Stockbrokers Association of Australia
Incorporating SDIA

19 July, 2010

Chris van Homrigh
Senior Executive Leader
Investment Banks
Australian Securities and Investments Commission
GPO Box 9827
Sydney NSW 2001

Dear Mr van Homrigh

ASIC CONSULTATION PAPER CP 107 SECURITIES LENDING AND SUBSTANTIAL HOLDING DISCLOSURE

We refer to your letter of 7 June 2010 inviting further comment and feedback on a number of issues arising from ASIC Consultation Paper CP 107 and the industry responses thereto. The Stockbrokers Association of Australia appreciates the opportunity to provide further comment on those matters.

The Stockbrokers Association welcomes the indication that ASIC is considering relief in the terms set out in the letter. In general, the relief outlined would be an improvement on the present position, in that it would reduce the regulatory burden by removing the need to report certain positions which currently require to be reported, but with no corresponding loss of control information that would be of any relevance to the market.

However, whilst a positive move, in our submission the proposed relief would still not go far enough to address all of the significant practical difficulties generated by the application of the substantial shareholding requirements to stock lending and prime

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broking. In this respect, we refer to the matters which were set out in the submission dated 19 August 2009 which the Association (then known as the Securities & Derivatives Industry Association) lodged in respect of CP 107 ("our previous submission").

Set out below are further submissions addressing each of the specific questions in your letter.

Relief for Prime Brokers

1. **Would this relief address the practical difficulties you see with compliance with the existing requirements under s671B for relevant interests arising from a prime broker's rehypothecation right?**

The proposed relief would represent a substantial benefit in reducing the unnecessary burden of compliance in this area. In effect, movements arising from changes in holdings of securities as prime broker would no longer be required, and entities would be able to focus instead on movements generated by their securities lending back office systems.

The feedback from members is that the reporting burden would be reduced dramatically. In some cases, in the order of half to three quarters of total substantial shareholder notifications have been the result solely of changes in prime broking holdings. Hence, the volume of reports, the bulk of which arise due to movements by the underlying clients and not by the prime broker, should be significantly reduced.

We refer to our previous submission, in particular to Section C, as to the lack of intrinsic value to the market arising from this information. ASIC's proposed relief would address what the Stockbrokers Association called for in Paragraph C2. Requiring that disclosure be made at the time that stock is actually borrowed is in our submission the correct approach. We have been advised by members that the bulk of securities held under prime broking arrangements are not in fact ever borrowed, and the figure for prime broking holdings actually borrowed are in the order of 10% and no more.

However, as stated in our previous submission, even if the proposed relief in relation to prime broking were to be granted, this would not deal with all of the difficulties which currently arise in relation to substantial shareholder reporting in relation to stock borrowing/lending, and which are detailed in Section B of our previous submission. These difficulties would continue to present themselves to a prime broker (as well as to

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any other stock borrower or lender) in the absence of relief being extended to those issues as well.

2. What other benefits might flow from this relief?

Aside from the resource efficiencies which would follow from the reporting burden being reduced, the proposed relief would result in better transparency and less "noise" as regards information about control transactions in the securities of listed issuers.

As mentioned above and in Section C of our previous submission, much of the information generated by prime broking disclosures bears no relationship to corporate control, and the existence of these reports has frequently acted to confuse rather than inform the market. The existing reporting of prime broking holding has the tendency to lead to multiple reporting and over-reporting of "substantial shareholdings". There is also the likelihood of over-reporting of "transactions", where prime brokers may be required to file notices of change arising simply from movements into and out of custody or between accounts, where no true movement or transfer of the securities has actually taken place. It has frequently been difficult for market participants and observers to align these reports with information about substantial shareholding within the "true" scope of the objectives of the legislation.

There is also an additional benefit in that there would be a reduction in the regulatory uncertainty currently facing participants who wish to comply with the substantial shareholder requirements but who face genuine difficulties in complying with, or interpreting how to comply with, the existing black letter obligations under those provisions as they may relate to prime broking.

3. How should prime broking be defined for the purposes of the relief?

There does not appear to be any uniform definition of the term "Prime Broking", although most definitions which can be found are largely consistent.

In our previous submission, the Stockbrokers Association referred to "Prime Broking" as "..... as a relationship under which a Prime Broker provides a range of services to clients, including execution, custody, financing, stock lending and equity swap exposure. A Prime Broking agreement will commonly give the Prime Broker the right to borrow or rehypothecate the client's securities for use in the Prime Broker's stock

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lending program…." For extra clarity, we would add that these services include settlement. Other definitions include references to "operational support", which may include statements and reporting, which may be useful additional amplification should these not be considered to come within the terms used in the above definition.

It is not clear to us whether it is necessary for a uniform definition of the term to be agreed upon in order to grant the proposed relief, or whether it should be sufficient to merely refer to prime broking as commonly understood by the market.

4. **What, if any, problems do you see arising if we were to give this relief? How could those problems be addressed?**

The Stockbrokers Association does not see any problems arising from the granting of this relief. The relief would be beneficial not only to prime brokers but also to market transparency for the reasons outlined above.

It could be argued that some participants, including issuers themselves, could be reliant on the existing level of reporting to identify potential hedge fund holdings, or an accumulation of hedge fund holdings, in their securities long before those holdings or individual holdings would on their own trigger a reporting requirement.

In our submission, it would not be fair to attach too much weight to this consideration. The legislature determined the reasonable level at which substantial shareholding by an individual or by associates should arise, namely 5%. Requiring prime brokers to continue to bear the burden and be required to undertake the existing level of reporting to ensure that information about holdings of lesser size continues to be available to the market is not, in our view, an appropriate outcome from the point of view of legislative intent.

In any case, for the reasons mentioned earlier, the amount of "noise" and over-reporting which exists around prime broking reporting is such that it is hard to see how the information reported could be regarded as reliable by any observers, including listed issuers.

5. **Would this relief have any cost implications for you/your members' business? If so, please describe and estimate.**

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Prime brokers will have already established systems to enable identification and reporting of positions under the existing interpretation of the substantial shareholding requirements. However, the relief will save new entrants to the prime broking industry the cost of having to establish systems to measure and report these movements, and will enable existing prime brokers to save resource cost by discontinuing the operation and maintenance, and future upgrades and IT support, of their systems.

Because the proposed relief will generate fewer disclosures, the resource cost involved in identifying the existing disclosures, verifying their accuracy, and preparing the reports, which together are quite significant, would be saved. As to arriving at an estimate of the level of cost savings, we are not in a position to put forward figures that would be applicable to prime brokers generally, however our members have indicated that the savings will be worthwhile and highly desirable to them.

There will be further potential cost savings to listed issuers, who will frequently issue tracing notices to lodging parties, either by themselves or using paid agents, in an effort to explain or to amplify the existing information about substantial shareholders of the issuer. Reports lodged by prime brokers will frequently generate a tracing notice, and subsequent correspondence in relation to the replies. These efforts are no doubt costly for the issuer, and often fruitless given that the information reported will often be more likely to confuse than to inform. Answering tracing notices is a costly exercise on the part of the recipient, and the scheduled costs under the Corporations Act which may be imposed for answering tracing notices is only a fraction of the true cost. To the extent that irrelevant tracing notices will decline in frequency, there should be a corresponding saving to all parties, with no corresponding loss of market transparency in our view.

6. **Do you consider that the market would be deprived of important information with this relief? Why**

For the reasons given in the answer to 2 and 4 above, and also as set out in our previous submission, we believe that the quality of information to the market and the level of market transparency would, in fact, improve.

7. **Do you consider ASIC should impose any condition to this relief? If so, what conditions would you suggest?**

There are no conditions that we would suggest that warrant being imposed. As the terms of the proposed relief are that a reporting obligation would arise once stock is

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actually borrowed by the prime broker, then there is no further need that we can envisage for any conditions over and above this.

8. **Do you have any other comments relating to this relief or the application of the substantial shareholding provisions to prime broking generally.**

We refer to the comprehensive submissions set out in our previous submission. As set out in the introductory paragraphs to this response, the proposed relief does not go far enough to address all of the significant practical difficulties generated by the application of the substantial shareholding requirements as they apply to stock lending and prime broking, and should be expanded to deal also with the matters set out in our previous submission.

We also would submit that the proposed relief should not be limited to the substantial shareholding reporting requirements. If one accepts the logic of the argument that the right of a prime broker to re-hypothecate securities does not warrant reporting until the securities are actually borrowed, and that because the information of those rights is not relevant to the control of listed issuers, then it should also follow that those same interests of a prime broker should also be carved out from the calculation of a number of other thresholds, namely;

- Takeovers provisions
- Foreign Investment Review Board approval requirements
- Specific company ownership thresholds.

A prime broker who may also be active in a range of other activities, such as funds management, client facilitation, market making, hedging swaps and structured products, proprietary trading, can be exposed to issues in managing the inadvertent breach of the above thresholds, which can variously be between 5% for certain company thresholds to 14.9% for the FIRB and 19.9% for takeover bid purposes.

Because the interests arising under a prime broking arrangement depend on the size of the holding of one or more clients, none of whom may be in any association with the other, and because the movements will generally result from movements in securities by the client(s), the prime broker may be exposed to what could be a serious breach of the above statutory thresholds, and face potential criminal liability, for action of which the prime broker had no knowledge until after they had taken place. The only course of preventative action the broker could take would be to sever one or more prime broking

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client relationships, and/or to unwind any of the trading activities mentioned, nearly all of which involve the provision of a valuable service to clients and/or to the market.

Hence, we submit that ASIC should give consideration to providing consequential relief in the same terms as that being foreshadowed in relation to the substantial shareholding reporting requirements, so that these same rights of a prime broker are also not to be counted for calculation of the underlying substantial shareholding position itself, so that the thresholds mentioned are not triggered for that reason alone.

Matched borrowing and loan transaction for securities lending instruments

We note that ASIC is canvassing the option of class order relief to allow relevant interests to be disregarded for s671B purposes only in the situation where the relevant interest arises from a matched securities lending transaction which is carried out on the same trading day.

We note from the reference in ASIC's letter to borrowing and on-lending by a "securities intermediary", and that the relief would only be available to the intermediary.

1. **Would this relief address difficulties that arise in the context of a securities lending business conducted on an intermediary basis?**

The Stockbroker Association again sees the proposed relief as a positive outcome. It accords with the Association's previous submission at B9 –B16.

However, again, the Association would submit that the proposed relief is too limited, and does not deal with all of the practical issues arising from stock lending that are set out in our previous submission.

First, the relief should not be limited only to persons who carry on a stock lending business as an intermediary, as this may be an unduly restricted group having regard to some definitions of intermediary, such as that used by the Australian Securities Lending Association (ASLA).

We understand that distinctions may sometimes be drawn between parties that lend directly to a borrower rather than using an agent or intermediary, and parties who act as intermediaries between lenders and borrowers, taking a fee for the service as part of the "spread".

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As argued in our previous submission, there should be general relief afforded so that any party should only be obliged to report the overall amount of the relevant interest resulting from stock borrowing/lending on an end-of-day net basis, with stock lent out being netted against stock borrowed. The relief should not be limited to persons who may be defined as "intermediaries", but should be available to any person who is a borrower and lender of securities.

In our submission, it is only the net position that would be of any relevance to the market, and the same is true whether the person was an "intermediary" or any other person. We do not see there to be any risk of avoidance or "warehousing" arising if the relief were to be granted more widely.

In addition, there are not always perfect correlations in the two legs or borrowing and on-lending transactions. The process of matching the transactions can prove to be quite complex, and costly in terms of time and resources. Stock may be sourced from a number of locations, including internal trading desks as well as other lenders, which results in stock being co-mingled. The volume may not correlate with the second leg(s) on a one 1 to 1 basis. Similarly, stock may be borrowed in a single line and then used for a number of purposes, including on-lending and to cover short sales. The legs may also not always take place on the same day.

The proposed limitations would detract from availability of the relief, or the extent to which parties might be in a position to avail themselves of the proposed relief, without, we would argue, any policy justification. The relief should be available to stock loan/borrow positions netted on any day.

2. **What other benefits might flow from this relief?**

The existing requirements lead to multiple reporting and distortions and "noise" in relation to corporate control in precisely the same way as the requirements in relation to prime broking. Hence, the same benefits as are referred to in 2 above in relation to Prime Broking will flow similarly from this relief, including greater transparency and removal of regulatory uncertainty. There should also be reduced costs in relation to fewer notices needing to be filed, and the potential lesser burden relating to tracing notices, as referred to in 5 above in relation to Prime Broking.

3. **Should this relief be limited to a person operating a securities lending business on an intermediary basis? What parameters do you suggest?**

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No. Please see answer to 1 above.

4. **What if any problems do you see arising if we were to give this relief? How could those problems be addressed?**

We do not see any problems arising from the granting of this relief per se. Similar to the discussion in paragraph 4 under prime broking above, it may be that some parties, such as listed issuers, would want as much information as possible. However for the same reasons as outlined in that paragraph, our submission is that the information is of limited reliability and clarity, and does not justify the cost and effort involved in its reporting.

However, the problems we do see arising from the granting of the relief in the terms foreshadowed is that, for the reasons set out in 1 above, the relief is unduly restricted and will not solve the problems being faced by all parties, including those who might not fall within the definition of "intermediary".

Also, for the reasons set out at the outset to this section and in section B of our previous submission, the terms of the relief do not deal with the broader list of practical difficulties which arise in relation to stock lending disclosure under the substantial shareholder provisions generally. These problems will continue to exist if the more extensive relief called for in our previous submission is not granted.

5. **Do you consider that the market would be deprived of any important information as a consequence of thise relief? If so, how?**

For reasons given above and in our previous submission, the relief should only serve to improve the quality and transparency of the information generated by section 671B notifications.

6. **Should ASIC impose any conditions to this relief etc?**

As already indicated, the proposed limitations to the availability of the relief only narrow the availability of the relief unnecessarily. In addition, there should not be any further requirement or condition that the second borrower be an unrelated third party. It is not uncommon for a securities lender to conduct a matched trade with another group entity e.g. an Australian entity may lend to a group entity in the UK, which may not be a party to the securities lending agreement with the lender, or who may be in the same time zone or country as the ultimate borrower. The difficulties arising from

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compliance with these requirements commonly arises in such a case involving transactiond within a group.

7. How are "matched" borrowing and lending transaction with a securities lending intermediary normally "unwound"? Does our proposed relief satisfactorily deal with this situation?

To the extent that one is able to refer to there being a "normal" scenario for the unwinding of a matched stock lending transaction, the transaction can be unwound by either party at any time. The stock could be recalled by the lender or returned voluntarily by the borrower. The first party could then return the stock to the original source from whom it was obtained (in fact, it may be the original lender who "unwound the transaction by recalling the stock that had first been lent). The party in the middle might obtain stock from a separate lender in order to return them to the original source, thereby allowing it to keep the second leg on foot and not recall it from the party who had borrowed the original stock.

The proposed relief would not deal with the situation satisfactorily if any of the parties in the chain did not fall within the definition of "intermediary" employed for the purposes of the relief. For the relief to deal adequately with the situation, it should be open to any party in the chain to net off loans against borrows on a daily basis, regardless of their categorization.

8. Would this relief have any cost implications for your/your members' business?

If the relief was granted broadly as we suggest, then there would be cost savings to stock lenders as the task of verifying movements and identifying positions to be reported would be much less complex.

If the relief were to be limited to "matched" borrowing and lending transactions occurring within a trading day only, there would be a requirement to undertake IT development of existing systems to automate the data capture. There is the potential that the cost of system development compared to any cost savings through reduced reporting would be such as to make the relief not worth utilizing.

There are potential cost savings to be gained in relation to reduced filing and also in relation to tracing notices, referred to in 2 above.

9. Do you have any other comments relating to his relief?

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The only additional comment we wish to make is to reiterate our earlier comments in paragraph 8 above about the importance of the additional relief sought in Section B of our previous submission in relation to the practical difficulties in complying with many of the specific requirements of the substantial shareholding provisions. These include the disclosure of consideration, line by line movements, counterparties and copies of agreements.

These issues remain of concern to parties who carry out securities lending. It may be that these issues are already receiving consideration by ASIC separately to this further consultation. Even if the proposed relief were to be granted, and even if granted as broadly as we suggest, the other practical difficulties would continue to exist in relation to the remaining disclosures that would be required, and hence remain as significant as ever.

Thank you for the opportunity to address these questions. We would be happy to discuss any issues relating to this matter at your convenience. Please do not hesitate to contact me on (02) 8080 3200 or email pstepek@stockbrokers.org.au.

Yours sincerely

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Managing Director & CEO

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