

Securities Lending & Corporate Governance

Commissioned by
International Securities Lending Association

Endorsed by
Association of Corporate Treasurers
British Bankers' Association
London Stock Exchange
National Association of Pension Funds
Securities Lending and Repo Committee

Written by
Mark C. Faulkner, Managing Director, Spitalfields Advisors



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This paper was commissioned by the International Securities Lending Association, and endorsed by the Association of Corporate Treasurers, the British Bankers' Association, the London Stock Exchange, the National Association of Pension Funds and the Securities Lending and Repo Committee. It is welcomed by the Association of British Insurers and the London Investment Banking Association. The author is Mark C. Faulkner, Managing Director of Spitalfields Advisors Limited.

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About the Author

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

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

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

Whilst occupying these different posts he has gained experience as a lender, borrower, conduit borrower and prime broker. During his career he has worked closely with the UK Inland Revenue and has represented firms at the Securities Lending and Repo Committee and the London Stock Exchange's securities lending committees. Being an independent advisor since 1995 has provided Mark with a unique insight into the operation of the securities financing market. In 2004 he authored the book 'An Introduction to Securities Lending'.

Mark lives with Jude and their son Archie in Canonbury, London. To download a free copy of this paper or contact Mark about it please visit: www.spitalfieldsadvisors.com

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Foreword

Securities lending plays an important role in today's capital markets by providing liquidity that reduces the cost of trading and promotes price discovery in rising as well as falling markets. The resultant increase in efficiency benefits the market as a whole - from the securities dealers and end investors through to the corporate issuers which depend on efficient, liquid markets to raise additional capital.

Good corporate governance is a cornerstone of the modern financial system. Well-managed companies will tend to attract investors helping to finance faster growth. Responsible investors will, in turn, wish to exercise their rights, for instance by voting at Annual General Meetings, in order to ensure that companies remain well governed.

When 'An Introduction to Securities Lending' was published in March 2004 the section on 'Corporate Actions and Voting' highlighted the importance of ensuring that beneficial owners are made aware that when shares are lent the right to vote is also transferred. The publication also emphasised that a balance needs to be struck between the importance of voting and the benefits derived from securities lending, and went on to recommend that beneficial owners should have a clear policy to ensure that voting instructions are dealt with in a coordinated way, including where a lending agent has been appointed.

Recognising that the debate has moved on in many ways since the original publication, sponsoring organisations felt it would be a useful and timely exercise to produce an update, taking current market practice into account and in particular exploring how securities lending and good corporate governance can be arranged so as support the requirements of the market as a whole.

I would like to thank the organisations which have reviewed, commented on, welcomed and endorsed Mark's authoritative and well-researched paper. It is gratifying to note that that we are achieving a high degree of consensus across the industry as we continue to address these important issues.

Richard Steele
Chairman
International Securities Lending Association

Copies of this paper and 'An Introduction to Securities Lending' are available for download from the following websites:

www.isla.co.uk

www.spitalfieldsadvisors.com

www.bankofengland.co.uk

www.bba.org.uk

www.londonstockexchange.com

www.treasurers.org

The Purpose of this Paper

The purpose of this paper is to consider the central issues and to explore how securities lending and good corporate governance can be arranged so as to minimise conflict to the overall benefit of the institutions involved, the corporations and the market. Various reviews of this important topic are underway, including those by Paul Myners, The International Corporate Governance Network (ICGN) and the EU Commission. Market practitioners will typically be familiar with the themes presented, the intended target audience is as follows:

- The individuals responsible for corporate governance at beneficial owners and asset managers
- Members of the press who write on the subject of corporate governance or securities lending
- The individuals responsible for, or considering participation in, securities lending at beneficial owners and their agents
- Associations that are considering how to address the perceived conflict between securities lending and good corporate governance
- Regulators with responsibility for oversight in this area

It will also be of interest to corporate issuers who wish to understand the mechanisms of how securities lending can affect corporate governance.

It is our contention that securities lending and the pursuit of good corporate governance are not necessarily in conflict. Both activities can, and do, co-exist happily within the investment management mainstream. We hope that the arguments and information put forward in this paper substantiate this position. It is our intention that this paper, which draws examples from the UK lending market place but is applicable to the broader marketplace, will add substance to the ongoing debate in this area.

What is Corporate Governance?

Corporate Governance has increased in importance over recent years. This high profile has been supported by investors, their associations and increasingly by regulators. As the Organisation for Economic Co-operation and Development writes in response to the following frequently asked question “What is corporate governance and why is it important?”:

Corporate governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders. How well companies are run affects market confidence as well as company performance. Good corporate governance is therefore essential for companies that want access to capital and for countries that want to stimulate private sector investment. If companies are well run, they will prosper. This, in turn, will enable them to attract investors whose support can help to finance faster growth. Poor corporate governance, on the other hand, weakens a company's potential and, at worst, can pave the way for financial difficulties and even fraud. ¹

Exercising the right to vote is therefore an integral and important aspect of good corporate governance for institutional investors. To be more precise the exercising of a right to vote against management is the ultimate sanction that a shareholder has and can be seen as a major step in meaningful engagement with the company.

What is Securities Lending?

Securities lending is increasingly recognised as part of the investment management activity with an estimated \$3 trillion or more of securities on loan at any given time. As David Rule of the Bank of England, Chairman of the Securities Lending and Repo Committee (SLRC), writes in the foreword of ‘An Introduction to Securities Lending’:

Securities lending provides liquidity to the equity, bond and money markets, placing it at the heart of today's financial system. This increase in liquidity reduces the cost of trading, thereby increasing market efficiency and benefiting all. Securities lending markets allow market participants to sell securities that they do not own in the confidence that they can be borrowed prior to settlement. They are also used for financing, through the lending of securities against cash, forming an important part of the money markets. The ability to lend and borrow securities freely underpins the services that securities dealers offer their customers and the trading strategies of dealers, hedge funds and other asset managers. On the lending side, securities lending forms a growing part of the revenue of institutional investors, custodian banks and the prime brokerage arms of investment banks. ²

¹ www.oecd.org

² ‘An Introduction to Securities Lending’, Mark C Faulkner, Spitalfields Advisors, 2004

Avoiding Conflict

There has been widespread discussion regarding the possible conflict between the exercising of good corporate governance on behalf of investors and the lending of securities. This discussion focuses upon the ability of investors, either directly or by instructing their agents, to vote when they have securities on loan.

We will draw upon specific examples, where appropriate, and highlight best practice.

The Legal Position

There are differing views in the market place as to the exact meaning of the term Securities Lending. “The word ‘lending’ is in some ways misleading. In law the transaction is, in fact, an absolute transfer of title against an undertaking to return equivalent securities.”³

This results in some important consequences arising from the nature of securities lending transactions:

- Absolute title over both lent and collateral securities passes between parties, meaning that these securities can be sold outright or “on lent”
- Once securities have been passed, the new owner of them has certain rights. For example they have the right to sell or lend them to another buyer and vote in the AGMs/EGMs if they are the holder at the record date
- The lender of equities no longer owns them and has no entitlement to vote. But they are still exposed to price movements on them since the economic exposure to owning those securities is not passed. Typically lenders reserve the right to recall equivalent securities from the borrower and must exercise this option if they wish to vote

Shares should not be borrowed for the purpose of voting

As Paul Myners writes in the March 2005 Report to the Shareholder Voting Working Group, ‘Review of the impediments to voting UK shares’,

Borrowing shares for the purpose of acquiring the vote is inappropriate, as it gives a proportion of the vote to the borrower which has no relation to their economic stake in the company. This is particularly the case in takeover situations or where there are shareholder resolutions involving acquisitions or disposals. The potential to vote borrowed shares means that there is a risk that decisions could be influenced by those that do not have an economic interest in the business. I believe that this merits the attention of lenders, fund managers and the ultimate beneficial owners, and their respective trade associations. They should visit existing practices to see whether practical procedures could be put in place to prohibiting the borrowing of stock for the purposes of voting. In this respect, the Securities Borrowing and Lending Code of Guidance states: “there is consensus in the market that securities should not be borrowed solely for the purposes of exercising the voting rights at, for example, an AGM or EGM. Lenders should also consider their corporate governance responsibilities before lending stock over a period in which an AGM or EGM is expected to be held”.⁴

Similarly collateral held, which can be of equal or greater value than the shares lent, should not be voted.⁵

This is a clear position and one of which practitioners actively engaged in the business of securities lending are acutely aware.

It is the case that securities on loan cannot be voted by the lender. Should they wish to exercise their right to vote, they need to recall these securities by the pre-determined time i.e. record date. Notwithstanding the above, it is not the case that, in aggregate, all votes on lent shares are lost. Some shares that have been borrowed will be delivered into the market to settle sales and end up with buyers. These buyers will be oblivious to the fact that these shares have been borrowed and will view them as their property and choose to vote as they see fit. It is the case that there may be some loss of votes associated with collateral positions or positions sitting long in trading books because shares held as collateral or in trading books are not normally voted.

³ An Introduction to Securities Lending, Mark C Faulkner, Spitalfields Advisors, 2004

⁴ SLRC Code of Guidance Clause 7.4

⁵ ‘Review of the impediments to voting UK shares’, Paul Myners, Report to the Shareholder Voting Working Group, March 2005

The right to recall any security on loan is enshrined in the legal agreement underpinning this activity and typically the lender recalling securities must provide their agent or borrower with “standard settlement period notice.” Recalls are part and parcel of the securities lending business. However, borrowers seek to avoid recalls wherever possible and frequent recalls may discourage borrowers from accessing portfolios. In practice the lenders, or their agents, communicate the lender’s position with regards to voting to the borrowers so as to avoid any surprises. It is important for all parties that they understand the importance of this communication and the rights of the underlying client to recall their securities to vote.

There are several positions that can be taken and these are driven by the owners of the assets made available for loan. At all times it is the owner who determines what can and cannot be done with their securities.

The Beneficial Owners

The beneficial owners of these assets include the following types of organisations:

- Pension Funds
- Mutual Funds
- Insurance Companies
- Unit Trusts
- Charities and Religious Institutions

The Practitioners

They in turn need to ensure that they or their counterparts/agents act in accordance with the beneficial owner’s requirements. The counterparts or agents will include the following types of organisations:

- Asset Managers
- Local Custodians
- Global Custodians
- Third Party Lending Specialists
- Proxy Voting Contractors e.g. ISS or ADP
- Broker Dealers

The Lenders’ Choices

The following positions are possible and there are securities lending programmes constructed to cater for each of them:

1. Voting (and therefore recalling) securities at every opportunity e.g. when the owner has a strong culture of voting and does not wish to miss an opportunity to demonstrate its position to the company

This is quite a rare position to take and is often only made in a subset of markets that are very important to the owner e.g. A UK pension fund might wish to recall all UK securities to vote. In his report Paul Myners accepted that investors might have legitimate economic reasons for not recalling all securities to vote. ⁵

2. Voting (and therefore recalling) securities only when the vote is deemed important enough e.g. when a takeover is being considered

This is a more commonplace position and enables the owners to enjoy higher securities lending revenues whilst voting when they feel it is warranted. It is important to note that the beneficial owner determines when it is important to vote, not their agents or borrowers. Here again the owners might focus upon their local market where their corporate governance aspirations are understandably higher than they might be overseas.

3. Not voting securities at all

There are still organisations that choose, for their own reasons, not to vote. This is their decision although increasing pressure in the UK from the government and others with regulatory responsibility may well encourage greater voting over time. However, should they change their mind and make an exception, they would have the capability to notify their agent or borrower and recall the securities in the normal way.

⁵ ‘Review of the impediments to voting UK shares’, Paul Myners, Report to the Shareholder Voting Working Group, March 2005

4. Maintaining a buffer of at least one share in all holdings

To ensure that the beneficial owner or asset manager receives direct advice regarding voting (and all other corporate actions) the retention of at least one share in their account is advisable. This has the advantage of ensuring the efficient and direct flow of information whilst retaining optimal lending returns. It is typical for there to be some retention or “buffer” of securities to be made in a lending programme and this level could be as low as one share or could be expressed as a percentage of the value of the holding.

Market Practice

Currently the majority of lenders of securities do not recall securities for voting except for the more contentious votes. This choice is theirs to make and should they wish to alter this position they are free to do so.

Typically a lender of securities would let their counterparts know their position regarding corporate governance and propensity to vote before joining a lending programme. Lending agents have strong operational procedures in place to ensure recalls are made where appropriate.

The May 2005 Euromoney survey conducted by the International Securities Finance Magazine (“ISF”) of 117 international beneficial owners exhibited the following results:

Do you ever recall securities to vote?

Yes	42%
No	58%

If you do make recalls to vote, what issues are you voting on?

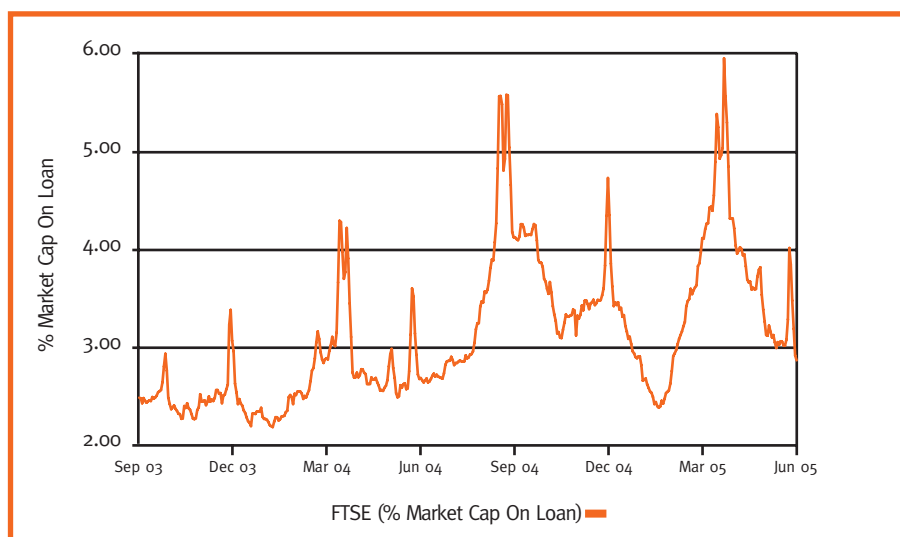
On contentious issues	44%
All proxies	19%
Mergers & Acquisitions	22%
Board composition and pay	14%

This means that of those responding 8% recall every security to vote, i.e. of the 42% of those that recall to vote, 19% do so for all proxies.

As the results above demonstrate, the majority of lenders of securities (58%) do not recall securities in order to vote. A change in this position may result in the lender forgoing some or all of their securities lending income.

FTSE 100 Borrowing

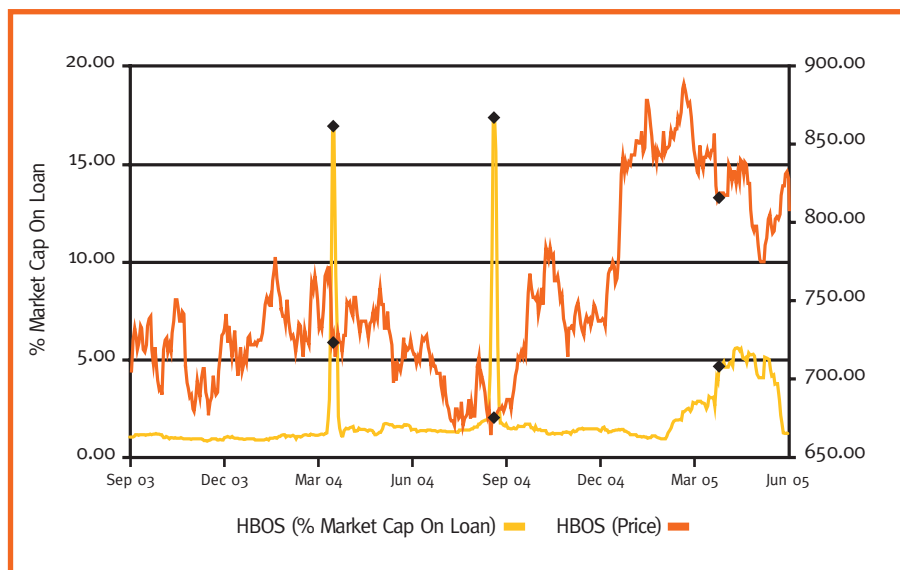
The scale of lending related disenfranchisement needs putting into context and the following charts may assist in this regard:



Source: Index Explorer

The chart above shows that the percentage of the market capitalisation of the FTSE 100 index that was on loan over the period from September 2003 to June 2005. This peaked at 6% in April 2005. Normal levels of borrowing would seem to be in the 2½% to 3½% range and the extraordinary peaks can be identified as coinciding with the dividend dates.

The impact of dividend dates on some securities can be demonstrated in the chart below that shows how borrowing changes over time. Halifax Bank of Scotland (“HBOS”) is one of many UK securities that has, until recently, offered its shareholders the option of taking the dividend in either stock or cash. The inserted diamonds are the record date for the dividends.

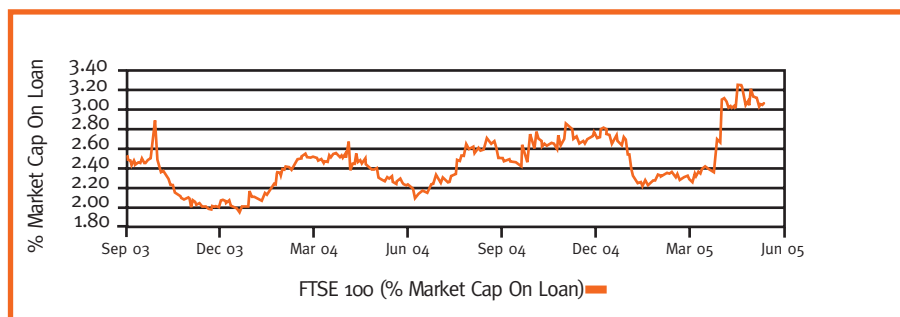


Source: Index Explorer

It is clear that HBOS and other dividend related borrowing is having a significant impact upon the FTSE 100 peaks in March and September. This is a traditional dividend payment time.

The Impact of Dividends

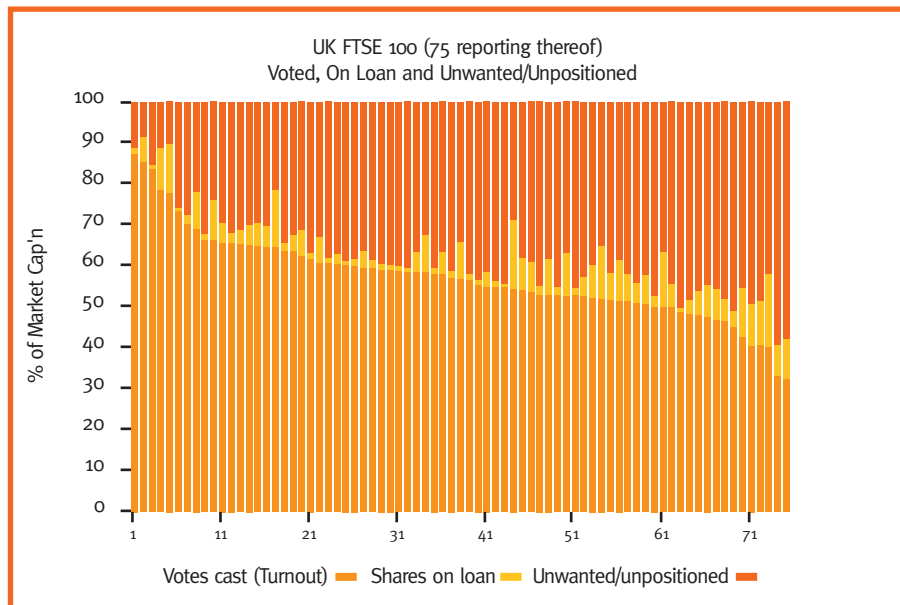
Below we show that once the amount of borrowing specifically around dividend dates is excluded, the value of the FTSE 100 on loan is much less volatile.



Source: Index Explorer

So there is a material amount of borrowing in this blue chip index that peaks over dividend dates. What impact does this pattern have upon voting turnout and thereby upon corporate governance? It is difficult to say in specific terms without going into detailed examples and space prohibits us from doing so here. However, the following conclusions easily emerge from the research. The scale of securities lending does not typically exceed the voluntary disenfranchisement one sees at typical AGMs. In other words more investors choose not to vote (for whatever reason) than choose to lend (and not recall).

The graph below shows measures of voting turnout regarding company remuneration policy in 2004. We have analysed the proportion of shares on loan, shares voted and shares not voted for the 75 companies of the FTSE 100 for which information is publicly available.



Source: Makinson Cowell, Spitalfields Advisors

The votes cast block shows the percentage of shares that were voted at the meeting. The shares on loan block represents the percentage of shares in each company that were on loan at the time of the meeting. The unwanted/unpositioned block shows the percentage of shares that were neither voted at the meeting or on loan at the time of the meeting.

Suggestions

So what should be done to alleviate the perceived problem? Here are some suggestions that are currently being considered and that will make a difference if implemented:

Transparency

All stakeholders, not just securities lending professionals, e.g. fund managers and corporate governance professionals, should understand the following:

- The established legal framework underpinning the lending arrangement
- Securities must be recalled to vote
- The exact notice required to recall the shares to vote – this may be different to normal market settlement periods depending on the lending agent being used
- Securities which are on loan
- How to access loan and/or governance information
- The potential effect of dividend record dates

Some beneficial owners are already in receipt of detailed reporting from their lending agents, although it is fair to say that the frequency and distribution of this information varies. Best practice is to provide daily reports securely on the internet. This enables permissioned users throughout the beneficial owners organisation to understand which securities are on loan.

Consistency

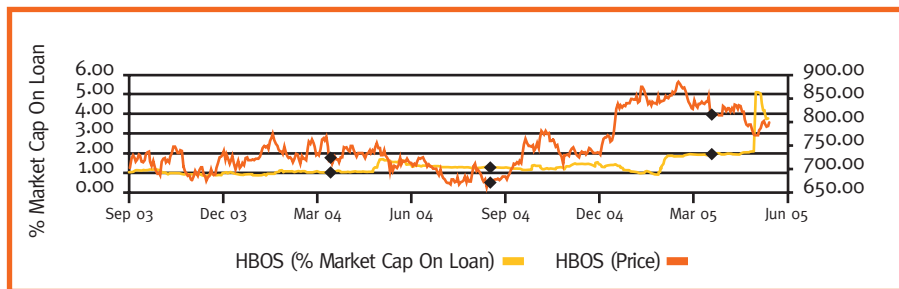
A clear policy is required so that the inherent conflict between the securities lending income forgone and the “value” of recalling to vote is addressed explicitly. This policy should be carefully drafted and agreed by stakeholders. In practice accurately assessing the economic trade off is challenging – the opportunity cost of making a recall may be known and is easier to assess than the benefit of making a vote. Any policy should be flexible enough to take into account a wide variety of security specific situations.

Communication

It is imperative that all stakeholders have access to all necessary information in time to make informed decisions. This requires accurate communication of data throughout the chain of organisations that are involved in lending, including the stakeholders at the beneficial owners, all teams at their providers and also the issuer. The efficient communication of any recalls is a vital part of the process that is normally well documented in the securities lending agreement. Beneficial Owners should typically expect that securities on loan will be returned upon the provision of standard settlement period notice.

Timing

Given the scale of lending activity around the dividend record date it is constructive to maintain the separation of the record date from the AGM. However, the issuers should ensure that the necessary documentation regarding the shareholders meeting are distributed prior to the record date so that the owners can decide whether they would prefer to vote or make the securities available for loan. Furthermore, bringing the payment date closer to the AGM would ensure that the dividend timetable is not unduly lengthened. This would enable lenders that wish to participate in profitable dividend related lending activity to do so with less voting conflict. It will also ensure that lenders are fully informed and can vote when it matters to them. This change does not require changes in company law and could be affected by the issuing companies. The graph for HBOS shown below, which has been adjusted for dividend impact (i.e. the extra ordinary dividend related borrowing has been removed) shows what one could call “normalised” borrowing levels. The difference between this chart and the one presented earlier (including dividend related borrowing) is stark and the normal level of borrowing is much less volatile.



Source: Index Explorer

Guidance

It is clear from the SLRC Code of Guidance and the Myners reports on the subject of securities lending and voting that the practice of borrowing shares specifically to vote is unacceptable.

Many active participants in the securities lending business already have the suggested measures outlined above in place. That should be a source of comfort to those concerned about the activity.

Lending is only part of the picture

The evidence suggests that lending is not one of the primary reasons why voting turnout is low. The value of a vote is determined by the owner of that vote – if they do not value it they may choose not to exercise their right, irrespective of their willingness to lend.

As the law currently stands in the UK, borrowing securities in order to build up a holding in a company with the deliberate purpose of influencing a shareholder vote is not illegal. However, based on recent headlines and the work done by the International Corporate Governance Network, institutional lenders have recently become more aware of this possibility and tend not to see it as a legitimate use of securities borrowing.

Since the demise of the borrowing purpose test, it is technically possible for someone to borrow securities to vote. However, it has been made very clear that this is not acceptable practice as the UK Annex to the Stock Borrowing and Lending Code, SLRC, 11 May 2004 makes clear.

Should this activity become an issue of concern in the future, it would draw regulatory attention very quickly, with the widespread support of the securities lending industry.

It is vital that beneficial owners are aware that when shares are lent the right to vote is also transferred. The SLRC Code of Guidance states that “agents should make it clear to clients that voting rights are transferred.”⁵

Going forward, a balance needs to be struck between voting securities and the benefits derived from lending securities. Quantifying these competing benefits is challenging. The income derived from securities lending can be explicitly measured but the value of a vote is perhaps less tangible - particularly now that most securities carry a vote and the majority of equity securities in publicly quoted companies rank *pari passu* (i.e. there are fewer companies that issue both voting and non voting shares that can be compared with one another).

Beneficial owners need to ensure that any agents they have made responsible for their voting and stock lending act in a co-ordinated way. This may mean that portfolio managers need to receive reports regarding securities on loan so as to avoid any situation whereby votes that they intend to make are not possible. This should be straightforward as notification of a vote taking place is given well in advance and securities can easily be recalled if necessary.

Conclusion

Securities lending and the pursuit of good corporate governance are not necessarily in conflict. Both activities can and do co-exist happily within the investment management mainstream. Today, many of the foremost proponents of good corporate governance successfully combine an active voting role with a successful securities lending role. The information flow and communication necessary to ensure that conflict is avoided is already in place but could be developed further. Those that are concerned about possible conflict need to openly discuss the issue with their securities lending counterparts and corporate governance colleagues. There is no need for anyone to feel that securities lending will disenfranchise them. At all times it should be remembered that the owner of the securities determines whether securities are either lent or voted.

⁶ Stock Borrowing & Lending Code of Guidance, Securities Lending & Repo Committee, December 2000