

## **UK ANNEX TO THE SECURITIES BORROWING AND LENDING CODE**

### **1 Introduction**

The Securities Borrowing and Lending Code of Guidance was published in December 2000 and a revised edition was issued in December 2004. The Code is supplemented by a UK Annex in order to assist market participants in applying the Code to transactions involving UK securities. The Annex is produced, like the Code, by a sub-group of the Securities Lending and Repo Committee (see section 2 below). This Annex will be kept under review and updated from time to time. This is the second edition of the Annex and has been updated to reflect the issue of the second edition of the Code.

This Annex covers the United Kingdom and deals with securities borrowing and lending in gilts, equities and corporate bonds traded and settled in the United Kingdom. It amplifies some of the provisions of the Code, and refers to regulation, settlement arrangements, Companies Act notification requirements, voting and tax.

The Annex does not provide a comprehensive description of all UK market arrangements and regulation; and it does not seek to duplicate other relevant material, including the FSA Handbook, the rules of the London Stock Exchange, or the publications of CREST about UK settlement arrangements. If market participants have any questions about the application of particular legal requirements they should take professional advice.

The Annex should be read in conjunction with the Securities Borrowing and Lending Code and with the Gilt Repo and Equity Codes of Best Practice. These are available on the Bank of England's website at <http://www.bankofengland.co.uk/markets/slrc/htm>.

### **2 Securities Lending and Repo Committee**

The Securities Borrowing and Lending Code was produced by the 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 Financial Services Authority (FSA), and is chaired by the Bank of England. The SLRC provides a forum in which structural (including

legal, regulatory, trading, clearing and settlement infrastructure, tax, market practice and disclosure) developments in the securities lending and repo markets can be discussed, and recommendations made, by practitioners, infrastructure providers and the authorities. It also co-ordinates the development of the Securities Borrowing and Lending Code and the Gilt and Equity Repo Codes. The SLRC also 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 securities lending and repo markets; and maintains a sub-group on legal netting. It also 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 and the terms of reference of the Committee are available on the Bank of England's website, at <http://www.bankofengland.co.uk/markets/slrc/htm>.

### **3 International Securities Lending Association**

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 overseen the development of the main legal agreements used in the securities lending market. These agreements include the Overseas Securities Lending Agreement (OSLA 1995 version), the Gilt Edged Stock Lending Agreement (GESLA 1996 version), the Master Equity and Fixed Interest Securities Lending Agreement (MEFISLA 1999 version) and the Global Master Securities Lending Agreement (GMSLA May 2000).

### **4 UK regulation**

Any person who conducts securities borrowing or lending business in the United Kingdom would generally be carrying on a regulated activity in terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and therefore would have to be authorised and supervised under that Act. The securities borrower or lender would, as an authorised person, be subject to the provisions of the FSA Handbook, including the Inter-Professional Conduct chapter of the Market Conduct Sourcebook; and they would also have to have regard to the market abuse provisions of the Financial Services and Markets Act 2000 and the related Code of Market Conduct issued by the

FSA. The Conduct of Business Sourcebook may require a beneficial owner's consent to securities lending on its account. The FSA Handbook contains rules, guidance, and evidential provisions relevant to the conduct of the firm concerned in relation to the FSA's High Level Standards.

The FSA's address is  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

Tel: 020 7066 1000

Any questions on whether an activity by a person requires authorisation may be put to the FSA's Authorisation Enquiries Department. Firms should also seek legal advice.

FSA publications can be accessed on the FSA website: [www.fsa.gov.uk](http://www.fsa.gov.uk).

## **5 Companies Act 1985**

Firms that are engaged in equity borrowing and lending will need to comply, where appropriate, with the notification requirements applying to notifiable interest in shares as set out in Part VI of the Companies Act 1985. Work is currently underway in the EU to finalise a Directive on Transparency which might lead to some modification in the Companies Act 1985 Part VI notification requirements. Firms which are uncertain about the application of Part VI should seek legal advice.

## **6 The Rules of the London Stock Exchange ('the Exchange')**

Under the Rules of the London Stock Exchange ('the rules'), transactions in *chargeable securities effected pursuant to a lending agreement* are *on Exchange* and therefore subject to the Exchange's rules (see rule 3002.2). Lending transactions in securities which are not *chargeable securities* are *off Exchange* (see rule 3010.5). Equities, unlike gilts and other bonds, fall within the definition of *chargeable securities* in the rules. Chargeable securities are defined in section 99 of the Finance Act 1986 and include stock as defined in the Stamp Act 1891. Equity repo and securities lending and borrowing transactions by London Stock Exchange members are (broadly) *on Exchange* and

therefore subject to the rules. Repo and lending and borrowing transactions in gilts and other fixed interest securities are, in contrast, *off Exchange* and therefore not subject to the rules.

The Exchange rules define a *lending agreement* as ‘an arrangement entered into between a member firm, whether acting as agent or principal, and another party under which one party is to transfer securities to the other party and securities of the same kind and amount are to be transferred by that other party to that first party’. This definition covers both repo and securities borrowing and lending transactions.

The Exchange’s rules apply where the *on Exchange* transactions are between two Stock Exchange members or between a member and non-member.

Stock Exchange rules apply generally to *on Exchange* transactions, whether or not the purchase or sale is ‘outright’ or part of a repo or securities borrowing and lending transaction. There are, however, some rules relating specifically to borrowing and lending transactions.

Under rules 2140-2142 member firms must enter into a written agreement before entering into any lending arrangement; and the written agreement should substantially correspond to any standard form of agreement that the Exchange has authorised. Where the Exchange has not authorised a standard form of agreement which covers the circumstances in which a member firm proposes to enter into any lending arrangement, the member firm is required to ensure that the lending agreement includes provisions of equivalent effect to those referred to in rule D160 in the default procedures. Rule D160 provides that in relation to a lending arrangement all unperformed obligations of the defaulter and the counterparty shall be discharged and replaced by a single net obligation calculated in accordance with the valuation provisions in the rules.

Also of relevance to the securities borrowing and lending market is rule S410 in the settlement procedures. This rule is concerned with the timescales for the passing on of election instructions in the situation where there is a benefit distribution of a dividend with alternatives. This rule provides that ‘except in the case of overseas securities and central counterparty transactions, where a company declares a dividend with one or more alternatives, a buyer wishing to opt for an alternative shall give the seller an instruction notice stating the form in which it requires the dividend:

S410.1 if the seller is acting as agent, not later than three days before the last date given by the company for accepting an alternative; or

S410.2 if the seller is acting as principal not later than four days before the last date given by the company for accepting an alternative’.

The definition of ‘buyer’ includes ‘in respect of a lending arrangement, on the outward leg the borrower and on the return leg the lender’; and the definition of ‘seller’ includes ‘in respect of a lending arrangement, on the outward leg the lender and on the return leg the borrower’.

The London Stock Exchange’s address is:

London Stock Exchange  
10 Paternoster Square  
London  
EC4M 7LS

Tel: 020 7797 1000

The rules of the London Stock Exchange can be accessed on its website:

[www.londonstockexchange.com](http://www.londonstockexchange.com) .

## **7 UK taxation**

*Stamp duty / stamp duty reserve tax (SDRT)*

Persons conducting borrowing or lending of UK securities (in particular UK equities) need to consider whether stamp duty or SDRT is payable on the transfer (and re-transfer) of the securities.

There is an exemption from stamp duty and SDRT in relation to securities lending transactions in equities effected on the London Stock Exchange (the exemption extends to transactions effected on foreign exchanges, but in practice the rule is most relevant to London). The exemption should apply to the majority of the securities lending transactions done in the market. The conditions for the exemption are, broadly, that the securities lending transaction is effected on the Exchange (which means that it is subject to the rules of the Exchange and is reported to the Exchange in accordance with its rules) and the securities lent are regularly traded on the Exchange. Accordingly, provided at least one of the parties to the securities lending transaction is a member of the Exchange, no stamp

duty or SDRT should normally need to be paid in relation to a securities lending transaction over UK listed equities and relief is typically given at source. For securities held in CREST, the reporting requirements are met by the transaction reports which the member firm makes to the Exchange through CREST.

### *Manufactured dividends*

Under securities lending agreements, borrowers are normally required to make payments to lenders representative of any dividends or coupons paid on the underlying securities during the term of the securities loan (so-called 'manufactured dividends'). The objective is to put the lender into the same economic position as the lender would have been had the securities not been lent. For UK resident borrowers and lenders, the United Kingdom's domestic tax code attempts to tax lenders and borrowers, in accordance with the economic substance, as if the underlying securities had not been transferred (so, for example, a manufactured dividend in relation to UK equities is treated for tax purposes in the hands of the lender as if it were a dividend on the underlying securities). The same might not be true for non-UK borrowers or lenders: the tax treatment of a manufactured dividend may diverge from the treatment of the real dividend or coupon. Also, the tax treatment of the real dividend in the hands of the borrower may be different to the treatment in the hands of the lender. Lenders and borrowers should therefore have an understanding of their own tax status relative to others.

The Inland Revenue contact for securities lending tax enquiries is:

Richard Rogers  
Inland Revenue  
Revenue policy, Business Tax  
Room 4E1, 4<sup>th</sup> Floor  
22 Kingsway  
London WC2B 6NR

Tel: 020 7438 6563

## **8 Voluntary corporate actions**

An issue of concern for participants in the equity securities lending market is the handling by a borrower or lender of shares of voluntary corporate actions including elections on dividends.

Paragraph 7.5 of the Code says ‘The arrangements to be followed in the event of a rights issues or other corporate action should be clearly established by all parties before a securities loan is made, with due recognition of local market rules and practice and any deadlines imposed by the various parties’ local agents or custodians’. The Global Master Securities Lending Agreement (GMSLA) refers to a ‘reasonable time’ with regard to how much notice must be given by a lender of securities (usually a fund manager or custodian on behalf of a client) to a borrower specifying what he wants to receive following a corporate action.

This matter has been discussed by the SLRC and with the London Stock Exchange which amended its rules to shorten the deadlines for a buyer giving an instruction notice to a seller on the dividend election - to three days where the seller is acting as agent and four days where the seller is acting as principal. The rules are summarised more fully in section 6 above.

Where borrowers and lenders are not members of the Exchange the SLRC would encourage the parties to consider agreeing terms under which they would act as if the Exchange’s rules relating to corporate actions and deadlines for giving instructions applied to them.

Market participants have also had concerns that borrowed securities might be returned without prior notice very close to the election date for a corporate action such that the original lender was not able to make an election on time. Under the Exchange’s rules a lender may instruct a borrower on the election he requires for the securities on loan. This may occur at any time from the announcement of the corporate action right up to the last time for instruction, that is, 11am on the day before the election/record date. The potential problem arises because the last time for settling a transaction is 4.30 pm on the day before an election date which is well after the 11am deadline. This means that the borrower would unilaterally be able to return securities between 11am and 4.30pm, so that in this event, the borrower would not be required to act upon the buyer instruction sent by the lender.

The SLRC has discussed the problems that can be caused by such returns; and agreed that minimum good practice would be for there to be a ‘callover’ period between the deadline for buyer instructions between 11am and the deadline for settlement (4.30pm). During this period, the borrower wishing to return the securities would be required to contact the lender to inform him of the intention to return the securities and in any event must contact the lender no later than the time of the return. This would enable the recipient of the returned securities to be ready to make the election. If, however, the

borrower failed to give notification, any return settling would be treated as invalid and the borrower would be constrained by any buyer instruction issued up to 11am on that day. Market participants should consider whether such arrangements would be suitable for their particular circumstances and whether their securities lending agreements should be amended to reflect the 'callover' arrangements described in this Annex.

More generally, whether or not 'callover' arrangements are put in place, market participants should be alert to the difficulties that returns close to election dates can cause and seek to agree with counterparties how they should be avoided or dealt with.

## **9 Voting**

Under securities lending agreements the right to vote passes to the buyer / borrower together with the absolute ownership of the equities concerned. This means that in principle a person could borrow shares in order to be able to exercise the voting rights and influence the voting decision at a particular meeting of the company concerned. There is a consensus, however, in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at e.g. an AGM or EGM. Lenders should also consider their corporate governance responsibilities before lending securities over a period in which an AGM or an EGM is expected to be held. Beneficial owners need to ensure that any agents they have made responsible for voting and for securities lending act in a co-ordinated way. A number of market bodies, in the United Kingdom and internationally, have been addressing the relationship between securities lending and voting. For example, the January 2004 report by Paul Myners to the UK Shareholders Voting Working Group stressed that the borrowing of shares for the purpose of voting is not appropriate and that the holders of collateral should not be expected to vote shares held as collateral.

## **10 Settlement: securities lending and collateral transfer functionality in CREST**

CREST provides the UK settlement system for gilts, equities, corporate bonds and money market instruments.

CREST provides securities lending and collateral transfer functionality for all CREST settleable securities through three transaction types, the Stock Loan, the Repo and the Delivery By Value

(DBV). The use of all three transactions (which are normally settled against payment to reduce settlement risk) results in title to the lent securities passing outright to the transferee. CREST itself is never counterparty to any loan or collateral transaction.

The securities loan transaction requires the independent input of instructions by both parties, who 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 effected against sterling, euro or dollar consideration or made free of payment. Where transactions involve currencies other than sterling, transactions may settle on UK Bank Holidays.

Immediately after the settlement of the loan, CREST automatically creates a pre-matched securities loan return transaction with an intended settlement date of the next business day. The return is prevented from settling until the borrower has sufficient securities and intervenes to raise the securities priority of the transaction. The securities lender may freeze the cash side of the transaction in order to prevent the securities from returning but has no control of the securities side. Where loans are dealt with on a free of payment basis and no cash side to the transaction exists, the lender is unable to prevent settlement.

In the event that a securities on loan are sold on a DvP (Delivery vs Payment) basis and a recall to the relevant borrower is made, the lender should ensure that the borrower returns the securities prior to the close of the DvP settlement window as free of payment transactions are able to settle later in the day.

CREST provides full revaluation facilities for all securities out on loan which are settled on an against payment basis. 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 (the previous day closing price). Any deficit or surplus of cash collateral of a securities loan return arising from revaluations 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 where revaluation is not actioned.

The repo transaction is an instruction to transfer specified securities as collateral, generally against a cash amount. It requires the independent input of instructions by both parties who must complete a number of matching fields, such as the amount and currency of the cash to be transferred and the securities involved (up to ten lines may be specified). An interest rate must also be input to enable CREST to calculate and transfer accrued interest as it arises.

A return date for the automatically generated return transaction may also be specified. Functionality exists to enable the parties to agree to return the securities early or roll over the repo to a later date. The parties may also agree to substitute individual lines of securities within the repo.

The delivery by value transaction (DBV) is an instruction from a member to the CREST system, requesting it to assemble a package of securities of a nominated value from a specified member account, to pass to another member as overnight collateral against the borrowing of cash or securities. It is often used to provide securities lenders with collateral in the form of securities rather than cash, with the aggregate cash consideration of the loan transaction being returned to the borrower via the DBV transaction against securities of a specified value and quality. DBVs are sometimes used to settle overnight repo transactions.

There is no direct or indirect link between securities loan transactions and DBVs, and the two inputs are wholly independent. Members match the cash consideration, the value of the collateral sought and the margin (by which the value of the securities must exceed the cash consideration). Additionally, members must agree the type and quality of acceptable securities by selecting from one of 29 DBV classes into which CREST places securities. Members may also agree to pass a diversified portfolio of collateral by applying a concentration limit to the transaction; this limit ensures that the value of any single securities will not exceed 10% of the total value of the package of securities transferred. On occasion however, a single company may have more than one line of securities issued which forms part of the same index. In this scenario, total exposure may exceed 10%.

Receivers of DBVs should be aware that it is not possible to request the exclusion of individual stocks within DBV unless (i) requirements under the Companies Act prevent a receiver from receiving their own securities and (ii) issues with nationality declaration requirements arise. All other requests are typically refused.

DBVs must be input for same day, with settlement occurring in a discrete window after the close of normal settlement against payment. At the point of settlement, CREST automatically creates a series of DBV returns for settlement the next business day, with one movement for each line of securities and the consideration pro-rated across the returns.

Members may also agree a rate of interest on cash lent via a DBV transaction; CREST automatically calculates the interest payable, using the appropriate currency convention, and creates an interest payment for settlement the next day.

One of the necessary conditions for exempting securities loans, repos and DBVs from Stamp Duty Reserve Tax (see section 7 above) is that the transaction is undertaken 'on exchange' and reported to that exchange. CREST accordingly provides automatic transaction reports for all securities loans and DBVs (including the relevant returns) and forwards these on to the exchange specified by the user.

For more information, see the October 2000 CREST document entitled "A Guide to Stock Lending and Collateral Transfers in CREST" or the July 2003 "Extending Repo Facilities in CREST" white book, both of which are available from the CREST website ([www.CRESTCo.co.uk](http://www.CRESTCo.co.uk)).

CRESTCo provides some time-delayed information on the values of securities financing transactions in the top 350 UK equities. This information was first published in September 2003 and excludes intermediary activity where possible.

Bank of England

On behalf of the Securities Lending and Repo Committee

16 December 2004