers under the first and second legs of a securities lending transaction were exempt from stamp duty. Accordingly, broadly, all such transfers were recorded either by brokers or by transferors and transferees, as the case may be, as being exempt from duty. But, even then, such transactions were not required to be reported to the relevant Stock Exchange.

(b) No reporting under ASX Business Rules

- 4.11 Currently brokers (now called "market participants") and non-broker participants (now called "non-market participants") in CHESS do not treat securities lending transactions in which they are a borrower or a lender as reportable transactions under the ASX Business Rules. This is so whether or not the relevant borrowing is to settle an underlying trade (eg, in the case of a broker, to settle a sale on behalf of a client or, in the case of a market maker, to settle a short sale). To date the ASX has taken the same view.

(c) Reporting of short sales

- 4.12 Broadly, section 1020B of the Corporations Act prohibits short sales of equity and debt securities in Australia, including Government bonds, unless either certain specific disclosures are made in connection with the sale or an exemption applies.
- 4.13 There is no express civil action for a contravention of the short selling prohibition. Nor does a contravention necessarily affect the enforceability of a contract. However, a contravention is an offence. And a court has various other statutory discretionary remedies.
- 4.14 The immediate predecessor to the ASIC, the ASC, spent some time reviewing the regulation of short selling in Australia. (Presently, if a person wishes to short sell securities but has arranged to borrow equivalent securities in order to settle the sale, market practice is that the seller does not regard itself as under an obligation (under Corporations Act section 1020B) to disclose the sale as a short sale. This gave rise to particular problems prior to the introduction of ASX Business Rule 4.10A (which was later deleted, in October 1999).) Following that review, in May 1994 the ASC released a Discussion Paper on short selling. The ASC subsequently had intensive discussions with a range of industry bodies with a view to formulating recommendations to the federal Attorney-General regarding short selling.
- 4.15 However, the ASC never finalised any recommendations. And it seems that the finalisation of any recommendation by the ASC's successor, ASIC, regarding the reporting of securities lending transactions has a low (if any) priority.

- 4.16 It is possible that the eventual outcome will be that short sales of equity securities which are to be settled by the delivery of borrowed securities will have to be specifically disclosed as short sales, in contrast to the view which is currently taken of the operation of section 1020B of the Corporations Act. (If so, the ASX presumably would have to change its Business Rules to require similar disclosure.) However, at present it seems unlikely that current practice will change in the near future. Accordingly, at present no distinction is drawn between the different purposes to which borrowed securities may be put.

(5) Corporations Act (see part 12(2) in Chapter 4)

- 4.17 Lenders and borrowers need to ensure (as far as possible) that they either avoid or comply with any restrictions on, or reporting requirements relating to, the percentage of either shareholdings, or relevant interests in shares, which can be acquired or are disposed of.

(a) Substantial shareholdings

- 4.18 Broadly, under the Corporations Act, a substantial shareholder in an Australian incorporated publicly listed company must give notice of either the acquisition of a substantial shareholding or a change in a substantial shareholding.
- 4.19 A person is defined as a substantial shareholder in a company if entitled to more than either 5% of the voting shares of the company or 5% of the voting shares in any class in the company.
- 4.20 The statutory requirements take no account of the possible consequences of a securities lending transaction, especially if the borrowed securities are used to settle a short sale (see 4.11 to 4.16 above). Professional opinion as to the strict notice requirements under the existing law on the one hand, and market practice on the other hand, may not coincide. The ASIC and its predecessor bodies have refrained from publicly entering the debate, though the National Companies and Securities Commission (a predecessor to the ASIC) previously made declarations under the now superseded Companies Code regarding one major institution.

(b) Other similar requirements

- 4.21 Similar issues could in theory arise with the 15% threshold under the Foreign Acquisitions and Takeovers Act 1975 (Cwlth), and the thresholds applicable under the Broadcasting Services Act 1992 (Cwlth) (which affects companies with extensive interests in the television and/or print media) and various other Australian Federal and State Acts regulating particular industries (eg gambling or companies with interests in that industry, such as in casinos) or companies (eg Qantas). These restrictions can give rise to particular problems in practice - eg a non-resident lender of shares in Qantas may find it impossible to become registered as the holder of equivalent shares before a record date for the payment of a distribution, because the registration of that transfer would cause Qantas' foreign ownership limit to be exceeded.

(6) No transparency in the Australian market (see part 12(3) in Chapter 4)

- 4.22 There are no official statistics on the volume or value of equity securities lending transactions in Australia. ASLA has made one informal attempt to gather statistics on a voluntary basis, but the reliability of those statistics is unknown.

(7) *Takeovers Panel (see part 12(4) in Chapter 4)*

- 4.23 The Takeovers Panel, constituted under Part 10 of the Australian Securities and Investments Commission Act 2001, has wide ranging powers conferred on it by or under the corporations legislation.
- 4.24 It has considered on several occasions the significance of swaps (involving shares in Burns Philp, John Fairfax and most recently Centennial Coal). However, as far as the writer is aware, it has never considered any securities lending transactions or activity.

5 Risks, regulation and market oversight in Australia

[The comments in this Part 5 are supplemental to those in Chapter 5 of the main text.]

(1) What are the main financial risks involved in securities lending in Australia, and how are they managed?

- 5.1 The risks inherent in lending securities are not always readily apparent, but must be considered when entering into a securities lending programme. The comments in this part 5 are intended to supplement those in Chapter 5.
- 5.2 Broadly, as stated in the IOSCO/CPSS Report (page 39), securities lending transactions are similar to a deposit (by the securities lender) with the counterparty (securities borrower), in that there is a creditor's agreement to advance value (securities in this case, instead of cash) in exchange for a promise to pay at a later date.
- 5.3 However, there are some differences. The comments below seek to supplement those in Chapter 5 by highlighting the main differences. (A fuller explanation, also covering repos and buy/sell back agreements, is contained in the IOSCO/CPSS Report.)
- (a) Counterparty credit risk*
- 5.4 As in the case of a cash deposit, the greatest risk in a securities lending transaction or programme is that of counterparty (ie borrower) default (whether or not due to insolvency).
- 5.5 Counterparty (ie borrower) default can arise in respect of any one or more of a number of obligations/situations:
- (a) the failure of the borrower to return equivalent securities on the due date (a settlement or a market risk);
 - (b) the failure of the borrower to pay or provide manufactured income or equivalent other rights or entitlements on the due date;
 - (c) (if applicable) the failure of the borrower to pay margin calls as and when obliged to do so;
 - (d) another situation is either where the transaction is uncollateralised or where the proceeds of the realisation of any collateral held by or on behalf of the lender are insufficient to purchase replacement securities or any equivalent other rights or entitlements. (The latter risk is sometimes separately called the replacement cost risk.)
- 5.6 Apparently, in a non-insolvency situation, such defaults occur rarely and, when they do, it is almost invariably because of operational problems.
- 5.7 Accordingly, in practice, it is normally the potential insolvency of the counterparty which poses the greatest risk to a lender.
- 5.8 In a *principal* programme with a custodian bank, the lender is concerned only with the credit worthiness and the insolvency risk of the custodian and may consider the custodian a good credit risk and be comfortable with the level of its exposure to the custodian, without the need to receive and hold any collateral. (Where there are other relationships

between the lender and the custodian, the lender's exposure can also be minimised by an appropriate set-off or close out netting provision with the custodian.) If so, the client would only need to monitor and regularly review the custodian's credit rating and the limit(s), and actual exposure, applicable to it.

5.9 In an *agency* programme:

- (a) The legal relationship is between the lender and the person to whom the agent has lent the securities. Accordingly, it is the borrower (and not the agent) who is the counterparty. In other words, the client cannot automatically look to the agent to make good the borrower's default. Accordingly, the lender is likely to insist on every borrower providing collateral. Also, collateral exposure lies with the lender.
- (b) Accordingly, the lender is vitally interested in the credit worthiness of each of those borrowers and must therefore:
 - (i) come to its own view, perhaps with the help of an external rating agency, of the appropriateness of the borrower for inclusion on the agent's list of potential borrowers;
 - (ii) if it wishes to do so (eg having regard to other exposures to any borrower on the agent's list and to the rating given to those borrowers by external rating agencies), set any limits on the level of exposure that it is willing to have to particular borrowers on the agent's list;
 - (iii) monitor and regularly review permissible borrowers and limits;
 - (iv) having regard to the above, determine acceptable collateral (or agree with, or differ from, the agent's list of acceptable collateral).
- (c) Invariably, the lender will also have recourse to the collateral provided by the borrower. The sole purpose of the collateral is to minimise the exposure of the lender to counterparty credit risk. The collateral is subject to the various risks associated with collateral described below. Normally, in a properly managed collateral management programme, the risk should be limited to an intra-day or overnight risk of an adverse market movement in the value of the lent securities or the collateral, and then only when the extent of the aggregate adverse movements exceeded the normal margin or buffer. But, as will be seen below, there are other risks.
- (d) Sometimes (subject to a cap) the agent will offer one or more indemnities to the lending customer (eg against an inadequacy of collateral due to an overnight increase in the value of the loaned securities or an overnight decrease in the value of collateral held or for the failure of the borrower to return equivalent securities on the due date). These indemnities require the lender to assess the credit worthiness of the agent.

(b) *Collateral risks*

5.10 As the IOSCO/CPSS Report noted (page 51), "while collateral reduces credit risk, it can add to other risks, such as legal, operational, liquidity and market risk".

5.11 The main risks in an *agency* programme, where collateral is provided, are outlined below.

- 5.12 At the outset, it is important to again note that, in an agency programme, collateral exposure lies with the lender, except to the extent (if at all) expressly indemnified by the agent.
- (i) *Delivery (versus payment or versus delivery) risk (if applicable)*
- 5.13 Delivery risk occurs when collateral is received or is to be received.
- 5.14 This issue is presently not so important in practice in Australia, because:
- (a) Transactions involving equity securities can now be settled through CHESS on a dvp basis, so that cash collateral can be credited contemporaneously with the delivery of the relevant securities.
- (b) Transactions involving debt securities such as Government Bonds and inscribed stock and semi government and corporate bonds can also be settled on a dvp basis through Austraclear.
- (c) The majority of securities loans for which the collateral is cash are now settled on a dvp basis in these ways, both on the initial and on the return leg.
- 5.15 The same issue arises where non cash collateral (other than a L/C) is to be provided - a delivery versus delivery (“**dvd**”) risk.
- 5.16 Where for any reason there cannot be dvp or dvd, the normal practice of an agent is to require the provision of collateral before delivery of the lent securities is made (and likewise, on the return leg, to require the provision of equivalent securities before redelivery of the collateral or equivalent collateral).
- 5.17 However, variation margin payments and refunds cannot be settled in this way.
- (ii) *Collateral title risk (if applicable)*
- 5.18 A lender should always ensure that there is clear title to any collateral received.
- 5.19 In practice, this is not a problem where the borrower is a bank. But the issue needs to be addressed in the course of a credit assessment of every non-bank borrower.
- (iii) *Adequacy of collateral risk (if applicable)*
- 5.20 The adequacy of collateral is the main collateral risk. The additional risks where transactions are collateralised with other securities (instead of cash or an LC) are explained in greater detail in part 2(2) of Chapter 5.
- 5.21 Where the lender is relying on the adequacy of the collateral, as well as the credit worthiness of the potential counterparties:
- (a) The margin above market value must cover market fluctuations. This is particularly important in a rising market. This risk is normally minimised by the agent continually monitoring collateral levels and making timely margin calls.

- (b) Current market practice in Australia generally is that the collateral should be maintained within the range of:
 - (i) at least 102-105% for equities secured by cash collateral (and sometimes substantially higher (eg 110%-130%) in the case of non cash collateral); and
 - (ii) 0-2% for debt securities such as Government and semi government bonds and inscribed stock,

of the daily marked to market value of the borrowed securities. The value of the borrowed securities is marked to market daily. The agent has sophisticated software to assist in making these calculations.

- (c) It should also be noted in passing that overcollateralisation by more than 15% can have significant regulatory capital implications for ASX regulated entities.

5.22 The making of timely margin calls could still leave an intra-day or overnight exposure if there is a sudden substantial increase in the market price of the borrowed securities.

5.23 All these operational activities are often called “loan maintenance”.

(iv) When taking cash as collateral - Re-investment of cash collateral risk

5.24 This risk is referred to in part 2(2) of Chapter 5. It is probably the second most important collateral risk.

5.25 In keeping with the legal position that collateral exposure lies with the lender, the lender is exposed to a market risk of incurring losses on re-invested cash collateral. In other words, if the cash collateral received by or on behalf of the lender is invested so that, on the return of equivalent securities by the borrower to the lender, there is insufficient cash for the lender to fully repay the borrower, then the lender is legally obliged to make good the shortfall. This exposure exists because, to obtain the desired incremental yields on the cash reinvestment, a lender (or the lender’s agent) typically will match only part of the term of the securities loan with the term of the cash investment: eg pay the rebate based on a 24 hour call rate, while investing in a 30 day money market instrument.

5.26 This kind of exposure materialised in the US in 1994 (see the IOSCO/CPSS Report, page 42), due to a sudden and unforeseen increase in US short-term interest rates (even though many custodian banks operating the relevant agency programme voluntarily compensated their customers). A similar thing may have happened more recently in one case in the US: see International Securities Finance magazine, June 2003, pages 4 and 6.

5.27 Any indemnification provided by an agent will typically never extend to any devaluation of collateral due to market movements or issuer default.

5.28 Agents typically manage this risk exposure by maintaining a short asset/liability mismatch window and a short weighted average portfolio maturity, by investing in a portfolio of liquid assets of high quality issuers and by investing in high correlated indices.

(v) When taking an LC as collateral - Default by LC bank

5.29 In keeping with the legal position that collateral exposure lies with the lender, if a lender in an agency programme agrees to accept a letter of credit from an approved L/C issuing

bank, then the lender may find itself under collateralised if the borrower and then the L/C issuing bank default.

(c) *Accrued benefits risk*

5.30 The lender must be able to accurately determine the benefits to which it is entitled and may wish to be satisfied that the borrower is able to remit them on the due date.

5.31 In this regard:

- (a) Where collateral is provided (as in an agency programme), normally the accrued benefit up to the relevant record date is taken into account in calculating margin requirements, because it is reflected in the market price of the relevant security.
- (b) There is an exposure between the record date and the payment date. In practice, this is not taken into account in calculating margin requirements in an ongoing relationship. Only in an exceptional case would a lender wish to ensure that, if securities are on loan over a books' closing date for a distribution, but returned before the distribution payable date, the benefit due is also secured.
- (c) In practice, the only accrued benefits which are captured and adjusted for are non-cash entitlements such as entitlement to participate in a dividend re-investment plan or a rights issue.

(2) *Is standardised documentation used in Australia?*

5.32 Standardisation of the forms of agreement used by overseas lenders (eg the UK Overseas Securities Lender's Agreement ("OSLA") and the US Bond Market Association Master Securities Loan Agreement) prompted the Australian Securities Lending Association ("ASLA") to attempt to standardise the securities lending documentation in use in Australia.

5.33 After considering various alternative approaches, a decision was made to adapt OSLA for use in Australia for loans of Australian securities. In April 1997, a specimen Australian Master Securities Lending Agreement ("AMSLA") and accompanying User's Guide prepared by Mallesons Stephen Jaques for the Australian Securities Lending Association were publicly released. The AMSLA quickly gained a high degree of market acceptance.

5.34 An updated version of the AMSLA and supplementary User's Guide were released in December 2002. A further very minor list of suggested amendments was subsequently released. A consolidated version of the AMSLA and User's Guide prepared by Mallesons Stephen Jaques were released and published by the Australian Financial Markets Association (AFMA) in its 28 November 2003 Update 8 to its On-Line Guide to OTC Documents.

5.35 As a consequence of the widespread acceptance of the AMSLA, potential new participants in the Australian securities lending market face a lower barrier to entry, because of, among other things, a lessening of concerns about relevant legal issues, the perceived cost of getting appropriate legal advice and developing their own form of agreement. (The cost of the development of appropriate systems (or, alternatively, the cost of a standard software package) is now a more important issue.)

(3) *Set-off/ netting arrangements in Australia*

- 5.36 The principles of Australian insolvency law are based on English law.
- 5.37 Accordingly, as indicated in part 3 of Chapter 5, a lender's risk exposure can be minimised by an appropriately drafted set-off or close out "netting" provision in the relevant master agreement.
- 5.38 Broadly, among other things, where a contract is governed by Australian law and where one of the parties to the contract is subject to Australia law (eg an Australian incorporated company), the Payment Systems and Netting Act 1998 (Cwlth) gives statutory force in Australia to the effectiveness of properly drafted close out or market netting provisions before any insolvency of a counterparty.
- 5.39 The Act also provides protection to a close-out netting (or market netting contract) where a counterparty to the contract goes into insolvency and either the contract is governed by Australian law, or the insolvency of the counterparty is governed by Australian law (which includes the winding up in Australia of a foreign company, under ancillary winding up procedures).
- 5.40 Unlike some overseas netting legislation, the Act does not list specific forms of financial contracts to be protected. Instead, the term "close-out netting contract" is broadly defined, by reference to the features of the netting provision in the relevant contract.
- 5.41 The netting provisions in the AMSLA are contained in clause 8.2. In its terms, the provision can apply if there is an event of default, both before and after any insolvency of the counterparty.

(4) *What are the Australian regulatory and compliance issues?*

(a) *FSRA issues*

- 5.42 The Financial Services Reform Act 2001 (Cwlth) (FSRA) introduced a licensing regime under the Corporations Act that may apply to both lenders and borrowers who enter into securities lending arrangements. The licensing requirements apply where a person "carries on a financial services business" "in this jurisdiction".
- 5.43 Among other things, a person provides financial services when the person deals in a financial product. Accordingly, unless exempt, the lender and the borrower would be required to obtain an Australian financial services licence (and satisfy obligations such as maintaining adequate resources and risk management systems and training for its staff) if carrying on a business of dealing in any financial products. In this regard:
- (a) The financial products involved in a securities lending transaction involve:
- (i) shares in companies (a security within s 761A of the Corporations Act and therefore a financial product under s 764A(1)(a));
 - (ii) corporate debentures (as for shares in a company);
 - (iii) government bonds (a financial product under s 764A(1)(j)); and
 - (iv) the securities lending transaction itself, if it is a derivative (a financial product under s 764A(1)(c)).

- (b) Accordingly, by entering into securities lending arrangements, both counterparties could be carrying on a business of dealing in financial products if such arrangements constitute a dealing under section 766C of the Corporations Act.
 - (i) *Is a securities lending transaction a “derivative” for the purposes of the Corporations Act?*
- 5.44 In general, it is possible to view a securities lending transaction as being a financial product on the grounds that it is a derivative, as defined, even though it might not traditionally be thought of as a derivative. “Derivative” is defined in section 761D of the Corporations Act as an arrangement in relation to which the following requirements are satisfied:
 - (a) a party to the arrangement must, or may be required to, provide consideration at some future time (being generally not less than 1 business day); and
 - (b) importantly and relevantly, the amount of consideration or the value of the arrangement is ultimately determined, derived from or varies by reference to, the value or amount of something else (such as an asset, a rate, an index or a commodity).
- 5.45 The term is intended to embrace financial contracts such as futures, options, warrants, swaps, share ratios and other composites (though this list is not exhaustive) and exotics (ie complex variations of standard derivatives).
- 5.46 It is arguable that the securities lending transaction satisfies both of the above requirements on the basis that:
 - (a) the borrower is required to provide consideration at a future time (ie equivalent securities and, importantly, manufactured payments and any non-cash rights); and
 - (b) the amount of consideration for the initial lending leg (ie the promise to redeliver equivalent securities and also to make manufactured payments and provide the value of non-cash rights), or value of the arrangement, may vary by reference to something else: at the very least the value of the manufactured payments and any non-cash rights varies by reference to the distributions and non-cash rights that arise in respect of the identical securities to the lent securities.
- 5.47 On the other hand, unlike options and futures contracts, it may be arguable that the “loan” or retransfer under a securities lending transaction takes it outside the statutory definition. The argument is that, if the “consideration to be provided in the future” is the delivery of the equivalent securities at the end of the borrowing, the “amount of consideration” provided in the future is fixed, not variable (it is the equivalent number of borrowed securities) and that, depending on the structure of the securities lending arrangement, the “value of the arrangement” is the fee or the margin achieved by the lender above the interest rate on the cash collateral, neither of which is “determined, derived from or varies by reference to the value or amount of something else”.
- 5.48 However, irrespective of the generally understood meaning of a “derivative” or of the parties’ understanding of a securities lending transaction, the agreement of the borrower to make manufactured income payments and also (in the case of equity securities) to compensate the lender for any non cash rights would seem to drag any securities lending transaction within the statutory definition.

- 5.49 Accordingly, even though the legal position may not be clear cut, it is prudent to assume that a securities lending transaction constitutes a “derivative” as defined in the Corporations Act and therefore a “financial product” for Corporations Act purposes.

(ii) Dealing in financial products

- 5.50 Dealing in a financial product is defined to mean applying for, acquiring, issuing, varying or disposing of a financial product or, in relation to securities or managed investments, underwriting the securities or interests (section 766C(1)). Arranging for a person to engage in such conduct is also ‘dealing’, unless the actions amount to providing financial product advice (section 766C(2)).
- 5.51 Entering into a derivative transaction involves the “issue” of a derivative, which is a dealing service (s 761E(5) and s 766C(1)(b)). Accordingly, if a securities lending transaction is a financial product (on the grounds that it is a derivative), then it is likely that a party to the transaction will fall within the above definition of dealing. In that event, a person “lending” or “borrowing” shares under a master securities lending agreement would be likely to be “dealing” in the securities lending arrangement for the purposes of Chapter 7 of the Corporations Act.
- 5.52 There is an exception in the legislation that provides that a person is taken not to deal in a financial product if the person deals in the product on their own behalf (whether directly or through an agent or other representative), unless the person is an issuer of financial products and the dealing is in relation to one or more of those financial products (section 766C(3)). However, importantly, as noted above the effect of section 761E(5) is that the lender and the borrower are both taken to be an issuer of a derivative not entered into or acquired on a financial market. Therefore, the section 766C(3) exception will not apply.
- 5.53 Consequently, if a securities lending transaction is a derivative, it is likely that securities lending will involve dealing in financial products under section 766C of the Corporations Act.
- 5.54 However, some likely securities lenders, such as some superannuation trustees or other persons regulated by the Superannuation Industry (Supervision) Act 1993, may be exempt from licence requirements under regulation 7.6.01 or other provisions.

(b) Receipt of cash collateral, and provision of non cash collateral, by special entities

(i) Superannuation funds, ADFs and PSTs

- 5.55 In October 1992, the Insurance and Superannuation Commission (“ISC”) (the predecessor of the Australian Prudential Regulating Authority (APRA)) was asked to consider whether the acceptance of cash collateral by a superannuation fund in connection with a securities loan by the fund might technically constitute a “borrowing” of money by the fund for the purposes of the predecessor to the current Superannuation Industry (Supervision) legislation. The same issue is relevant to ADFs and PSTs. A similar issue is relevant for life insurance companies (see 5.61(b) below).
- 5.56 In its written submission dated 2 August 1993 to the Senate Select Committee on Superannuation, and in subsequent oral testimony before the Committee, Mallesons Stephen Jaques, on behalf of the Superannuation Committee of the Law Council of Australia, requested legislative clarification of the issue. Subsequently, on 27 October

1993, ASLA put in a further written submission, also prepared by Mallesons Stephen Jaques, to the same effect.

- 5.57 Unfortunately, the Superannuation Industry (Supervision) Act 1993 (Cwlth) is completely silent on the point. This is despite the fact that the SIS Act imposes a civil penalty (which provides for civil and criminal consequences) on fund trustees for breach of the relevant statutory prohibition on the borrowing of money (see sections 67, 93 and 97).
- 5.58 However, by letter dated 18 February 1994 to ASLA, the ISC advised that, in its view, the acceptance and holding of cash as security in the course of a securities lending transaction of the kind described in the ASLA submission, to be repaid when the transaction is completed, would not amount to the “borrowing” of the cash. (The letter however did go on to say that this conclusion was dependent on:
- (a) the purpose of the transaction being restricted to the lending of securities [ie being a securities driven transaction] and not extending to the borrowing of money [ie being a cash driven transaction];
 - (b) the terms of the securities lending agreement being consistent with the character of the cash as security [ie with the transaction only being a securities driven transaction]; and
 - (c) the transaction being bona fide.)
- 5.59 An additional issue arises for any superannuation entity that *borrow*s securities. Subject to certain limited exceptions, a regulated superannuation fund and an ADF are not permitted to give a charge over, or in relation to, an asset of the fund. If such a fund provided non-cash collateral, in the form of say bonds or equities, in connection with a securities borrowing by the fund, could that constitute the granting of a charge over that collateral? In the writer’s view, at least under the AMSLA, the answer is a definite “No”. It is plain under that Agreement that the recipient of the collateral acquires absolute title to the collateral and is only obliged to redeliver equivalent collateral (see clause 1.4(b)). In other words, in effect the collateral is itself the subject of a securities lending type arrangement (see now also new clause 6.12). There is no mortgage, charge or other encumbrance over any such collateral received by the lender. A similar issue is relevant for life insurance companies (see 5.61(c) below).
- (ii) *Statutory authorities*
- 5.60 A similar issue to the “borrowing” of money issue discussed above also arises for any statutory authorities which manage equity or bond portfolios and which are subject to restrictions on their power to “borrow” money. Likewise, if the statutory authority is not permitted to charge or otherwise encumber its assets.
- (iii) *Life insurance companies*
- 5.61 Similar issues arises for life insurance companies:
- (a) The Life Insurance Act 1995 requires a life company to have at least one statutory fund.
 - (b) It also prohibits a company from borrowing money for the purposes of the business of a statutory fund, by means of an unsecured borrowing, if the result would be that the total amount of principal outstanding under unsecured

borrowings for the purposes of the business of the fund would exceed an amount ascertained in accordance with the regulations (see sections 38(4) and (5)). Broadly, regulation 4.01 limits the maximum amount of principal outstanding under all unsecured borrowing relating to a fund to 50% of the “free assets” (as defined in regulation 4.01(1)) of the fund. The writer is not aware of APRA’s view regarding securities lending by life companies and, in particular, regarding the receipt of cash collateral by them. It is presumed that, if it takes the view expressed in the ISC’s 18 February 1994 letter in relation to superannuation entities, it takes the same view in relation to life companies, namely that a receipt of cash collateral in a securities driven transaction does not involve the borrowing of money for the purposes of the Life Insurance Act.

- (c) The Life Insurance Act (section 38(3)) also prohibits a life company from mortgaging or charging any of the assets of a statutory fund unless certain exceptions apply (see also section 4 and regulation 4.00A). For the reasons mentioned in 5.59 above, it is considered that, under the AMSLA, the provision of non-cash collateral in connection with a securities borrowing transaction by a life company would not constitute the granting of a mortgage or charge over that collateral.

5.62 One additional issue arises for any life company that borrows securities. The assets of one statutory fund cannot be used as collateral for the borrowing of securities on behalf of another statutory fund (section 38(2)).

(c) *APRA issues for insurance companies and superannuation entities*

5.63 Finally, for both insurance companies and superannuation entities, an issue arises as to:

- Whether the lender’s rights under a securities lending agreement come within the concept of a “derivative” for the purposes of relevant APRA Prudential Standards (eg Prudential Standard GPS 220, Risk Management for General Insurers) and Guidance Notes (eg Guidance Note GGN 110.4 Investment Risk Capital Charge). (The same issue arises if a superannuation entity or insurance company was a borrower of securities.)
- If so, the consequences thereof.

The comments below illustrate the issue for an insurance company.

(i) *Regulatory background for an insurance company*

5.64 Insurers are required to set aside capital to cover the investment risk of derivative transactions. For this purpose, a “derivative” is not defined. However paragraph 23 of Guidance Note GGN 110.4 Investment Risk Capital Charge states:

“Derivatives include forwards, futures, swaps, options and other similar contracts.”

5.65 See also a similar statement in paragraph 14 of Guidance Note GGN 220.3 (quoted below).

5.66 The principal concern about derivatives is that they expose the investor to kinds of risk which are not associated with an ordinary investment in a physical asset, such as basis risk

(as well as the ordinary market risk associated with any physical investment), and facilitate speculation. This concern has prompted the requirements for the separate assessment and reporting of derivative exposures.

(ii) Is a securities lending transaction a “derivative” for APRA purposes?

- 5.67 There are several arguments as to why a securities lending transaction might not be a derivative for the purposes of relevant APRA Prudential Standards and Guidance Notes.
- 5.68 Further, in the absence of a relevant definition of the kind found in the Corporations Act, it is not clear what significance (if any) ought to be attached to the fact that, under a securities lending agreement, the borrower is obliged to make manufactured income payments and also (in the case of equity securities) to compensate the lender for any non cash rights.
- 5.69 However, paragraph 23 of Guidance Note GGN 110.4 (quoted above) and paragraph 14 of Guidance Note GGN 220.3 (quoted below) both state that a “derivative” is taken to include a “forward” contract, which would include a forward purchase contract (which is akin to the second leg of a securities lending transaction).
- 5.70 Accordingly, while the position may not be clear cut, it may be prudent for any authorised insurer to assume that a securities lending transaction also constitutes a derivative for the purposes of APRA Prudential Standards and Guidance Notes.

(iii) Risk Management Strategy Document

- 5.71 Insurers are also required by Prudential Standard GPS 220 Risk Management For General Insurers and Guidance Note GGN 220.2 Risk Management Systems to have a Risk Management Strategy Document which has been approved by the Board of the Insurer and to provide a copy of that document to APRA.
- 5.72 Each year (at the time the insurer lodges its statutory accounts with APRA) the Board of the insurer is also required to provide APRA with a Board Declaration which, among other things, states that:
- (a) the Board and senior management have identified the key risks facing the insurer and have a Risk Management Strategy (“RMS”) in place to manage and monitor those risks;
 - (b) the insurer has substantially complied with its RMS; and
 - (c) the copy of its RMS Document provided to APRA is accurate and current.
- 5.73 The use of derivatives by the insurer must be specifically addressed in its RMS. Guidance Note GGN 220.3 Balance Sheet and Market Risk states that an insurer’s RMS must include certain minimum policies and procedures in relation to the insurer’s use of derivatives. For these purposes, paragraph 14 of that Guidance Note states:

“Derivative transactions are financial contracts and include a wide assortment of instruments such as forwards, futures, swaps, options and other similar transactions.”

- 5.74 Whether or not securities lending is a derivative for those purposes, engaging in securities lending transactions is in any event something which an insurer's RMS should probably address:
- (a) For example, regard should be had to the obligations assumed under (what is effectively) a deferred forward purchase agreement.
 - (b) A decision to enter into securities lending transactions is also likely to be directly relevant to the insurer's investment decision making policies and procedures - which are matters an insurer's RMS should also include in its ambit.
 - (c) An insurer's current RMS may also, in accordance with its terms, require that new risks - such as those which would be assumed under a securities lending arrangement - be incorporated into the insurer's RMS.
- 5.75 If the change might be regarded as material to the RMS, an insurer would as a matter of practice normally first discuss the proposed change with APRA, before implementing it.
- (5) *Is there an Australian equivalent to the UK Stock Borrowing and Lending Code?*
- 5.76 In December 1997, ASLA drew up a Securities Lending "Code of Guidance". It sets out, for guidance, a summary of the basic procedures which Australian based participants in securities lending observe as a matter of best practice.
- 5.77 A copy of the Code of Guidance can be viewed as ASLA's website at <http://asla.com.au/aslancode.php>

6 Frequently asked questions in Australia

[The comments in this Part 6 are supplemental to those in Chapter 6 of the main text. For example, the comments below under the heading “A2” refer back to Part A2 of Chapter 6. Note: If there is no mention below of a question in Chapter 6 of the main text, then the position in Australian is substantially the same as stated in the answer to that question in Chapter 6 of the main text.]

6.1 A2: What [does a transfer of title] mean for the lender?

In Australia : see clauses 4.2 and 4.3 of the AMSLA.

6.2 A6: [Standard documentation in Australia]

The standard Australian securities lending agreement for entirely domestic transactions is the AMSLA.

However, cross border transactions involving Australian securities are often governed by an overseas master agreement such as the GMSLA.

6.3 A7: What happens if something goes wrong?

The discussion under heading A7 in Chapter 6 applies equally in Australia as if:

- a reference to English law was to the law applicable in Australia;
- a reference to the UK was to Australia or Australian, as the case may be; and
- a reference to England was to Australia.

Obviously, the EU Collateral Directive does not apply in Australia.

6.4 B1: What happens if the lender has lent a stock over the dividend period?

In Australia : see clause 4.2(a) of the AMSLA.

6.5 B6: Do [Australian] lenders get higher loan rates if they take cash for a scrip dividend?

In Australia, currently only occasionally do major issuers offer a financial incentive to their shareholders to take scrip rather than cash.

6.6 C10: What happens if market prices rise between the borrower defaulting and cash being made available following the liquidation of the collateral?

In Australia, see clauses 8.2 to 8.4 of the AMSLA.

6.7 C14: Is accrued interest included in the calculations of market value for collateral, loan and fees?

Unlike the GMSLA, the AMSLA does **not** expressly provide for the valuation of either or both of securities and collateral to include any of:

- accrued income,

- dividend or interest payments declared but not yet due by the issuer; and
- dividends paid in the form of securities.

See the definition of “Value” in clause 26 of the AMSLA. See also 5.30 and 5.31 above.

6.8 *C15: What happens if a borrower doesn’t return a stock when called or at maturity?*

In Australia : see clause 8.4(b) of the AMSLA.

6.9 *D2: How long are term loans usually on loan for?*

In Australia, there is no typical period. It can vary anywhere from 1 day to the normal maximum of about one year.

6.10 *F7: What are the normal fees that [a custodian, acting under either a principal or an agency securities lending program] would charge?*

In Australia, a lender would normally get about 50% of the extra income earned from securities lending, but some lenders of a large portfolio may obtain a higher percentage of the income.

7 Australian taxation issues

[The comments in this Part 7 are self-contained and do not relate to any particular part of the main text.]

(1) What are the Australian stamp duty issues?

(a) No transfer stamp duty

7.1 Since 1 July 2001, no Australian State or Territory has imposed stamp duty on the transfer of shares quoted on the ASX (and other approved exchanges). (There is no federal stamp duty.)

7.2 There is also no stamp duty on the transfer of debt, fixed interest or other money market securities.

(b) No mortgage duty

7.3 The securities lending agreement itself should not be liable to mortgage duty in any State or Territory, because securities lending does not involve a mortgage or charge over either the lent securities or any cash or non-cash collateral.

(2) What are the Australian GST issues?

7.4 There is a federal goods and services tax (“GST”). However:

(a) No GST is imposed on a securities lending transaction (ie the transaction between the securities “lender” and the securities “borrower” involving the transfer of the original securities, the return of equivalent securities and the payment of equivalent distributions (if any)). Rather, securities lending is an input taxed supply (unless it qualifies for GST-free treatment, for example under the “export” provisions).

(b) There is also no GST imposed in respect of either:

(i) the provision of cash collateral, the payment of a “rebate” (ie interest) thereon and the return of equivalent cash collateral; or

(ii) the provision of non-cash collateral, the return of equivalent non-cash collateral and the payment of equivalent distributions (if any).

7.5 However:

(a) Where a custodian is lending securities under an agency programme on behalf of its custody client, GST will be imposed on the custodian by reference to the consideration that the custodian charges the client for the custodian’s services (ie typically a share of the “spread” where cash collateral is provided under a “borrow vs cash” arrangement, or a share of the fee where collateral is provided under a “borrow vs cash pool” or “borrow vs pool” arrangement: see 2.17 above for an explanation of these different arrangements).

(b) Likewise, where a custodian bank is the borrower under an uncollateralised principal programme, GST will be imposed on the client lender by reference to the fee that the client charges the custodian bank for lending the client’s securities to the custodian.

(3) *What are the ordinary Australian income tax issues?*

7.6 In addition to residency rules and permanent establishment and source type issues, lenders of Australian securities must be aware of the application of:

- (a) ordinary income tax;
- (b) capital gains tax (“CGT”) (which is not a separate tax, but, broadly, simply results in a net capital gain being included as assessable income for ordinary income tax purposes); and
- (c) withholding tax,

to any securities lending transaction into which they enter.

7.7 Loans of equity securities can raise more complicated Australian income tax issues than loans of debt securities. However, the two types of loans do have some issues in common. Accordingly, those common issues will be discussed first below.

(4) *What income tax issues are common to the lending of both debt and equity securities?*

(a) *Is there a disposal of the security for tax purposes?*

7.8 As was mentioned in Part 1 of this Australian Supplement (see paragraphs 1.1(d) and 1.2), securities lending involves a disposition of securities and the subsequent acquisition of identical (but not necessarily the same) securities, even though the securities industry treats the transactions as if they involved a loan, and later return, of the same securities.

7.9 This sale and repurchase view was adopted by the Australian Taxation Office when it first became aware of securities lending arrangements. The first leg of a securities lending transaction could therefore crystallise a liability to ordinary income tax or CGT, because it involves the realisation of an asset, namely the securities being “lent”. (For both ordinary income tax and CGT purposes, the consideration for the initial disposal of the securities would be regarded as the then value of the promise to later return equivalent securities (ie the market value of the lent securities at the time of disposal).)

7.10 However, broadly, this consequence can now be avoided, provided that certain conditions are fulfilled. Under section 26BC of the Income Tax Assessment Act 1936 (“ITAA 1936”), a domestic lender is not subject to any Australian ordinary income tax or CGT consequences arising from the disposal of the lent security and the later receipt of an identical security, (other than those arising from being paid a fee) if, among other things:

- (a) the securities lending agreement is in writing;
- (b) an equivalent security is returned within twelve months after the borrowed security is lent;
- (c) the borrower and the lender deal at arm’s length in relation to the transaction (note: the borrower and the lender may not be at arm’s length (eg because they are related companies; but that will not preclude them from dealing with each other at arm’s length “in relation to a particular transaction”);

- (d) the consideration paid by the borrower (including any fee) is specifically identified; and
- (e) the lender retains the total consideration due under the agreement.

7.11 A non-Australian resident holder of an Australian equity who holds the equity on capital account (and not either as trading stock or otherwise on revenue account) ought generally not be concerned with whether or not any disposal of the equity under a securities lending transaction qualifies for non-recognition treatment for Australian tax purposes under section 26BC. This is because any disposal of the equity by the non-resident would normally not be subject to the Australian CGT. This is because:

- (a) In the case of a non-resident, under Division 136 of the ITAA 1997, the non-resident is subject to CGT in respect of the relevant asset only if that asset “has the necessary connection with Australia”.
- (b) Under item 5 in the table in section 136-25 of the ITAA 1997, a share in a company will have that connection only if:
 - (i) the company is an Australian resident, and a public company, for the Australian income year in which the relevant CGT Event happens;
 - (ii) and, importantly, the lender and its associates beneficially owned at least 10%, by value, of the shares in the company (other than shares that only carried a right to participate in a distribution of profits or capital only to a limited extent, such as preference shares) at any time during the 5 years before the CGT Event happens. In practice, relatively few non-resident securities lenders satisfy this second requirement. Accordingly, relatively few non-resident lenders need to be concerned at meeting the requirements of section 26BC, or at the implications of not meeting those requirements.
- (c) As part of the 2005/2006 Federal Budget, handed down on 10 May 2005, the **Government proposes to remove capital gains tax for non-resident investors on the sale of Australian assets** (except direct interests in real property and non-portfolio interests in entities that invest in real property). The proposal paper is set out in Attachment B to the Treasurer's Press Release of the same date, no 2005 / 044, which can be accessed using the following link: <http://www.treasurer.gov.au/tsr/content/pressreleases/2005/044.asp>. The proposed changes (if and when enacted) will only apply to relevant CGT events occurring on or after the date of Royal Assent to the relevant legislation. The Government intends to introduce the relevant legislation before 30 June 2006.

7.12 There is, however, a (perhaps unintended) potential quirk in relation to the non-recognition treatment afforded to Australian resident lenders by section 26BC(6) for Australian CGT purposes (which is likely to be more relevant for most Australian resident lenders than the ordinary income tax consequences). In this regard:

- (a) The provision (section 26BC(4)) which gives relief to the lender from any ordinary income tax consequences (if applicable to the lender) treats the lender as if the lender had held the lent security at all times (ie as if the equivalent security was the lent security).

- (b) By way of contrast, the provision (section 26BC(6)) which gives relief to the lender from any CGT consequences simply says that “any capital gain or loss from the disposal of the [lent] security by the lender is disregarded”. Importantly, in contrast to section 26BC(4), section 26BC(6) does not have the effect of deeming the equivalent security to have been acquired by the lender when the lent security was originally acquired by the lender.
 - (c) The difference may be significant if the lender subsequently disposes of the equivalent security within 12 months of acquiring it under the second leg of the securities lending transaction. In particular:
 - (i) In order for any capital gain on disposal of the equivalent security by an Australian resident lender to qualify for discount capital gains tax treatment under Division 115 of the ITAA 1997 (if available), which can reduce the applicable tax rate by 50%, it seems that the equivalent security must have been acquired by the lender at least 12 months before the date on which the equivalent security is deemed to have been disposed of by the lender for CGT purposes: see sections 115-25 and 115-40 of the ITAA 1997.
 - (ii) It is not sufficient that the lent security had been acquired by the lender more than 12 months before the lender contracted to sell the equivalent security.
 - (iii) For example, if an Australian resident lender acquired a share on 1 January 2000, lent it on 1 January 2005 and, following the giving by it of a recall notice, received an equivalent share on 1 April 2005, which it later sold at any time before 1 April 2006, the gain on disposal would seem not to qualify for discount capital gains treatment.
- 7.13 In addition, there are specific requirements if a distribution (such as an interest coupon, in the case of debt securities, or a dividend or the issue of a right or option, in the case of equity securities) in respect of the borrowed security occurs during the borrowing period. The treatment of distributions for debt securities and equity securities, respectively, is considered below.
- 7.14 It is generally easy for a lender to meet all these requirements, if it wishes to do so. Likewise, it is generally easy for parties to avoid meeting these requirements, if (usually for tax reasons) one of them wishes to do so. A transaction which fails to meet the requirements is generally referred to as a “non-complying” securities loan (correspondingly, a transaction which meets the requirements is generally referred to as a “complying” securities loan).
- (b) *Normally, no debt/equity classification issues*
- 7.15 The Australian tax legislation contains special rules for determining whether “financing arrangements” are “debt” or “equity” for particular tax purposes. However, a securities lending arrangement covered by section 26BC of the ITAA is not a “financing arrangement” for this purpose.
- 7.16 Accordingly, provided that the relevant securities lending transaction meets the requirements of section 26BC (but not otherwise), then, whether or not the transaction is securities-driven or cash-driven, the transaction itself should not qualify as either debt or

equity for relevant Australian income tax purposes. This is relevant to the treatment of manufactured payments discussed below.

7.17 It should be noted that section 26BC does not refer to collateral. In this regard:

- (a) Where non-cash collateral (ie collateral securities) is provided, the provision of those collateral securities and later return of equivalent collateral securities in
- (b) effect involves a separate securities lending transaction, contemporaneous with, and in parallel to, the loan of the principal securities. Clause 6.12 of the AMSLA expressly says so, in order to clarify that this collateral transaction is also eligible for non-recognition treatment for Australian tax purposes under section 26BC.
- (c) However, where cash collateral is provided (eg in the case of an agency programme), a rebate paid to a securities borrower in respect of any cash collateral can still be characterised for tax purposes as interest on a debt interest in the securities lender.

(c) *Is any securities borrowing fee liable to any Australian tax?*

7.18 Broadly, Australian source interest (as defined for withholding tax purposes), which includes any amount in the nature of interest, derived by a non-resident is subject to withholding tax at a flat rate of 10% on the gross amount. There are exceptions in sections 23(jb) and 128F of the ITAA 1936. The rate is now also reduced in certain instances by Australia's double tax agreements with the US and the UK.

7.19 There is an issue as to whether any borrowing fee paid by a securities borrower to a securities lender could be characterised as an amount of interest for interest withholding tax purposes.

(5) *What additional income tax and CGT issues apply for loans of debt securities?*

(a) *Interest coupon equivalent receipts of securities lender*

7.20 If the securities lending agreement complies with section 26BC and debt securities are lent under it, then the coupon equivalent receipt of the lender generally will be treated the same as an original interest coupon that the lender would have received, had it continued to hold the relevant debt security (eg Government, semi-government or corporate bond).

7.21 So, if the lender would have been assessable on the interest coupon (the "otherwise assessable amount"), it will be assessable on the equivalent manufactured payment which it receives.

7.22 However, it needs to be recognised that, in practice, to date most debt securities in Australia have been "lent" under reciprocal purchase (or buy/sell-back) agreements, such as the GMRA. Quite different Australian tax (and legal) issues and considerations apply to repos and buy/sell-back transactions.

(b) *Interest withholding tax*

7.23 There is an issue:

- (a) As to whether a coupon equivalent amount paid by a resident debt security borrower to a non-resident debt security lender can be liable to interest withholding tax.
- (b) If not, as to whether the anti-avoidance provisions in either:
 - (i) the bond washing provisions; or
 - (ii) Part IVA of the ITAA 1936;can apply to the coupon equivalent amount.

Note: The discussion below does not apply to original issue discount type securities to which Division 16E in Part III of the ITAA 1936, and related provisions, apply.

(i) *Ordinary position*

7.24 Apart from the possible application of the bond washing provisions or Part IVA (discussed below), in the writer's view, the ordinary position is that the manufactured payment is not interest (even within the extended meaning of that term for interest withholding tax purposes) and therefore is not liable to interest withholding tax. (However, a corollary is that, if the borrower simply pays the non-resident lender the net amount that the lender would otherwise receive after the deduction of 10% interest withholding tax (say \$90, in respect of a gross coupon of \$100), the lender will not have any foreign tax credit which it can claim in its home jurisdiction.)

7.25 Where a comprehensive double tax agreement with Australia does not apply to the distribution equivalent amount, there may, however, be a risk (depending on the circumstances) that the amount is Australian source income of the recipient, which is assessable to it as ordinary income, at the corporate rate (30%) in the case of a corporation. (The position may be especially complicated in practice where (as is often the case) the lender is a custodian or sub-custodian for other non-residents (be they institutions, trusts or corporate entities).)

(ii) *Possible application of bond washing provisions*

7.26 The bond washing provisions, which took effect on 20 August 1996, consist of:

- (a) paragraph (c) of the definition of interest in section 128A(1AB) of the ITAA 1936, which is as follows:

“ ‘interest’ includes an amount ...

- (c) to the extent that it could reasonably be regarded as having been received in exchange for interest in connection with a washing arrangement”; and

- (b) the definition of “washing arrangement” in section 128A(1AB), which is as follows:

“ ‘washing arrangement’ means an arrangement under which the title to a security is transferred to a resident shortly before an interest payment is made, where the sole or dominant purpose of the arrangement is to reduce the amount of withholding tax payable by a person”.

7.27 In the writer’s opinion:

- (a) Those provisions are quite capable of applying to some securities lending transactions involving ordinary interest bearing debt securities.
- (b) However, there are other such transactions which, for various reasons (too complex to explain in this summary), may not be caught by these provisions.

(iii) *Possible application of Part IVA*

7.28 Since 20 August 1996, Part IVA (which contains the general anti-avoidance provisions) in the ITAA 1936 has also applied to schemes or arrangements involving the avoidance of dividend, interest or royalty withholding tax: see section 177CA of the ITAA 1936.

7.29 Where Part IVA applies to a distribution equivalent amount, the payer of that amount is made liable to pay the avoided withholding tax retrospectively: see sections 177F(2A) to (2G) of the ITAA 1936 and related provisions in Schedule 1 of the Taxation Administration Act 1953.

7.30 It should not be assumed that, just because a securities lending transaction involving an ordinary interest bearing debt security escapes the application of the special bond washing provisions, the transaction is not susceptible to the possible application of the general anti-avoidance provisions in Part IVA.

(6) *What additional income tax and CGT issues apply for loans of equity securities?*

(a) *Distribution equivalent receipts of securities lender: Dividend imputation*

(i) *Franking credits generally*

7.31 For Australian tax purposes, Australian tax resident shareholders receiving distributions from an Australian tax resident company must gross up the distribution received (by the amount of tax paid by the distribution paying company on the profits out of which the dividend was paid), but are then generally entitled to a tax credit for the amount of the gross up (the franking credit). This franking credit can be applied against tax payable either on the distribution or on other income of the recipient of the distribution.

7.32 Broadly:

- (a) Franking credits are irrelevant to non-resident holders of Australian equities - ie they do not gross up the distribution and claim a franking credit or tax refund from the Australian Taxation Office.

- (b) However, franked distributions (or, in the case of a partly franked distribution, the franked component of the distribution) are exempt from Australian dividend withholding tax: section 128B(3)(ga) of the ITAA 1936.

(ii) *Transfer of shareholder status for dividend imputation purposes*

- 7.33 Under the general rules relating to franked distributions, any franking credit that attaches to a distribution is utilised by the registered security holder (or, where the registered security holder is a custodian or Australian sub-custodian, by the ultimate beneficial owner of the security).
- 7.34 However, under Division 216 of the ITAA 1997, a fully or partly franked distribution paid directly by an issuer to a borrower under a securities lending arrangement which falls within section 26BC of the ITAA 1936 is generally deemed to have been paid to the lender. The legislation also requires the borrower to issue a statement in an approved form to the lender, advising it of the transfer of shareholder status for dividend imputation purposes.
- 7.35 Importantly, franking credits referable to franked distributions are only transferable under Division 216 if the transferor can transfer a genuine distribution. Thus, if the borrower is not entitled to a genuine franked distribution from an issuer, eg because it has on-sold the securities (and consequently cannot transfer any franking credit to the lender), both parties must ensure that the contractual arrangements between them specify exactly what compensation (if any) will be due. Well drawn documentation for any complying loan will require in an appropriate case that the distribution equivalent amount or “manufactured” income payment be grossed-up (by a compensatory payment) for any loss of the franking credit to the lender (see, for example, clause 9.2 of the AMSLA).
- 7.36 In practice, unless otherwise agreed, if a loan on behalf of an Australian tax resident lender would extend over a distribution record date, most custodian banks will contact the borrower and confirm whether or not the borrower will give the required statement. Unless it is certain that the borrower will do so, the custodian bank will generally recall the securities. Where there is no recall but the borrower fails to give the required statement, the gross up compensatory payment referred to in the preceding paragraph should adequately compensate the lender.

(iii) *Application of the “at risk” holding period rule and the related payments rule to securities lending transactions*

- 7.37 The “45 day holding period rule” and the “related payments rule” both require the taxpayer, subject to certain exceptions, to hold shares at-risk for not less than 45 days (or 90 days in the case of preference shares) in a certain qualification period in order to be able to gross up the distribution and claim a franking credit, as described in 7.31 above. The qualification period differs for each rule, with the qualification period for the related payments rule being more onerous. Both rules are intended to prevent certain forms of franking credit trading.
- 7.38 However, in effect, neither the “at risk” holding period rule nor the “related payments rule” referred to in section 160APHO applies to affect the ability of the lender to utilise franking credits under securities lending arrangements that fall within section 26BC of the ITAA 1936: this is the effect of section 160APHH(8) of the ITAA 1936 (to be re-enacted in the ITAA 1997).

7.39 Prior to the introduction of the “at risk” holding period rule, non-complying arrangements were frequently entered into by non-resident lenders and Australian borrowers. This was because:

- (a) Non-resident holders of Australian equities effectively cannot use any franking credits referable to distributions which they receive (see 7.32(a) above).
- (b) By making the lending arrangement non-complying, *prima facie*, the borrower obtained the benefit of the franking credit, which the lender otherwise could not have used.

This practice was overcome by the “at risk” holding period and related payments rules.

(iv) *Section 177EA of the ITAA 1936*

7.40 Section 177EA, applicable since 13 May 1997, is a “catch-all” anti-avoidance provision applicable to schemes that seek to provide a taxpayer with an imputation benefit and that are otherwise not affected by specific integrity provisions such as the “at risk” holding period rule and the related payments rule.

7.41 The provision has already been successfully applied by the ATO in the *Electricity Supply Industry Superannuation (Qld) Ltd Case* (2003) 53 ATR 120.

(b) *Dividend withholding tax*

7.42 Generally, withholding tax must be withheld and remitted to the Australian Taxation Office on the unfranked component of Australian sourced dividends paid or credited to non-residents.

7.43 Withholding tax on the unfranked component of dividends is generally imposed at a flat rate of 30%, but the rate is reduced to 15% for dividends paid to residents of countries with which Australia has concluded a comprehensive double tax agreement and to as low as 0% in the case of some US and UK residents under recent amendments to the US and UK agreements. Importantly, tax need not be withheld on that part of a distribution which is fully franked (ie where the company has borne full Australian tax on the profits out of which the distribution is paid).

7.44 The transfer of shareholder status provisions referred to in 7.33-7.36 above do not apply for dividend withholding tax purposes. Accordingly:

- (a) An issue therefore arises as to whether, in any circumstances (eg if, or to the extent to which, the underlying distribution is unfranked), a distribution equivalent amount paid by a resident borrower to a non-resident lender can be liable to dividend withholding tax.
- (b) This issue is also affected by the anti-avoidance provisions in Part IVA of the ITAA 1936.

(i) *Ordinary position*

7.45 Apart from the possible application of Part IVA (discussed below), the ordinary position is that the manufactured payment is not a dividend and therefore is not liable to dividend withholding tax, even if in lieu of unfranked or partly franked dividends which the non-resident lender would otherwise receive. (However, a corollary is that, if the

borrower simply pays the non-resident lender the net amount that the lender would have received after the deduction of any dividend withholding tax, the lender will not have any foreign tax credit which it can claim in its home jurisdiction.)

- 7.46 Where a comprehensive double tax agreement with Australia does not apply to the distribution equivalent amount, there may, however, be a risk (depending on the circumstances) that the amount is Australian source income of the recipient, which is assessable to it as ordinary income at the corporate rate (30%) in the case of a corporation. (The position may be especially complicated in practice where (as is often the case) the lender is a custodian or sub-custodian for other non-residents (be they institutions, trusts or corporate entities).)

(ii) *Possible application of Part IVA*

- 7.47 Since 20 August 1996, Part IVA (which contains the general anti-avoidance provisions in the ITAA 1936) has also applied to schemes or arrangements involving the avoidance of dividend, interest or royalty withholding tax: see section 177CA of the ITAA 1997.

- 7.48 Where Part IVA applies to a distribution equivalent amount, the recipient of that amount is made liable to pay the avoided withholding tax retrospectively: see sections 177F(2A) to (2G) of the ITAA 1997 and related provisions relating to both the recipient and the payer of the amount in Schedule 1 of the Taxation Administration Act 1953.

- 7.49 Thus, where:

- (a) a non-resident owns a share (including non-share equity) in an Australian company which pays unfranked or only partly franked dividends,
- (b) prior to the books' closing date for payment of the distribution, it lent the share to an Australian resident in an attempt to avoid the dividend being subject to dividend withholding tax, with the redelivery of an equivalent share occurring after the books' closing date, and
- (c) the borrower agrees to pay the lender, say, an amount greater than the net amount (after the deduction of normal withholding tax) that the lender would otherwise have received,

it is quite possible that the anti-avoidance provisions would apply, so that the Australian borrower would be liable to pay to the Australian Taxation Office the amount of withholding tax avoided and a penalty relating to that amount.

- 7.50 For that reason, as far as the writer is aware, informed lenders and borrowers generally ceased entering into arrangements such as those just described, as from 20 August 1996, being the date that the amendments introducing the withholding tax avoidance provision to Part IVA became effective.

(7) *What additional income tax issues apply to the provision of cash collateral?*

- 7.51 As was mentioned in part 2(7) above (see paragraphs 2.13 and 2.14), in an agency programme in Australia cash collateral (instead of, for example, securities or an irrevocable standby letter of credit) is often provided to the lender to secure the obligation of the borrower to deliver equivalent securities. In those circumstances (see paragraph 2.17(a)), usually no fee is payable by the borrower to the lender in connection with the transaction (and so no question arises as to the application of withholding tax to

any such fee). Instead, the lender makes a profit which comprises the spread between the yield which it makes on investing the cash collateral and the lower yield which is passed back to the borrower of the securities.

- 7.52 However, lenders and borrowers alike should be conscious of the possible impact not only of Australian, but also of foreign, interest withholding tax on this interest (or “rebate” as it is generally called in the context of securities lending) which the lender pays to the borrower. In the writer’s view, the rebate is interest within the ordinary meaning of that term.
- 7.53 Since Australian residents are usually net borrowers of Australian securities from non-residents (and not the lenders of securities to them), the rebates generally flow from offshore to Australia, and not vice versa. Accordingly, the possible impact of overseas (rather than Australian) interest withholding tax on any rebates received by Australian residents is likely to be more relevant for them.
- 7.54 However, increasingly, Australian residents are lending their overseas equities to non-resident broker/dealers. In that situation, if the Australian resident lender receives cash collateral (whether directly or through a custodian, and whether in Australian currency or (more usually) in a foreign currency, which may be invested offshore at all times), the potential application of Australian interest withholding tax to any rebate paid to the offshore borrower needs to be carefully considered.

8 Concluding comments

[The comments in this Part 8 are self-contained and do not relate back to any particular part of the main text.]

(1) Are there any unresolved issues affecting securities lending in Australia?

(a) Australian taxation law

- 8.1 Some securities lending transactions involving equities are documented as repos. (The principal difference involves the character of the cash which passes from the borrower to the lender at the time that the securities are lent. Under a securities lending agreement the cash is in the nature of a security deposit. Under a repo it is in the nature of purchase money.)
- 8.2 However, it is uncertain whether or not a repo qualifies as a “securities lending arrangement” for the purposes of section 26BC of the Income Tax Assessment Act.
- 8.3 An industry submission by the Australian Financial Markets Association in January 1993 asked the Australian Taxation Office for clarification on this and several other related issues. However, the ATO did not formally respond to the submission.

(b) Australian corporate law

- 8.4 As was noted in Part 5 of this Australian Supplement, the effect of securities lending transactions on “relevant interests”, for the purposes of the substantial shareholder provisions in the Corporations Act, is also uncertain, and possibly dependant on the position of a borrower (about which a lender of securities may be ignorant). We may get some clarification of the attitude of the ASIC to this issue in time.

(2) What does the future have in store for Australian securities lending?

- 8.5 The increasing array and volume of options, futures and other derivative products, and the continued existence of arbitrage opportunities, should help ensure continued substantial demand for securities lending in Australia.

Appendix 3: Glossary

Every business has its own business terms. Securities lending is no exception. Here we list the more esoteric terms mentioned in this booklet and some that might be encountered whilst exploring the market.

1 From the Original UK Publication

Accrued Interest: Coupon interest that is earned on a bond from the last coupon date to the present date.

Agent: A party to a loan transaction that acts on behalf of a client. The Agent typically does not take in risk in a transaction. See “Indemnity.”

All-in dividend: The sum of the manufactured dividend plus the fee to be paid by the borrower to the lender, expressed as a percentage of the dividend on the stock on loan.

All-in Price: Market price of a bond, plus accrued interest. Generally rounded to the nearest 0.01. Also known as “dirty price”.

Basis Point: One one-hundredth of a percent or 0.01%.

Bearer securities: Securities that are not registered to any particular party and hence are payable to the party that is in possession of them.

Beneficial owner: A party that is entitled to the rights of ownership of property. In the context of securities, the term is usually used to distinguish this party from the registered holder (a nominee for example) that holds the securities for the beneficial owner.

Benefit: Any entitlement due to a stock or shareholder as a result of purchasing or holding securities, including the right to any dividend, rights issue, scrip issue etc. made by the issuer. In the case of loaned securities or collateral, benefits are passed back to the lender or borrower (as appropriate), usually by way of a *manufactured dividend* or the return of *equivalent* securities or collateral.

BMA: The Bond Market Association – is a U.S.-based industry organisation of participants involved in certain sectors of the bond markets. The BMA establishes non-binding standards of business conduct in the US fixed income securities markets. Formerly known as the Public Securities Association or **PSA**.

Buy-In: The practice whereby a lender of securities enters the open market to buy securities to replace those that have not been returned by a borrower. Strict market practices govern buy-ins. Buy-ins may be enforced by market authorities in some jurisdictions.

Buy/Sell-Sell/Buy: Types of bond transactions that, in economic substance, replicate reverse repos and repos, respectively. These transactions consist of a purchase (or sale) of a security versus cash with a forward commitment to sell back (or buy back) the securities. Used as an alternative to repos/reverses.

Carry: Difference between interest return on securities held and financing costs.

Negative carry: Net cost incurred when financing cost exceeds yield on securities that are being financed.

Positive carry: Net gain earned when financing cost is less than yield on financed securities.

Cash-Orientated Repo: Transaction motivated by the need of one counterparty to invest cash and the other to borrow. See also 'Securities-Orientated Repo'.

Cash Trade: A non-financing purchase or sale of securities.

Clear: To complete a trade, i.e., when the seller delivers securities and the buyer delivers funds in correct form. A trade fails when proper delivery requirements are not satisfied.

Close-out (and) netting: An arrangement to settle all existing obligations to and claims on a counterparty falling under that arrangement by one single net payment, immediately upon the occurrence of a defined event of default.

Collateral: Securities or cash delivered by a borrower to a lender to support a loan of securities or cash.

Contract for Differences (CFD): An OTC derivative transaction that enables one party to gain economic exposure to the price movement of a security (bull or bear). Writers of CFDs hedge by taking positions in the underlying securities, making efficient securities financing or borrowing key.

Corporate action: A **corporate event** in relation to which the holder of the security must or may make an election or take some other action in order to secure its entitlement and/or to opt for a particular form of entitlement (see also *equivalent*).

Corporate event: An event in relation to a security as a result of which the holder will be or may become entitled to:

- a *benefit* (dividend, rights issue etc.); or
- securities other than those which he holds prior to that event (takeover offer, scheme of arrangement, conversion, redemption etc). This type of corporate event is also known as a *stock situation*.

Conduit borrower: See *intermediary*.

Custodian: An entity that holds securities of any type for investors and effects receipts and deliveries, and supplies appropriate reporting.

Daylight exposure: The period in the day when one party to a trade has a temporary credit exposure to the other due to one side of the trade having settled before the other. It would normally mean that the loan had settled but the delivery of collateral would settle at a later time, although there would also be exposure if settlement happened in reverse order. The period extends from the point of settlement of the first side of the trade to the time of settlement of the other. It occurs because the two sides of the trade are not linked in many settlement systems or settlement of loan and collateral take place in different settlement systems, possibly in different time zones.

Deliver-Out Repo: "Standard" two-party repo, where the party receiving cash delivers bonds to the cash provider.

Delivery by Value (DBV): A mechanism in some settlement systems (including CREST) whereby a member may borrow or lend cash overnight against collateral. The system automatically selects and delivers collateral securities meeting pre-determined criteria and to the value of the cash (plus a margin) from the account of the cash borrower to the account of the cash lender and reverses the transaction the following morning.

Distributions: Entitlements arising on securities that are loaned out, e.g., dividends, interest, and non-cash distributions.

DvP: Delivery versus payment, or the simultaneous delivery of securities against the payment of funds within a securities settlement system.

ERISA: The Employee Retirement Income Security Act, a U.S. law governing private U.S. pension plan activity, introduced in 1974 and amended in 1981 to permit plans to lend securities in accordance with specific guidelines.

Equivalent (securities or collateral): A term denoting that the securities or collateral returned must be of an identical type, nominal value, description and amount to those originally provided. If, during the term of a loan, there is a *corporate action* in relation to loaned securities, the lender is normally entitled to specify at that time the form in which he wishes to receive equivalent securities or collateral on termination of the loan. The legal agreement will also specify the form in which equivalent securities or collateral are to be returned in the case of other *corporate events*.

Escrow: See *triparty*

Fail: The failure to deliver cash or collateral in time for the settlement of a transaction.

Free-of-payment delivery: Delivery of securities with no corresponding payment of funds.

G7: The Group of Seven i.e. US, France, Japan, United Kingdom, Germany, Italy and Canada

G10: The Group of Ten i.e. US, France, Japan, United Kingdom, Germany, Italy and Canada, The Netherlands, Sweden and Switzerland

General Collateral (GC): Securities that are not “special” (see definition below) in the market and may be used, typically, simply to collateralise cash borrowings. Also known as “stock collateral”.

Gilt-Edged Securities (Gilts): United Kingdom government bonds.

Gilt Edged Securities Lending Agreement (GESLA) – see Master Gilt Edged Securities Lending Agreement

Global Master Securities Lending Agreement (GMSLA): The Global Master Securities Lending Agreement has been developed as a market standard for securities lending of bonds and equities internationally. It was drafted with a view to compliance with English law..

Gross-Paying Securities: Securities on which interest or other distributions are paid without any taxes being withheld.

Haircut: Initial margin on a repo transaction. Generally expressed as a percentage of the market price.

Hedge Fund: A leveraged investment fund that engages in trading and hedging strategies, frequently using leverage.

Hot/Hard Stock: A particular security that is in high demand relative to its availability in the market and is thus relatively expensive or difficult to borrow.

Hold in custody: An arrangement under which securities are not physically delivered to the borrower (lender) but are simply segregated by the lender in an internal customer account.

Icing/Putting Stock on Hold: The practice whereby a lender holds securities at a borrower's request in anticipation of that borrower taking delivery.

Indemnity: A form of guarantee or insurance, frequently offered by Agents. Terms vary significantly and the value of the indemnity does also.

Interdealer Broker: Agent or intermediary that is paid a commission to bring buyers and sellers together. The broker's commission may be paid either by the initiator of the transaction or by both counterparties.

Intermediary: A party that borrows a security in order to on-deliver it to a client, rather than borrowing it for its own in-house needs. Also known as a *conduit borrower*.

International Securities Lending Association (ISLA): A trade association for securities lending market practitioners.

ISMA: The Zurich based International Securities Market Association is the self-regulatory organisation and trade association for the international securities market. ISMA sets standards of business conduct in the global securities markets, advises regulators on market practices and provides educational opportunities for market participants.

London Investment Banking Association (LIBA): The principal trade association in the UK for firms active in the investment banking and securities industry. LIBA members are generally borrowers and intermediaries in the stock lending market.

Manufactured Dividends: When securities that have been lent out pay a cash dividend, the borrower of the securities is generally contractually required to pass on the distribution to the lender of the securities. This payment “pass-through” is known as a manufactured dividend.

Margin, Initial: Refers to the excess of cash over securities or securities over cash in a repo/reverse repo, sell/buy-buy/sell, or securities lending transaction. One party may require an initial margin due to the perceived credit risk of the counterparty.

Margin, Variation: Once a repo or securities lending transaction has settled the variation margin refers to the band within which the value of the security used as collateral may fluctuate before triggering a margin call. Variation margin may be expressed either in percentage or absolute currency terms.

Margin Call: A request by one party in a transaction for the initial margin to be reinstated or to restore the original cash/securities ratio to parity.

Mark-to-Market: The act of revaluing the securities collateral in a repo or securities lending transaction to current market values. Standard practice is to mark to market daily.

Market Value: The value of loan securities or collateral as determined using the last (or latest available) sale price on the principal exchange where the instrument was traded or, if not so traded, using the most recent bid or offered prices.

Master Equity and Fixed Interest Stock Lending Agreement (MEFISLA): This was developed as a market standard agreement under English law for stock lending prior to the Global Master Securities Lending Agreement. It has a legal opinion from Queen's Counsel and has been mainly, but not exclusively, used for lending UK securities excluding Gilts.

Master Gilt Edged Stock Lending Agreement (GESLA): The Agreement was developed as a market standard exclusively for lending UK gilt-edged securities. It was drafted with a view to compliance with English law and has a legal opinion from English Queen's Counsel.

Matched/Mismatched Book: Refers to the interest rate arbitrage book that a repo trader may run. By matching or mismatching maturities, rates, currencies, or margins, the repo trader takes market risk in search of returns.

Net Paying Securities: Securities on which interest or other distributions are paid net of withholding taxes.

Open Transactions: Trades done with no fixed maturity date.

Overseas Securities Lender's Agreement (OSLA): The Agreement was developed as a market standard for stock lending prior to the Global Master Securities Lending Agreement. It was drafted with a view to compliance with English law and has a legal opinion from Queen's Counsel. Intended for use by UK based parties lending overseas securities (ie excluding UK securities and Gilts), it has since become the most widely used global master agreement.

Pair off: The netting of cash and securities in the settlement of two trades in the same security for the same value date. Pairing off allows for settlement of net differences.

Partialling: Market practice or a specific agreement between counterparties that allows a part-delivery against an obligation to deliver securities.

Pay for Hold: The practice of paying a fee to the lender to hold securities for a particular borrower until the borrower is able to take delivery.

Prime Brokerage: A service offered to clients – typically hedge funds – by investment banks to support their trading, investment and hedging activities. The service consists of clearing, custody, securities lending, and financing arrangements.

Principal: A party to a loan transaction that acts on its own behalf or substitutes its own risk for that of its client when trading.

Proprietary Trading: Trading activity conducted by an investment bank for its own account rather than for its clients.

PSA: The Public Securities Association – the former name of the BMA.

Rebate Rate: The interest paid on the cash side of securities lending transactions. A rebate rate of interest implies a fee for the loan of securities and is therefore regarded as a discounted rate of interest.

Recall: A request by a lender for the return of securities from a borrower.

Repo: Transaction whereby one party sells securities to another party and agrees to repurchase the securities at a future date at a fixed price.

Repo Rate: The interest rate paid on the cash side of a repo/reverse transaction.

Repo (or Reverse) to Maturity: A repo or reverse repo that matures on the maturity date of the security being traded.

Repricing: Occurs when the market value of a security in a repo or securities lending transaction changes and the parties to the transaction agree to adjust the amount of securities or cash in a transaction to the correct margin level.

Return: Occurs when the borrower of securities returns them to the lender.

Revaluation (reval): See *repricing*.

Reverse Repo: Transaction whereby one party purchases securities from another party and agrees to resell the securities at a future date at a fixed price.

Roll: To renew a trade at its maturity.

Securities-Orientated Repo Trade: Transaction motivated by the desire of one counterparty to borrow securities and of the other to lend them. See also **Cash-orientated repo trade**.

Shaping: A practice whereby delivery of a large amount of a security may be made in several smaller blocks so as to reduce the potential consequences of a fail. May be especially useful where *partialling* is not acceptable.

SLRC: Securities Lending and Repo Committee.

Specials: Securities that for several reasons are sought after in the market by borrowers. Holders of special securities will be able to earn incremental income on the securities by lending them out via repo, sell/buy, or securities lending transactions.

Spot: Standard non-dollar repo settlement two business days forward. This is a money market convention.

Stock situation: See *corporate event*.

Substitution: The ability of a lender of general collateral to recall securities from a borrower and replace them with other securities of the same value.

TBMA/ISMA Global Master Repurchase Agreement (GMRA): The market-standard document used for repo trading. The GMRA, whose original November 1992 version was based on the PSA Master Repurchase Agreement, was revised in November 1995 and October 2000.

Term Transactions: Trades with a fixed maturity date.

Third-Party Lending: System whereby an institution lends directly to a borrower and retains decision-making power, while all administration (settlement collateral monitoring and so on) is handled by a third party, such as a global custodian.

Triparty: The provision of collateral management services, including marking to market, repricing and delivery, by a third party. Also known as *escrow*.

Triparty Repo: Repo used for funding/investment purposes in which bonds and cash are delivered by the trading counterparties to an independent custodian bank or central securities depository (the 'Triparty Custodian'). The Triparty Custodian is responsible for ensuring the maintenance of adequate collateral value, both at the outset of a trade and over its term. The Triparty Custodian marks the collateral to market daily and makes margin calls on either counterparty, is required. Triparty repo reduces the operational and systems barriers to participating in the repo markets.

2 Additional terms used in this publication

ASX: the Australian Stock Exchange Limited, a publicly listed company.

Australian Supplement: see *Appendix 2*.

CHESS: the acronym for the Clearing House Electronic Subregister System. It provides a centralised electronic subregister for holdings of approved financial products, in order to facilitate settlement of ASX market transactions between participants on a DvP basis. CHESS also allows for the electronic transfer of ownership of financial products. CHESS is owned and operated by ASX Settlement and Transfer Corporation Pty Ltd (ASTC), a wholly owned subsidiary of ASX.

IOSCO/CPSS Report: a report entitled "Securities Lending Transactions: Market Developments and Implications", published jointly by the Technical Committee of the International Organisation of Securities Commissions (IOSC) and the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (CPSS) in July 1999.

Original UK Publication: see the first paragraph in the Australian Foreword.

Appendix 4: Reference Sources

1 From the Original UK Publication

The web contains a lot of information on securities lending. A simple Google search on “securities lending” finds 580,000 results.

All of the major UK practitioners have sections of their websites dedicated to securities lending, repo, prime brokerage etc.

Below, we list in alphabetical order, some of the websites that could prove to be useful reference sources: -

ABI	www.abi.org.uk
Bank of England	www.bankofengland.co.uk
Barrie &Hibbert	www.barrhibb.com
BIS	www.bis.org
BMA	www.bondmarkets.com
CRESTCo	www.crestco.co.uk
Data Explorers Limited	www.dataexplorers.co.uk
DTI	www.dti.gov.uk
FSA	www.fsa.gov.uk
Index Explorer	www.indexexplorer.com
IOSCO	www.iosco.org
ISLA	www.isla.co.uk
ISMA	www.isma.org
LSE	www.londonstockexchange.com
NAPF	www.napf.co.uk
PASLA	www.paslaonline.com
Performance Explorer	www.performanceexplorer.com
Report Explorer	www.reportexplorer.com
Risk Explorer	www.riskexplorer.com
RMA	www.rmahq.org
Spitalfields Advisors	www.spitalfieldsadvisors.com

2 Additional reference sources relevant to this publication

IOSCO/CPSS Report: “Securities Lending Transactions: Market Development and Implications”, Technical Committee of the International Organisation of Securities Commissions (IOSC) and Committee on Payment and Settlement Systems of the central Banks of the Group of Ten countries (CPSS), July 1999. The publication is available on the IOSCO website and the BIS website listed in part 1 above.

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