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Securities Lending of *Equity Securities* in Australia

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1 Introduction

1.1 Background

Both domestic and more recently cross border securities lending is a well established business transaction in most developed international securities markets. Domestic securities lending first appeared in the United Kingdom during the 1950s and 1960s and then rapidly developed in the United States (lead by the US custodian banks) in the 1970s and 1980s, before developing in most other developed domestic markets in the 1980s and later in many emerging markets. Securities lending practices in the US, the UK, Canada, the Netherlands, Germany and Japan have reached a sophisticated and mature level. Securities lending practices in Australia have likewise reached a sophisticated and mature level.

In July 1999 the Technical Committee of the International Organisation of Securities Commissions ("**IOSC**") prepared a comprehensive report (the "**IOSC/CPSS Report**") entitled "Securities Lending Transactions: Market Developments and Implications" jointly for the IOSC and the Committee on Payments and Settlements Systems of the central banks of the Group of Ten countries ("**CPSS**"). The IOSC/CPSS Report noted in its Foreword that -

> "The growth in securities lending transactions, such as securities loans and repurchase agreements, has been such in recent years that they now represent a substantial part of the daily settlement value in many settlement systems and play an important role in facilitating market liquidity".

The IOSC/CPSS Report concluded that securities lending activity was expected to increase and become an even more integral component of financial markets in the future.

For the 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 widely viewed as a natural adjunct and value-added service to the custody service provided by custody banks. Although the incremental income is typically 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 to effectively 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 significantly affect performance ranking.

1.2 Focus of this paper

While parts 1-4 of this paper apply generally to the lending of both equity and debt securities, the principal focus of this paper 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 involved in the "lending" of debt securities. These are dealt with in a parallel paper focused solely on debt securities.) (However, several observations will be made in passing regarding the lending by Australian owners of *overseas* equity securities.)

Accordingly, the tax comments in part 5 of the paper are confined to equity securities.

The paper also tries to highlight the differences between a principal and an agency programme operated by a custodian bank.

Unless otherwise indicated, the paper assumes:

- that the transaction will take place under a common form master securities lending agreement, governed by Australian or English law (in particular, this paper does not deal with transactions under reciprocal purchase agreements); and

- that the transaction is securities-driven, not cash-driven (see 1.3(b) below).

1.3 What is "securities lending"?

(a) the "loan"

As the IOSC/CPSS Report observed (page 5), "in today's capital markets, securities seldom lie idle".

Securities lending arrangements arise when a longer term holder of securities agrees to provide them to a borrower for a period. 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. Consequently, at the end of the period, after the return of the replacement securities, the lender retains exactly the same portfolio as before. For that reason, the arrangement is viewed in substance, or economically, as a "loan" of the relevant securities, even though, legally (where the agreement is governed by Australian or English law), 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 as it thinks fit.)

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), other distributions or rights (if any) in respect of the securities which are paid or arise during the period of the loan.

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.

(b) two distinct markets

In practice, there can be two distinct drivers for a securities lending transaction:

(i) The principal type of transaction is a *"securities-driven"* one. This is where the borrower of the securities wants to effectively obtain temporary access to the specific securities.

These types of transactions 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, have traditionally been the custodian banks,.

This paper focuses solely on these types of transactions.

(ii) Another, much less common, type of transaction is a *"cash-driven"* one. This is where the securities lender simply wants effectively to borrow cash and to use the relevant securities as collateral for the transaction. The securities borrower is *not* seeking to obtain access to any particular securities and, within certain defined categories, will generally 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 effectively borrow cash at a cheaper rate than under a conventional secured loan facility.

This paper does not deal with any particular issues connected with this type of transaction.

(c) types of Australian securities lending programmes; role of intermediaries

A lender can run its own programme, provided it can itself source sufficient demand. Several of the biggest institutions in Australia do so. However, most institutions in Australia use an intermediary, to avoid the expense, the administrative and operational difficulties, and the credit and other risks of running their own programmes. As indicated above, the leading intermediaries for institutional investors, in terms of market share, have traditionally been the custodian banks.

There are two types of securities lending programmes offered by custodians:

(i) A *principal* programme.

Many institutions find it convenient to lend securities to an intermediary principal (eg a custodian bank), which 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 is usually uncollateralised.

(ii) An *agency* programme (with or without indemnification).

Many other institutions choose to enter into an agency programme with an intermediary (usually a custodian), which 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 main differences between the two types of programmes are described in some detail in part 2 below.

(d) collateral

In any *principal* programme with a custodian bank in Australia, normally collateral is not provided by the custodian bank.

In any *agency* programme, the borrower provides the lender (or the lender's agent) with collateral (usually cash) 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 (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),
- securities (such as bonds or equities), and
- occasionally, standby letters of credit ("**L/Cs**").

The administrative burdens involved in a direct lender receiving collateral have lead to the development of tri-party arrangements, in which a third party takes on the effective back-office role. However, they are still in their embryonic stages in Australia.

(e) fees

The lender effectively earns a fee for the use of the borrowed securities.

In an *agency* programme:

(i) 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 (ii) and (iii) below).

(ii) 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.

(iii) 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.

In a *principal* programme in Australia (where normally collateral is not provided by the borrower custodian bank), the borrower normally just pays a separate agreed fee to the lender (similar to (iii) above).

(f) distributions and other entitlements

The borrower also compensates the lender for distributions (for example, dividends or, in the case of debt securities, interest) and other rights (if any) which may accrue on the borrowed securities during the term of the loan. The compensation payments are often called "manufactured" payments (being the term originally used in the UK). The tax attributes of the manufactured payments are explained in part 5 below.

(g) benefits to lenders

Thus, as explained in the "Background" in 1.1 above, 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.

(h) true legal character of the transaction

The terms "lending" and "borrowing" describe the substance of the arrangement, but incorrectly describe its legal effect under the terms of a typical master agreement governed by Australian (or English) law:

(i) The first leg involves an outright disposition of absolute ownership of the securities by the lender.

(ii) Contemporaneously, the borrower in effect enters into a deferred forward sale agreement for *equivalent* (but not necessarily the original) securities.

Thus, there is no "lending" of the original securities by the lender. (Despite this, market terminology continues to use lending terminology, which is likewise adopted and used in this paper.) In technical legal parlance, most arrangements are *mutuums*.

(i) true legal character of provision of collateral securities

Likewise, in the case of the provision of collateral securities under a typical master agreement governed by Australian (or English) law, effectively, there is a separate securities lending transaction in respect of those collateral securities, contemporaneous with the loan of the principal securities. 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 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).

1.4 What securities are typically lent in Australia?

- The top 200 Australian equities and those securities with an associated derivative instrument.

- Government, Semi-Government and corporate bonds and inscribed stock. (For largely historical and also systems reasons, such securities are also often dealt with by reciprocal purchase agreements, or "repos" (and similar transactions known as buy/sell agreements), typically under as the BMA/ISMA Global Master Repurchase Agreement ("**GMRA**"), whose legal effect is different from a securities lending agreement.)

1.5 Who are typical borrowers and why do they borrow?

Borrowing currently occurs for one or more of several purposes.

(a) Margin requirements

There are borrowers who need to meet margin requirements and can do this more cheaply by borrowing securities, rather than by 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.

(b) 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 this country. These traders sell securities for a variety of reasons, most of which are hedging related, for example index/physical arbitrage, option or warrant hedging, other derivatives, as well as outright short selling.

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

(c) 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.

1.6 Who are typical lenders and why do they lend?

Generally, institutions lend their securities to increase gross portfolio returns, or to effectively reduce their net custody costs. However, it is necessary to distinguish the different circumstances of:

- Overseas institutions (for whom interest (and, in the case of equity securities, dividend) withholding tax are, or may be, relevant).
- Australian institutions (for whom, in the case of equity securities, franking credits are relevant).
- Local nominees and custodians, either as a principal or as an agent for local and overseas clients.

1.7 Size of the market

The size of the securities lending market in Australia is uncertain. This is principally because (as will be seen in part 6 below) in practice securities lending transactions are presently not reported in Australia, irrespective of the purpose of the borrowing.

The demand for equity securities dropped substantially after the May 1997 Federal Budget effectively removed the opportunity for franking credit tax arbitrage (see further part 5 below), but in 1999 the IOSC/CPSS Report estimated that the daily turnover in equities securities lending in Australia was A$550+ million.

1.8 Standard documentation

Regulatory changes in the United Kingdom, coupled with the efforts of the International Securities Lending Association and the Money Brokers' Association, brought a degree of standardisation to the forms of agreement used by overseas lenders. One such form of standard agreement is the UK Overseas Securities Lender's Agreement ("**OSLA**"). Another is the US Bond Market Association Master Securities Loan Agreement.

In 1997 the Australian Securities Lending Association ("**ASLA**") decided to attempt to standardise the securities lending documentation in use in Australia, by adapting the 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 the writer, were publicly released. The AMSLA quickly gained a high degree of market acceptance.

An updated version of the AMSLA and supplementary User's Guide, prepared by the writer, 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 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.

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.)

(As was mentioned above, for various reasons debt securities are more typically "lent" under the BMA/ISMA GMRA.)

1.9 Summary

In summary, in Australia:

- The level of securities lending is primarily "securities" (or demand) driven.
- This demand varies because of different market characteristics.
- Those market characteristics include:
    - the efficiency of the relevant settlement system,
    - the presence and nature of the derivatives market,
    - the fundamentals of the underlying relevant physical market, and
    - the tax and regulatory environment.
- The efficiency of the Australian securities markets and their settlement systems is dependant on the availability of securities lending.

2 Agency vs Principal Programmes

2.1 Principal programme

In a *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) In Australia, 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). Instead, the exposure of the client to the custodian bank appears similar to that arising if the client had deposited cash (or, perhaps more relevantly, foreign currency) with the custodian, subject only to the 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, it will invariably only do so 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 "Common Features".

2.2 Agency programme

In an *agency* programme:

(a) As the primary legal relationship 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 below, the lender has to initially consider and periodically review the credit worthiness of each potential borrower on the agent's list and set any exposure limits.

(b) For similar reasons, the lender has to consider and periodically review acceptable collateral and, in particular, its re-investment of cash collateral risk (which is invariably not indemnified by the agent). The collateral risks are described in more detail below.

(c) 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 lending institution's other exposures (if any) to every permitted issuing bank and whether the institution wishes to impose limits on the L/C exposure to any such bank and, if so, advise the agent accordingly.

(The agent will normally only accept an L/C issued by a bank with 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.)

(d) 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 clearly understand who will ultimately bear all the risks and, in particular, what risks are not covered by any indemnification.

2.3 Common features of principal and agency programmes

Typically, the custodian 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 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 and returning collateral; mark-to-market valuation of securities on loan and (if applicable) collateral; and (if applicable) calling for, receiving and returning variation margin);

(iv) collection and crediting of income equivalent, or "manufactured" income, payments;

(v) (if applicable) collection and whole or partial remittance of income on collateral;

(vi) in the case of equity securities, monitoring other corporate actions.

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.

2.4 Comparison: principal v agency

Uncollateralised lending to a custodian as a principal intermediary does involve the concentration of credit risk in a sole counterparty. However, it thereby 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;

(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.

3 Risks in Securities Lending

The risks inherent in lending securities are not always readily apparent, but must be considered when entering into a securities lending programme.

Broadly, as stated in the IOSCO/CPPS Report (page 39), securities lending transactions are in substance 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 by the counterparty (securities borrower) to pay at a later date.

However, there are some differences. The comments below seek to highlight the main differences. (A fuller explanation, also covering repos and buy/sell agreements, is contained in the IOSC/CPSS Report.)

3.1 Counterparty credit risk

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).

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.)

Apparently, in a non-insolvency situation, such defaults rarely occur and, when they do, it is almost invariably because of operational problems.

Accordingly, in practice, it is the insolvency of the counterparty which is likely to pose the greatest risk to a lender.

In a *principal* programme with a custodian bank, the lender is only concerned 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. (As indicated in 3.4 below, where there are other relationships between the institutional 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.

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. 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.

3.2 Collateral risks

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".

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

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.

(a) Delivery (versus payment or versus delivery) risk (if applicable)

Delivery risk occurs when collateral is received or is to be received.

This issue is not so important in practice in Australia nowadays, because:

(i) 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), as well as on a free of payment basis.

(ii) Transactions involving debt securities such as Government Bonds and inscribed stock and semi-government and corporate bonds can also effectively be settled on a dvp basis through Austraclear.

(iii) 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.

The same issue arises where non-cash collateral (other than a L/C) is to be provided - a delivery versus delivery ("**dvd**") risk.

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).

However, variation margin payments and refunds cannot be settled in this way.

(b) Collateral title risk (if applicable)

A lender should always ensure that there is clear title to any collateral received.

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.

(c) Adequacy of collateral risk (if applicable)

This is the main collateral risk. Where the lender is relying on the adequacy of the collateral, as well as the credit-worthiness of the potential counterparties:

(i) 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.

(ii) Current market practice in Australia generally is that the collateral should be maintained within the range of:

(A) at least 102-105% for equities (and sometimes substantially higher (eg 110%-130%) in the case of non-cash collateral); and

(B) 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.

(iii) 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.

All these operational activities are often called "loan maintenance".

(d) Re-investment of cash collateral risk

This is probably the second most important collateral risk.

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 is so invested that, on the return of equivalent securities by the borrower to the lender, there is insufficient cash to 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) will typically 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.

This kind of exposure actually 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.

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

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 highly correlated indices.

(e) Default by LC bank

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 issuing bank, then the lender may find itself under collateralised in the event of borrower and then L/C issuer default.

3.3 Accrued benefits risk

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

In this regard:

(i) Where collateral is provided (as in an agency programme), the accrued benefit up to the relevant record date is normally taken into account in calculating margin requirements, because it is reflected in the market price of the relevant security.

(ii) 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.

(iii) 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.

3.4 Set-off/Netting

Where collateral is provided (and subject to the adequacy of the collateral) or (in the case of a principal programme) where there are other relationships between the institutional lender and the custodian bank, a lender's risk exposure can be minimised by an appropriately drafted set-off or close-out "netting" provision if the borrower defaults, both before and after insolvency. The set-off provisions in the AMSLA are contained in clause 8.2.

4 Stamp Taxes and GST

4.1 No transfer stamp duty

Since 1 July 2001, no Australian jurisdiction has imposed stamp duty on the transfer of shares quoted on the ASX (and other approved exchanges).

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

4.2 No mortgage duty

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

4.3 Goods and Services Tax ("GST")

No GST is imposed on securities lending (ie the transaction between the securities "lender" and the securities "borrower"). Rather, securities lending is an input taxed supply (unless it qualifies for GST-free treatment, for example under the "export" provisions in section 38-190 of the GST Act).

However, where, for example, 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 client provides for the custodian's services (ie typically a share of the "spread" where cash collateral is provided, or a share of the fee where non-cash collateral is provided). Likewise, where a custodian bank is the borrower under an uncollateralised principal programme, GST will be imposed on the fee that the custodian bank pays to the lender custody client.

5 Income Tax Issues re Equity Securities

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

- Ordinary income tax, and
- if applicable:
    - Capital gains tax ("**CGT**"),
    - Dividend imputation, and
    - Interest and dividend withholding tax,

to any securities lending transaction involving *equity* securities into which they enter.

This part 5 is focused on the lending of *equity* securities.

In this part 5:

- the **ITAA 1936** means the Income Tax Assessment Act 1936;
- the **ITAA 1997** means the Income Tax Assessment Act 1997; and
- the **TAA 1953** means Taxation Administration Act 1953;

5.1 Ordinary income and capital gains tax ("CGT") re lending and re-delivery legs of transaction

As was mentioned in 1.3(h) above, securities lending involves a **sale** of securities and the subsequent **repurchase** of identical (but not necessarily the same) securities, even though the securities industry treats the transactions as if they involved a **loan** of securities.

This sale and repurchase view was adopted by the Australian Taxation Office when it first became aware of securities lending arrangements. Securities lending 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 capital gains tax purposes, the consideration for the initial disposal of the securities would be regarded as their market value at the time of disposal. (However, it should be noted at the outset that under current law (as affected by an announcement in the May 2005 Federal Budget), broadly, a non-resident of Australia is normally not liable to capital gains tax in respect of the disposal of shares in an Australian listed company unless it and its associates have beneficially owned at least 10% by value of the issued shares in the company (except preference shares) at any time during the five years before the relevant disposal. Different considerations apply if that 10% limit is exceeded or if the non-resident holds the shares on revenue account (rather than on capital account).)

However, (where otherwise applicable) any such tax liability can now be avoided if certain conditions are fulfilled. Broadly, under section 26BC of

the ITAA 1936, a lender is not subject to any tax consequences (other than those arising from being paid a fee) if, among other things:

- the securities lending agreement is in writing;
- the borrowed security (or an identical security) is in fact returned within twelve months after it is lent;
- the borrower and lender deal at arm's length in relation to the transaction;
- the consideration paid by the borrower (including any fee) is specifically identified; and
- the lender retains the total consideration due under the agreement.

In addition, there are specific requirements if a distribution, or the issue of a right or option, in respect of the borrowed security occurs during the borrowing period.

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 loan under an overseas master securities lending agreement will generally **not** comply with all the requirements of section 26BC. A transaction which fails to meet the requirements is generally referred to as a "non-complying" (as distinct from a "complying") loan. An Australian borrower may be largely indifferent as to whether the loan is a complying one, because (apart from possible debt/equity and transfer of shareholder status considerations) the tax consequences for it may be the same.

5.2 No debt/equity issues re complying securities lending transactions

Section 974-130(4)(b) of the ITAA 1997 effectively explicitly provides that a securities lending arrangement under section 26BC of the ITAA 1936 is not a "financing arrangement" for the purposes of the debt/equity rules in the ITAA 1997.

Accordingly, provided that the relevant transaction meets the requirements of section 26BC, then, irrespective of whether the transaction is securities driven or cash driven, the transaction itself should not qualify as either debt or equity for tax purposes. This is relevant to the treatment of manufactured payments for both domestic and withholding tax purposes.

(Note that section 26BC does not refer to collateral. Thus, in my opinion, 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 held by the securities borrower in the securities lender.)

5.3 Distributions

(a) Franking credits

Australian resident shareholders receiving distributions from a 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 (or "offset") for the amount of the gross up (the franking credit). This franking credit can be applied against tax payable on the distribution or other income of the recipient of the distribution.

(b) Possible transfer of shareholder status for tax purposes re fully or partly franked (but not totally unfranked) distributions under a complying securities lending transaction

Under the general rules relating to franked distributions, any franking credit that attaches to a distribution is normally only able to be utilised (if at all) by the registered security holder.

This rule is altered for securities lending arrangements that comply with Division 216 of the ITAA 1997, which is headed "The effect of a cum dividend sale or securities lending arrangement under the simplified imputation system". That Division provides for the transfer of shareholder status for franking credit purposes in certain circumstances.

Division 216 generally deems a fully or partly franked distribution (but **not** a totally unfranked distribution) paid directly by an issuer to a borrower under a securities lending arrangement which falls within section 26BC of the ITAA 1936 (or which is deemed to have been paid directly by the issuer to the borrower as a result of one or more previous applications of section 216-10) to have been paid to the lender. The legislation (section 216-30) also requires the borrower to issue a statement in an approved form to the lender.

An important limitation on the operation of Division 216 is that franking credits referable to franked distributions are only transferable under section 216-10 if the transferor can transfer a genuine distribution. Thus, if the borrower is not entitled to a genuine franked distribution, for example because it has on-sold the securities (and consequently cannot transfer any franking credit to the lender), Division 216 does not apply. Instead, both parties must ensure that the contractual arrangements between them specify exactly what compensation will be due. Well drawn documentation for any complying loan will require 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, as amended to date).

In practice, unless otherwise agreed, if a loan on behalf of an Australian lender would extend over a distribution record date, most custodian banks will contact the borrower and confirm whether or not the borrower will give a section 216-30 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 a section 216-30 statement, the gross-up

compensatory payment referred to in the preceding paragraph adequately compensates the lender.

(c) Application of the 45 day holding period rule and the related payments rule (re claiming franking credits) to a complying securities lending transaction

The "45 day holding period rule" and the "related payments rule" (as contained in sections 160APHC to 160APHU of the ITAA 1936, to be re-enacted in the ITAA 1997) do not affect the ability of an Australian resident lender to utilise franking credits under securities lending arrangements that fall within section 26BC of the ITAA 1936.

The "45 day holding period rule" and the "related payments rule" both require an Australian resident 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. 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, with effect from the date of the May 1997 Federal Budget.

Complying securities lending arrangements are specifically excluded from the application of these rules. Section 160APHH(8) provides that, if a taxpayer disposes of shares or interests under a securities lending arrangement that satisfies section 26BC(4) of the ITAA 1936 (and therefore is deemed not to have disposed of the shares or interests for the purposes of the ordinary income or capital gains provisions of the ITAA 1936), then the taxpayer is also treated as not having disposed of the shares for the purposes of section 160APHO. In such a case, the lender will still be taken to hold the shares for the purpose of determining whether the lender has satisfied the holding period rule in relation to dividends paid on the shares.

The "45 day holding period rule" and the "related payments rule" will apply to deny access to franking credits for non-complying securities lending arrangements, being arrangements that do not fall within section 26BC and in respect of which section 216-10 does not operate. Prior to the introduction of the holding period rule, deliberately non-complying arrangements were entered into by **non-resident lenders** and Australian borrowers. This is because non-resident holders of Australian equities effectively obtain less value than would a resident holder from any franking credits referable to distributions which they receive. By making the lending arrangement non-complying, prima facie, the Australian resident borrower obtained the benefit of the franking credit, rather than the non-resident lender. This practice is overcome by the holding period and related payments rules because:

(i) at all times, the borrower is under an obligation to re-transfer identical securities to the lender, and so will fail the 45 day rule (unless the borrower is an eligible institutional investor (such as a complying superannuation fund) which has opted out of that test);

(ii) even if the borrower is an investor which has elected not to apply the 45 day rule, the limit imposed under the formula approach for such an

institution will effectively preclude the institution from accessing franking credits not referrable to its actual net equity exposure;

(iii) the borrower will usually be required to make related payments to the lender and therefore be required to satisfy the related payments rule; or

(iv) the borrower may fall foul of the anti-avoidance rules in section 160AQCBA or section 177EA if one of the purposes (other than an incidental purpose) of the arrangement is to obtain a tax advantage in relation to franking credits.

(d) Application of dividend withholding tax to distribution equivalent (or "manufactured") amounts

Broadly, withholding tax must generally be withheld and remitted to the Australian Taxation Office on Australian sourced unfranked dividends paid or credited to non-residents. (There are some exceptions under the Australia/US and Australia/UK double tax agreements and under section 23(jb) of the ITAA 1936.)

If applicable, withholding tax on unfranked **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 the current US and UK agreements. Importantly, tax need not be withheld on that part of a distribution which is fully franked (i.e. where the company has borne full Australian tax on the profits out of which the distribution is paid).

The transfer of shareholder status provisions do not apply for dividend withholding tax purposes. An issue therefore arises as to whether, in any circumstances (for example, 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.

This issue is also affected by anti-avoidance rules in Part IVA of the ITAA 1936.

(i) Ordinary position

Apart from the possible application of Part IVA (discussed below), the ordinary position is as follows:

(A) The dividend withholding tax provisions can only apply to dividends in the strict legal sense of that word (other than on non-equity shares (as defined in section 995-1 of the ITAA 1997)), and to non-share distributions (as defined in section 974-115 of the ITAA 1997) made in relation to "non-share equity interests" (as defined in section 995-1 of the ITAA 1997): see section 128AAA of the ITAA 1936.

(B) A distribution equivalent amount or manufactured payment is not a dividend in the strict legal sense. As discussed above, the securities

lender under a section 26BC complying transaction should not hold an equity interest in the borrower, Therefore, in such a case the distribution equivalent amount paid by the securities borrower to a non-resident securities lender cannot be treated as a non-share distribution so as to come within the dividend withholding tax provisions.

(C) Accordingly, in such a case the distribution equivalent amount paid to a non-resident lender 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 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.)

(D) However, where a comprehensive double tax agreement with Australia does not apply to the distribution equivalent amount, there may be a risk (depending on the circumstances) that the amount is Australian source income of the non-resident recipient, which is assessable to it as ordinary income at the corporate rate (30%) in the case of a corporation, under section 6-5(3)(a) of the ITAA 1997. (The position may be especially complicated where (as is often the case) the lender is a nominee or custodian for other non-residents (be they institutions, trusts or corporate entities).)

(ii) Application of Part IVA

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

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

Thus, where:

- a non-resident owns a share (including non-share equity) in an Australian company which pays unfranked or only partly franked dividends,

- 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 distribution being subject to dividend withholding tax, with redelivery occurring after the books' closing date, and

- the borrower agrees to pay the lender, say, an amount greater than the net amount (after deduction of any 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.

For that reason, as far as I am 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 provisions to Part IVA became effective.

5.4 Income tax issues re a securities borrowing fee

Broadly, Australian source interest, and 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.

This is an issue as to whether interest withholding tax can apply to any fee paid by an Australian securities borrower to a non-resident securities lender.

5.5 Income tax issues re the provision of cash collateral

As was mentioned in 1.3(d) and (e) above, in an agency programme in Australia cash collateral (instead of, for example, an irrevocable standby letter of credit) is generally provided to the lender to secure the obligation of the borrower to deliver equivalent securities. In those circumstances, no fee may be 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, in such a case 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.

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 my view, the rebate is interest within the ordinary meaning of that term.

Since Australian residents are usually net borrowers of Australian securities from non-residents (and not the lenders of securities to them), the rebates will 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.

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 operating an agency programme, 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.

6 Regulatory and compliance issues affecting the lending of equity securities or the provision or receipt of collateral (including issues specifically affecting superannuation funds, ADFs, PSTs, some statutory authorities and insurance companies)

6.1 Substantial shareholdings etc

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 shareholdings or relevant interests in shares which can be acquired or are disposed of.

Broadly, under the Corporations Act, a substantial shareholder in an Australian incorporated publicly listed company must give notice of the acquisition of a substantial shareholding or a 1% or more change in a substantial shareholding.

A person is defined as a substantial shareholder in a company if entitled to more than 5% of the voting shares of the company or 5% of the voting shares in any class of shares in the company. 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. Professional opinion as to the theoretical position under the existing law and market practice may not coincide. The ASIC and its predecessor bodies have refrained from publicly entering the debate, though the NCSC (a predecessor to the ASIC) previously made declarations under the now superseded Companies Code regarding one major institution.

Similar issues could in theory arise with the 15% threshold under the Foreign Acquisitions and Takeovers Act 1975 (Cth), and the thresholds applicable under the Broadcasting Act and various other Federal and State Acts regulating particular industries or companies.

6.2 Reporting of securities lending transactions involving equity securities

Currently brokers (now called "market participants") and non-broker participants (now called "non-market participants") in CHESS do not treat equity 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.

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 expressly

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 subsequently deleted in October 1999). 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 a recommendation to the federal Attorney-General.

However, as far as I am aware, no action resulted. And it seems that the finalisation of any recommendation by the ASIC regarding securities lending still has a low priority.

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 would presumably also have to change to its Business Rules to require similar disclosure.) However, it is likely to be some time before (if at all) current practice might change and a distinction might be drawn between the different purposes to which borrowed securities may be put.

6.3 FSRA issues

The Financial Services Reform Act 2001 ("**FSRA**") introduced a licensing regime 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".

Unless it is required to be licensed on some other basis, the lender and the borrower would be required to obtain an Australian financial services licence (and satisfy other obligations such as maintaining adequate resources and risk management systems and training for its staff) if it is carrying on a business of dealing in financial products. It could do so by entering into securities lending arrangements, if such arrangements constitute financial products under section 766C of the Corporations Act.

(a) Is there a financial product?

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)) [see (b) below].

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.

(b) Is a securities lending transaction a "derivative" for the purposes of the Corporations Act?

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 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

- 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).

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 (in other words complex variations of standard derivatives).

It is arguable that the securities lending transaction satisfies both of the above requirements, on the basis that:

- the borrower is required to provide consideration at a future time (in other words equivalent securities and, importantly, manufactured payments and any non-cash rights); and

- 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 identical securities to the lent securities.

On the other hand, unlike options and futures contracts, it is 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".

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.

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

(c) Dealing in financial products

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)).

Entering into a derivative transaction involves the "issue of a derivative, which is a dealing service (s 76IE(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.

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, 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.

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.

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 FSRA licence requirements under regulation 7.6.01 or other provisions.

6.4 Receipt of cash collateral, and provision of non-cash collateral, by special entities

(a) Cash, Superfunds, ADFs and PSTs

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.

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.

Unfortunately, the Superannuation Industry (Supervision) Act 1993 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).

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:

- the purpose of the transaction being restricted to the lending of securities [ie being a securities driven transaction - see 1.3(b)(i) above] and not extending to the borrowing of money [ie being a cash driven transaction - see 1.3(b)(ii) above];

- 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

- the transaction being bona fide.)

An additional issue arises for any superannuation entity that **borrows** 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 my 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.

(b) Statutory authorities

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.

(c) Life insurance companies

Similar issues arises for life insurance companies. The Life Insurance Act 1995 requires a life company to have at least one statutory fund. It also prohibits a life company from borrowing money for the purposes of the business of a statutory fund unless certain exceptions are satisfied (see section 38). I am not aware of APRA's view regarding securities **lending** by life companies and, in particular, regarding the receipt of cash collateral by them. I presume 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.

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).

6.5 APRA issues for superannuation entities and insurance companies

Finally, for both superannuation entities and insurance companies, 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 and Guidance Notes. (The same issue arises if a superannuation entity or insurance company was a borrower of securities.)

- If so, the consequences thereof.

(a) Regulatory background for an insurance company

An authorised insurer is required to maintain a certain minimum capital base.

(b) Special category for "derivatives"

In particular, insurers are required to set aside capital to cover the investment risk of derivative transactions. For this purpose, a "derivative" is not defined. However, for example, paragraph 23 of Guidance Note GGN 110.4 Investment Risk Capital Charge states:

> "Derivatives include forwards, futures, swaps, options and other similar contracts."

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

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.

(c) Is a securities lending transaction a "derivative" for APRA purposes?

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.

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.

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).

Accordingly, while the position may not be clear cut, it may be prudent for any authorised insurer to assume that a securities lending transaction constitutes a derivative for the purposes of APRA Prudential Standards and Guidance Notes.

(d) Consequence of being a derivative: Capital Charges for derivatives

A Capital Charge must be calculated for any securities lending transaction, if it is regarded as a derivative for APRA purposes.

(e) Risk Management Strategy Document

Insurers are also required by Prudential Standards and Guidance Notes 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.

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:

- 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;
- the insurer has substantially complied with its Risk Management Strategy ; and
- the copy of its Risk Management Strategy Document provided to APRA is accurate and current.

The use of derivatives by the insurer is something which its RMS must specifically address. For example, 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."

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:

- For example, regard should be had to the obligations assumed under (what is effectively) a deferred forward purchase agreement.
- 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.
- 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.

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.

7 Miscellaneous

7.1 Clarification of unresolved tax issues?

Some securities lending transactions involving equities are documented as repos. (The principal difference involves the character of any 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.)

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.

An industry submission by the Australian Financial Markets Association (settled by Mallesons Stephen Jaques) 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.

7.2 Clarification of effect of securities lending transactions on "relevant interests"?

As was noted in 6.1 above, 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). There may be some clarification of the attitude of the ASIC to this issue in time.

7.3 The future

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 of equity securities in Australia.

John C. King
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This is the fourth edition of this paper (previous versions were published in 1993, 1995 and 1997). The paper is not a definitive statement of the law or practice, or of the risks, relating to securities lending of equity securities in Australia. Readers should seek appropriate professional advice about their own circumstances before lending or borrowing securities.