



27th May 2005

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Dear Sirs,

**Transparency Directive (Reference CESR/05-267)
International Securities Lending Association response**

Background

Thank you for providing the opportunity to make further comments on the Transparency Directive (TD). I am pleased to submit a response on behalf of the International Securities Lending Association (ISLA).

The International Securities Lending Association is a trade Association established in 1989 to represent the common interests of the Securities lending industry. ISLA assists in the orderly, efficient and competitive development of the International securities lending market. In this regard, ISLA works closely with regulators and in the UK has representation on the Securities Lending and Repo Committee, a committee of market practitioners chaired by the Bank of England. The Association has contributed to a number of major market initiatives, including the development of the UK Stock Borrowing and Lending Code of Guidance and the industry standard international securities lending agreements, the Overseas Securities Lending Agreement (OSLA) and the Global Master Securities Lending Agreement (GMSLA).

Today, ISLA has over 70 members comprising insurance companies, pension funds, asset managers, banks and custodians representing more than 4,000 clients. In September 2004, ISLA changed its constitution to allow borrowers to become members for the first time: to date 14 borrowers have joined. Our quarterly market sizing survey has established that ISLA members account for in excess of seven trillion euros worth of securities available to lend, of which 1.3 trillion euros are actually on loan, providing significant liquidity to international and domestic bond and equity markets. The geographic spread of ISLA's membership base is global in nature, comprising substantial representation from the UK, Luxembourg, the Netherlands, Ireland and the other EU member states in addition to other major financial centres such as Switzerland and the United States. A full list of members may be found here: www.isla.co.uk/members.asp.

In the interest of clarity, this response does not address the specific questions posed in the current consultation. We are however concerned that the legal basis of securities lending transactions under market standard legal agreements may give rise to unintended consequences in the context of the TD, and wish both to raise this to your attention and also seek additional clarification in this regard. More specifically, we

have been unable to deduce from the TD documentation made available whether securities lending and collateral movements would become reportable under the current proposals. Under current market practice they are not, and should this position change it is our contention that significant additional costs would be incurred by this sector of the financial services industry as new systems would have to be developed in order to comply. A more detailed analysis of the situation follows.

Treatment of securities loans and collateral movements under securities lending agreements

Whilst the colloquial terms, used both within and without the market, are for securities ‘loans’ being made and ‘collateral’ being lodged by the borrower, in legal terms these are both misnomers. Under the terms of the standard market legal agreements¹, a ‘loan’ is in fact ‘an absolute transfer of title against an irrevocable undertaking to return equivalent securities at some time in the future (whether on demand by the lender or at the borrowers will)’. Similarly, ‘collateral’ is also an absolute transfer of title against an undertaking to return equivalent securities on demand (usually when the loan is returned and collateral is no longer needed). The term ‘equivalent’ is used to denote that it will (almost certainly) not be exactly the same shares involved in the reverse leg, but nevertheless the same type and number of shares.

In that it is an absolute transfer of title, all rights pass to the transferee, including the right to dividends and the right to vote. The legal agreement provides for any dividend that might arise on the loaned shares to be manufactured by the borrower so that the lender receives the same amount of cash as he would have done if the shares had not be loaned. Similarly, any dividend received on collateral is paid over to the lodger thereof. With regard to the vote, then the lender has the absolute right to recall the shares so that he can vote. This is embodied in the legal agreements and is also included in the Securities Lending and Repo Committee Code of Guidance (note 1) that shares should not be borrowed solely to gain the voting right. These conditions apply to all securities, wherever issued, and all parties, wherever based, who conduct their borrowing and lending through our standard legal agreements.

Detailed working example

The following example details the mechanics of a securities loan with collateral settlement in the UK CREST Securities Settlement System. The principles are similar in other settlement markets as well, although the DBV system described is unique to the UK.

A feature of CREST is the functionality for delivering ‘collateral’, the Delivery by Value (DBV). The DBV is available in different classes (e.g FTSE 100 shares) and the borrower will cause the system to create a bundle of shares in the appropriate class, subject to a 10% concentration limit, from the borrowers available shares in his Crest stock account. Neither borrower nor lender imposes any influence on how the system creates these bundles nor is generally concerned as to what the make-up is beyond the fact that they are (e.g.) FTSE 100 shares with a 10% concentration limit. Thus there will be at least 10 different shares in each DBV, and frequently many more up to a system-imposed limit of 99. As stated above, the DBV is an absolute transfer of title

¹ Copies of market standard securities lending agreements, and legal opinions may be found at www.isla.co.uk/industry_documentation.asp.

and the component shares are registered into the lenders name (or more likely that of his (custodian) nominee).

DBVs are delivered each afternoon and are automatically reversed by the CREST system at the beginning of each business day always against an Assured Payment (AP) to ensure that the lender is at all times secured.

To illustrate the whole process, let us take a brand new lender (L) making just one new loan to one borrower (B) on his first day of lending, say 1,000,000 ABC ordinary shares priced at £10 a share(i.e. value £10m)

Day 1 a.m.

L delivers 1m ABC to B over Crest against AP of £10m

Thus Loan £10m, security £10m cash.

Day 1 pm

L and B agree loan figure at £10m and L delivers FTSE 100 DBV over Crest against AP.

Thus Loan £10m, 'collateral' £10m in FTSE 100 shares (cash position now zero).

Day 2 am

Crest automatically revalues loans and posts compensating cash as collateral.

Assume ABC shares now £11 each. Crest debits borrower, credits lender £1m cash.

Also DBVs are automatically reversed against AP.

Thus loan now £11m, but collateral (AP) is also £11m.

Day 2 pm

L and B agree loan figure at £11m and B delivers DBV for £11m against AP.

Thus Loan £11m, DBV collateral £11m.

The process is repeated every day. Obviously in real life, there are loans and returns taking place all the time and also other types of collateral, but the principle is the same.

Having established the process, let us now assume:

1. In making the 1m share loan the Lender's registered holding in ABC falls from 5.2% to 4.8%.

2. One of the component shares in the DBV takes the lender's registered holding from 4.9% to 5.1%.

i.e. both crossing reportable thresholds.

Summary/conclusion

In summary, we would maintain that, although the shares involved are transferred to the borrower (or in the case of collateral to the lender), the legal agreements, supported by the Code of Practice, enable the original holder to retain control of the vote in practice, whether lender or collateral giver.

In addition to the above, the practical consequences, and thus the cost, militate against reporting these transactions, particularly with regard to DBVs. As has been stated above, no lender has ever tracked the actual constituents of a DBV apart from very occasionally for audit purposes. Such is the volume of shares making up DBVs, that the

building of systems and processing the volumes would be prohibitive. Also, in that DBVs reverse each morning, any reporting would only likely confuse the issue, rather than provide transparency.

Securities lending is supported by the ESCB/CESR proposals on Clearing and Settlement (Standard 5) and represents an ever growing important facet of the securities markets. It is essential that the activity is not burdened with additional unnecessary costs, in that the present arrangements work well.

Accordingly we wish both to raise this to your attention and also seek additional clarification in this regard. If appropriate, we would be very happy to discuss any aspects of the industry, with particular reference to the present proposals, either face to face or by conference call.

Yours faithfully

Richard Steele

Chairman
International Securities Lending Association

For further background reading we would refer you to:

1. Securities Borrowing and Lending Code of Guidance:
www.bankofengland.co.uk/publications/news/2004/173.htm
2. An Introduction to Securities Lending: www.isla.co.uk