ASIC
Australian Securities & Investments Commission

REPORT 235

Response to submissions on CP 107 Securities lending and substantial holding disclosure

April 2011

About this report

This report highlights the key issues that arose out of the submissions received in response to Consultation Paper 107 *Securities lending and substantial holding disclosure* (CP 107) and details our responses to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 222 *Substantial holding disclosure: Securities lending and prime broking* (RG 222).

Contents

Overview/Consultation process

1 In Consultation Paper 107 *Securities lending and substantial holding disclosure* (CP 107), we consulted on the substantial holding disclosure requirements for securities lending and prime broking. We are seeking to improve disclosure of substantial holdings that may arise from participation in securities lending or prime broking.

2 In addition to setting out our views as to the specific requirements, we consulted on:

(a) relaxing the requirement to attach a full copy of the underlying securities lending agreement (see Section B);

(b) providing guidance on the disclosure of consideration in the context of securities lending and prime broking (see Section C);

(c) providing guidance on the disclosure of the registered holder of the shares in which a relevant interest is disclosed (see Section D); and

(d) obtaining feedback on how the substantial holdings requirements could be made more workable while improving market transparency and avoiding the risk of avoidance or warehousing (see Section E).

3 The proposals were designed to improve disclosure of substantial holdings that may arise from participation in securities lending or prime broking.

4 This report highlights the key issues that arose out of the submissions received in response to CP 107 and our responses to those issues.

5 This report is not a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 107. We have limited this report to the key issues.

6 For a list of non-confidential respondents to CP 107, see the appendix. Copies of the non-confidential submissions are on the ASIC website at www.asic.gov.au/cp.

Responses to consultation

7 We received over 13 responses to CP 107 from a wide variety of sources, including relevant industry and professional associations, investment banks, investment and governance advisory bodies and listed companies. We also received additional feedback on issues raised in the initial responses. We are grateful to respondents for taking the time to consider our proposals and to send us their comments.

A Our policy approach

Key points

We maintain the view that disclosure of substantial holdings, however they arise, is important for an informed market in quoted securities.

Disclosure of substantial holdings needs to take place in a way that provides useful and accessible information to the market.

Context

8 We issued CP 107 with the aim of improving disclosure of substantial holdings that may arise from participation in securities lending or prime broking. We sought to do this by:

(a) setting out our view on how the relevant interest provisions in s608 and 609 of the *Corporations Act 2001* (Corporations Act) generally apply to standard securities lending transactions and prime broking arrangements;

(b) seeking feedback on proposals for providing more guidance on some of the requirements; and

(c) seeking feedback on ways in which the substantial holding disclosure requirements could be modified to improve disclosure.

Market concerns

9 There were mixed responses to our proposals.

10 A consistent theme was that the nature of the securities lending industry presents challenges for strict observance of the substantial holding provisions and enforcement of strict compliance is likely to be detrimental to the securities lending industry. In particular, it was contended that:

(a) securities lending is not relevant to having a substantial interest for acquisition or control situations; rather, it relates to the efficient operation of the business of prime broking or intermediation in the securities market;

(b) the disclosure requirements contemplated in CP 107 would result in unnecessary regulatory burden, reporting complexities and public disclosure of commercially sensitive information;

(c) the proposals would reduce liquidity, substantially increase compliance costs and be likely to lead to a less efficient and informed market;

(d) multiple reporting of the same underlying stock position needs to be avoided. Relevant movements in stock should be identified, but the 'noise' that would come from lodging irrelevant information in substantial holding notices should be avoided. This could result in misunderstandings of equity holding positions, particularly multiplication of holdings, resulting in misconstrued analysis by market participants and the financial press that could adversely affect market efficiency and ultimately investor confidence;

(e) including securities that are on-lent in substantial holding calculations would give rise to duplication of positions, which could mislead the market about where the controlling or voting interest actually lies; and

(f) intermediary type transactions are too short term to easily involve control situations. There are also operational requirements where banks and prime brokers are momentarily required to hold transactions as part of a sequence of operational issues.

11 Information was provided about the operation of the securities lending industry, including that securities lending:

(a) contributes to market efficiency, market liquidity, lower transaction costs (i.e. bid–offer spreads) and price discovery;

(b) assists in managing settlement risk by ensuring trades settle on time, even at times when the market experiences disruption or when market participants experience operational problems;

(c) is often motivated by the need to cover short sales, whether these short sales are directional trades, hedging transactions, market maker transactions or arbitrage transactions; and

(d) can occur for reasons unrelated to short selling, including borrowing to cover potential failed trades, financing trades or dividend-driven transactions.

12 On the other hand, one respondent referred to vote buying, a consequence of the temporary access to securities that arises from securities lending, which can distort the results of shareholder voting by:

(a) obtaining votes to cast at a meeting; and

(b) removing those securities from the free float of the company, which has the potential to influence the outcome of a close contest by withdrawing shares and their votes from, for example, the opposition to a proposed transaction with control implications.

13 While no actual examples of this occurring were provided, the potential for it to occur was seen to provide justification for full compliance with existing requirements.

Final policy direction

14 We remain of the view that disclosure of substantial shareholdings is important for an informed market in quoted securities. However, we recognise that disclosure of substantial holdings needs to take place in a way that provides useful and accessible information to the market. This involves a fine balancing of a strict application of the existing requirements of substantial holding disclosure and the nature of securities lending and prime broking activity. In brief, we have decided that some relief is appropriate and we set out our view on this relief in this report.

15 This relief is relevant to substantial shareholders of listed bodies where some or all of their substantial shareholding arises from their participation in securities lending and/or prime broking transactions.

16 This report does not consider what disclosures, if any, should be made by shareholders of listed bodies who may make their shareholdings available for securities lending. For example, the issues in this report do not apply to the disclosures that may be appropriate for a superannuation fund that makes its shareholdings available for securities lending.

B Attaching the full agreement

Key points

None of the respondents objected to our proposal to give relief from the requirement to attach the standard form securities lending agreement. However, some argued that there was limited market benefit to the condition of alternative disclosure.

There were various suggestions about what would constitute adequate disclosure. Most respondents said that requiring the substantial holder to provide documentation on request was inappropriate.

Respondents argued that relief from s671B(4) is appropriate for other documents connected with securities lending transactions, especially prime broking arrangements.

Relief from the requirement to attach the standard form securities lending agreement

17 In CP 107, we invited submissions on whether we should give relief from s671B(4) so that a substantial holder did not need to attach a copy of the Australian Master Securities Lending Agreement (AMSLA) or the Global Master Securities Lending Agreement (GMSLA). We proposed that this relief would be given on the basis that the substantial holding notice included adequate disclosure about the key terms of the particular securities lending agreement and any significant variations to the standard form agreement.

18 None of the respondents objected to our proposal to give relief from the requirement to lodge a copy of the AMSLA or GMSLA with substantial holding notices. The consensus was that attaching a copy of the relevant agreement makes the notices unhelpfully voluminous (given that each agreement is at least 40 pages in length) and imposes an onerous administrative burden on substantial holders, yet does not advance the purpose of the notification requirement. It was also noted by some that there are practical difficulties with filing large annexures comprising multiple documents on the Australian Securities Exchange (ASX) online platform.

19 While there was consensus on the appropriateness of granting relief, different opinions were expressed about the basis on which the relief should be granted.

Is a condition of alternative disclosure necessary?

20 Some respondents argued that there was limited market utility in including a summary of the key terms of the agreement in, or attaching a copy of the completed schedules to, the notice. It was noted that the standard wording can be accessed on the internet and that variations or amendments made to the standard wording are commercially sensitive.

21 In this regard, it was also suggested that, at least for ordinary securities lending transactions, the only party who would benefit from the details of an agreement or a schedule being attached would be the competitors of the discloser and/or its counterparty (e.g. other securities lenders).

> *ASIC's response*
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> We do not accept that no alternative disclosure is required, as there are some key terms of the agreements that provide useful information to the market as to the nature of the relevant interest.

What disclosure would constitute adequate disclosure for the market?

22 We received various suggestions for alternative disclosures to achieve adequate disclosure about the key terms of the securities lending agreement and any significant variations to the AMSLA and GMSLA. These included:

(a) a summary of position terms in place of the attachment of these documents, in line with Takeovers Panel Guidance Note 20 *Equities derivatives*;

(b) a summary of terms and conditions that is sufficient to enable market participants to determine the purpose of the loan transactions and noting any deviation from industry standards;

(c) a requirement to disclose the agreement type and whether it gives the borrower the right of return and/or the lender the right to recall the securities, and that this could be done either by completing a standard pro forma or noting these in the notice; and

(d) summary disclosure required only if the terms of a standard industry agreement are varied (e.g. to enable the borrower voting rights).

23 Concern was expressed about whether summary disclosure could be provided given the high volumes of stock loan transactions. Some respondents also noted that stock loan market participants do not complete schedules as suggested in CP 107.

Relief on condition of provision of documentation on request

24 Most respondents indicated that a condition requiring the substantial holder to provide documentation on request was inappropriate.

25 Two respondents suggested that substantial holders should only be required to offer to provide a copy of the standard master agreements where there was a significant deterrent to frivolous requests or if there was an ability to refuse requests in certain circumstances. The respondents noted most information should have been covered in the summaries and that costs of production should be considered. It was also noted that the standard form agreements are accessible to the public and that it would not be appropriate to require the release of commercially sensitive information between the contracting parties in the schedules.

26 Other suggestions were to:

(a) require the provision of the documentation on request to ASIC or the listed entity, but not to other parties (e.g. investors);

(b) oblige the ASX to include copies of standard agreements on their website; or

(c) refer to a source in the notice from which the AMSLA or GMSLA can be obtained (e.g. a website).

ASIC's response

We believe it is appropriate to grant relief from the requirement to attach a copy of the AMSLA and GMSLA documents, on the condition that summary information is provided. The summary must succinctly and clearly explain key aspects of the securities lending arrangement, such as voting rights, rights of disposal and recall, and length of holding. We have issued a class order conferring this relief (see Class Order [CO 11/272] *Substantial holding disclosure: securities lending and prime broking*) and published guidance explaining our expectations (see Regulatory Guide 222 *Substantial holding disclosure: Securities lending and prime broking* (RG 222) at RG 222.70–RG 222.73).

Relief for any other types of agreements

27 In CP 107, we indicated that we did not propose to give relief from s671B(4) for any other documents that may be connected with a securities lending transaction.

28 Respondents contended that relief is appropriate for other types of contracts or arrangements (e.g. Overseas Securities Lending Agreements, prime

broking agreements, borrowing requests or notifications of unconditional 'holds').

29 Regarding disclosure of prime broking agreements, it was argued that:

(a) they are essentially financing or margin loan documentation (containing events of default for failure to pay, key person risk clauses, net asset value falls, etc.) and that, on this basis, they contain commercially sensitive information;

(b) they do not contain information that is useful for the market about substantial shareholdings and corporate control;

(c) other than the term conferring the right for the prime broker to borrow the securities, the agreement is irrelevant;

(d) they are voluminous and highly complex documents, and the existing technical requirement is unnecessarily burdensome and duplicative;

(e) the length of notices, with the annexures, tends to confuse readers and cloud disclosure rather than enhance it; and

(f) their disclosure compromises sensitive commercial information and has the potential to adversely impact the core investment decisions of lenders.

30 It was also noted that borrowing requests and notifications of unconditional holds are generally made via Bloomberg messages (which are not easily retrieved except via Bloomberg in New York), trade files and by telephone. Accordingly, it was submitted that it is impractical to disclose these items.

ASIC's response

We believe it is appropriate to grant relief from the requirement to attach a copy of a prime broking agreement, on the condition that summary information is provided. The summary must succinctly and clearly explain the circumstances giving rise to the relevant interest. We have issued a class order conferring this relief (see [CO 11/272]) and published guidance explaining our expectations (see RG 222.74–RG 222.75).

C Guidance on consideration

Key points

There was general consensus that the proposed guidance on the requirement to disclose fees for securities lending and prime broking would be impractical and would have a detrimental effect on the securities lending industry and prime brokers.

Respondents argued that disclosure of fees for securities lending and prime broking is not useful for the market, given the purpose of the substantial holding disclosure regime.

Proposed guidance on disclosure of consideration

31 The prescribed form for notification of substantial holdings requires disclosure of the consideration for the acquisition or disposal of relevant interests comprising the substantial holding.

32 In CP 107, we indicated that we proposed issuing guidance confirming the existing requirement that notices for substantial holdings acquired through securities lending and prime broking must set out any benefits given by the holder for the securities, including any borrowing fees or reduction in fees or interest that would otherwise be payable. We also indicated that if any of these amounts could not be accurately estimated, then the notice should clearly explain how they will be calculated. On the other hand, we recognised that consideration remote from the particular transaction did not need to be disclosed.

33 There was general consensus that 'consideration' in the context of securities lending or prime broking is the margin or fee charged on the relevant transaction. Regarding disclosure of this, almost all of the respondents argued that information about fees is not useful information and the requirement to disclose it would have a detrimental impact on the willingness of parties to engage in securities lending, and thereby impact on the availability of borrowed stock. This could impact on a wide range of activities, most particularly hedging and market making, which would adversely impact on the financial and securities markets.

34 Reasons given included:

(a) the information is not relevant to substantial holdings and corporate control because:

(i) the fee has no bearing on the calculation of a premium for control or the price at which a takeover offer must be made;

(ii) it does not provide information on market liquidity; and

(iii) the fee does not bear any relationship to the price being paid for the acquisition or disposal of securities; and

(b) the information may obscure the information that is relevant to the market, or it is misleading, because:

(i) the fee is usually driven by non-control factors (e.g. arbitrage in relation to dividend reinvestment plans); and

(ii) the level of fees in the over-the-counter market reflects counterparty risk, long-standing commercial relationships, deal-specific factors (such as volume and type of securities to be lent or borrowed, duration of the loan and nature of the collateral provided) and other commercial arrangements.

35 In addition to submissions about the usefulness of the information, some submissions said that fees should not be required to be disclosed because:

(a) the stock loan fee itself is commercially sensitive information (being a factor in the credit worthiness of the borrower, the availability of supply of the relevant stock, the intermediary's spread, the depth of the intermediary's client relationship with the particular borrower and lender clients, the nature of the collateral provided and the stock loan market rates);

(b) the fees can be difficult and costly to separate out as they are usually embedded within a suite of fees and spreads;

(c) a stock loan fee is akin to a brokerage rate (e.g. for a cash trade through an agency broker), and since brokerage rates are not required to be disclosed, neither should stock loan fees; and

(d) the fee that would need to be disclosed is not static—the contention was that when stock is borrowed, a borrower will lodge either cash or other securities as collateral for the borrowing and agree to pay a borrowing fee. As the stock moves in value, either further cash or additional security is lodged (or released as the case may be) by way of collateral. While the initial price of the stock—on the date on which the borrowing was based—could be detailed in a notice, it is not relevant for the purposes of market disclosure, and is superseded by later changes in value.

36 Given these reasons, it was submitted that disclosure of fees in the manner described in proposal C5 of CP 107 would likely damage securities lending markets in a potentially significant way. In this regard, it was contended that disclosure of consideration would provide competitors of securities lenders and borrowers with access to commercially sensitive information.

37 Respondents also queried whether our view was that fee information would be beneficial to the market for reasons unconnected with acquisition of control (i.e. general market transparency in relation to securities lending).

They then submitted that, if this were the case, the most appropriate manner of presenting such information to the market would be on a generic basis, without identifying specific parties and specific transactions, to preserve the commercial sensitivity of such information.

Information about consideration that is useful for the market

38 In CP 107, we expressed our view that disclosure of consideration is a key substantial holding content requirement and that the requirement is 'any and all benefits, money and other, that any person from whom a relevant interest was acquired has, or may, become entitled to receive in relation to that acquisition': see notes to Forms 603 *Notice of initial substantial holder*, 604 *Notice of change of interests of substantial holder* and 605 *Notice of ceasing to be a substantial holder*. We also recognised that there are various interpretations about how consideration for securities lending should be disclosed in substantial holding notices.

39 In view of this, we sought feedback on what information about consideration is useful for the market, given the purpose of the substantial holding disclosure regime. The majority of respondents submitted that the most important information for an investor is the price at which a borrower of securities sells those securities, which is information that is disclosed as part of the sale transaction.

40 In general, respondents indicated that no useful or relevant information would be provided to the market by disclosing fees. Some respondents noted that information on liquidity will be available through the disclosure of securities lending through the ASX.

41 One respondent indicated that the disclosure of consideration can be an important indicator of whether a securities loan is a standard transaction (e.g. a temporary borrowing to facilitate short sales) or a non-standard transaction (e.g. the loan is an in-substance loan and a director or other related party is using the loan to raise money).

ASIC's response

We have taken into account the objections to disclosure of consideration and have decided to give relief from this requirement. While the fee may differ for different securities, given the number of other factors affecting the fee, clear disclosure of the consideration will not necessarily lead to a more fully informed market. We have issued a class order conferring this relief: see [CO 11/272].

D Guidance on disclosure of registered holder

Key points

Respondents raised practical issues with the proposed guidance on the requirement to include details of the registered holder.

Disclosure of the registered holder can, however, provide useful information.

Proposed guidance

42 In CP 107, we proposed issuing guidance that notices for substantial holdings acquired through securities lending or prime broking must give full disclosure of the registered holder of the shares in which a relevant interest is disclosed.

43 This guidance reflects the current requirement in the prescribed forms to disclose the identity of persons registered as holders of the securities in which the substantial holder (or its associate) has a relevant interest.

44 All the respondents submitted that it would be impractical or difficult for ASIC to require disclosure of the identity of the registered holders. The practical difficulties with disclosure included:

(a) the lender or prime broker will not yet know who the current registered holder is before the securities are received or transferred to a borrower;

(b) as soon as a loan is settled through the CHESS system, the borrower can transfer those securities to another party, so any disclosure of who the registered holder of the securities is at that time may change before the substantial holding notice is lodged; and

(c) it imposes a significant administrative burden for some market participants (even with those participants only being required to file a summary of particulars).

45 Some submissions stated that disclosure of the identity of the registered holder may be inconsistent with the underlying policy of the substantial holding regime, or would otherwise not be useful information, because:

(a) in securities lending arrangements it is not useful to disclose the name of the lender, especially since it is ASIC's view that the lender will retain a relevant interest itself;

(b) information on initial signing of a prime broking agreement is not useful because the prime broker does not have voting control of the securities;

(c) when the registered holder is a nominee or custodian (including a prime broker) who must act on the instructions of their client, the information about the registered holder does not assist the purposes of the substantial holding disclosure regime. This reasoning is the basis for the exemption for nominees and custodians from having to lodge substantial holding notices on their own behalf;

(d) disclosure of the client positions that have reached the threshold on the basis of a prime broker's aggregated holding of client's securities places clients of large prime brokerages at an unfair commercial disadvantage; and

(e) the individual clients holding the securities that have been aggregated to make up the prime broker's substantial holding do not themselves hold a substantial holding and thus cannot exert material control over the company (nor can the prime broker).

46 One of the industry associations also submitted that the broad consensus view from their members was that traders are interested in knowing how the relevant interest arises under a prime broking agreement or securities lending, so they can factor this information into their analysis of the market. It is not important to know who the underlying clients are for positions reported in a substantial holding notice by a prime broker. Consequently, the association said that its members do not believe a prime broker should have to identify each underlying client.

47 Moreover, another respondent contended that aggregating client positions and disclosing their interest under a prime broking arrangement in effect unfairly places an additional disclosure obligation on them that is different to other investors and would not be required under the law in the absence of the prime broking agreement. It was also suggested that it could commercially disadvantage clients in some circumstances, by giving their competitors an insight into their business or creating unhelpful rumours and speculation about their investment objectives or motives. This, in turn, could deter institutional investors (particularly those in jurisdictions outside Australia) from investing in Australian listed securities.

ASIC's response

We consider that disclosure of the registered holder is important for ensuring an informed market and should apply to relevant interests arising from securities lending and prime broking. We have confirmed our guidance in RG 222.

Useful information: registered holders

48 In CP 107, we also sought feedback on what information about a registered holder was useful information. We recognised that this could mean just disclosure of the name of the nominee holder of the shares, rather than the beneficial owner.

49 Many respondents indicated that information about the registered holder of the shares is only useful market information when the registered holder is actually the entity that has or is deemed to have 'control' of the securities (e.g. the transferee where a relevant interest is disposed of by a lender once a substantial holding is obtained, or the beneficial owner of the shares rather than the registered holder). One respondent noted that disclosing the registered holder may be misleading or confusing in the absence of the entire chain of interests, which may be difficult to ascertain.

50 It was also submitted that the market does not need to know who the underlying clients are for a position reported in a notice (unless the client themselves is a substantial holder, in which case the client will also lodge a notice).

51 We also received feedback that the reference to registered holders facilitates the listed company, or its agent, in issuing tracing notices under Pt 6C.2 to establish beneficial ownership of shares.

E Feedback on workability of substantial holdings requirements

Key points

Some information on securities lending transactions is important for the market.

Concerns were expressed about multiple substantial holding notices for the same holding.

Suggestions were made for specific relief.

What is important information?

52 In CP 107, we sought feedback about how the requirements could be made more workable while retaining market transparency. To that end, we sought feedback about the type of information on substantial holdings acquired through securities lending or prime broking arrangements that is important for the market.

53 Generally, respondents indicated that the following information is important:

(a) voting control and removal of blocks or parcels that can affect voting control;

(b) general indication of trading volume and nature of the securities traded;

(c) identities of beneficial owners;

(d) for the party that lends securities, the existence of securities lending (but not necessarily the detail);

(e) the scheduled return date of borrowed securities; and

(f) the price at which the borrower of securities sell the securities.

Issues with aspects of ASIC's guidance

54 In CP 107, we sought feedback about whether there were any aspects of our guidance on relevant interest and substantial holdings disclosure requirements that are inappropriate for prime broking or securities lending. The following issues were raised by various respondents.

Multiple holders of relevant interests

55 Many respondents raised concerns about how the substantial holdings regime currently applies to securities lending (as described by ASIC in CP 107) such that multiple parties (i.e. the borrower, the lender and potentially others in the chain) continue to hold a relevant interest.

56 Some respondents were concerned this result was the consequence of a presumption that all loaned securities are physically returned when recalled by the lender. Other respondents were concerned this result was the consequence of a failure to acknowledge the potential disposal of the securities by a transaction other than a securities lending transaction.

57 Some respondents were also concerned that the holding of relevant interests by multiple parties was inconsistent with the principles of the legal effect of a transfer of the securities as determined in the securities lending agreements and as ratified in *Beconwood Securities Pty Ltd v ANZ Group Ltd* (2008) 246 ALR 361. That is, once settlement of the securities takes place through CHESS, the lender has effectively disposed of the securities to the borrower. If the securities are returned to the borrower in accordance with a recall notice, the transfer of the securities to the lender is treated as an acquisition of the securities from the borrower. The lender would not have the right to vote the securities. The lender also would not have control to dispose of the securities.

ASIC's response

It is consistent with the substantial shareholding regime that multiple substantial holders may notify relevant interests amounting to a substantial holding over the same parcel of shares. The detail provided in a fully completed notice can reduce the apparent noise that may be associated with this.

We are mindful of concerns about the implications of a subsequent borrower's actions. We remain of the view that it is prudent and good policy for the original borrower and lender to assume they retain their respective relevant interests.

Accordingly, we have provided class order relief for the original borrower and subsequent lenders, so they do not need to consider whether there has been a change to their relevant interest caused by a subsequent borrower's activities with those securities: see [CO 11/272].

When does a borrower gain a relevant interest?

58 One respondent contended that a relevant interest for the borrower does not arise until settlement of the loan (i.e. T+3). The reason for this is that, while the AMSLA creates a binding contract (a breach of which will give rise to damages), it excludes the availability of specific performance. Accordingly, the borrower does not actually have an ability to control the power of

disposal of those securities until such time as the borrower has taken delivery on settlement.

> *ASIC's response*
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> We do not accept this legal analysis and confirm our view that a borrower will have to consider its substantial holding notice obligations once it has a firm (legally binding) commitment to transfer the borrowed securities.

Substantial holdings and the business of prime broking

59 A common theme of many submissions was the difficulty in complying with the substantial holding requirements for prime brokers. While many submissions raised a number of constraints, they also contended more generally that recognising relevant interests in prime broking activity is inconsistent with the way securities are treated in this business. That is, securities are used to facilitate the operation of a prime broking business, rather than for the purposes of control. A substantial holding held by a prime broker would tend to be represented by a number of unrelated clients, each with a small holding, and that these aggregated do not in any sense ever translate to effective control for takeover purposes.

60 The constraints raised included the following:

(a) The strict requirement under s671B(3)(e) to disclose purchases and sales in the preceding four months in the case of an initial substantial holding notice, or movements since the previous notice, giving rise to the substantial shareholding was very problematic for prime brokers. This was because:

(i) the change in relevant interest on the part of the prime broker is constituted by the movement in the balance of the overall holdings in that security, held under prime broking arrangements by the prime broker for all of its prime broking clients. As such, the prime broker's relevant interest rises or falls based on the increase or decrease in the underlying client's holdings in the security that are subject to the prime broking relationship. The individual transactions are those of the client(s), not the prime broker. There is actually no purchase and sale or any other transaction by the prime broker. The prime broker does not pay or receive any consideration relating to the movements; and

(ii) reporting prior movements of stock held by a prime broker is not an accurate reflection of any trading in the security and may in fact give a misleading appearance of activity in the security. Disclosure of relevant interests arising from prime broking arrangements has tended to confuse some readers of notices, who may have been led to attach a greater significance to the existence of the relationship

than is the case. There have been instances where financial journalists have endeavoured to make sense of movements attributable only to prime broking movements as somehow reflecting control transactions, when that was not in fact the case.

(b) If the prime broker is not the executing broker, it may not be aware of these transactions until it is called on to settle the transaction as custodian, delivering or accepting stock or funds, where the trade has been executed by a different broker. There may also be a transfer by the client of stock out of the custody arrangement with the prime broker, but without there being any acquisition or disposal of the stock at all.

(c) The carve-outs for bare trustees (s609(2)), for foreign custodians under the *Foreign Acquisitions and Takeovers Act 2006* and for options (s609(6)) indicated legislators' intent to keep various types of transactions out of the reporting loop and prime broking arrangements fall into this category, as prime brokers are subject to client instructions and do not actively manage portfolios or client positions.

(d) If a client uses several prime brokers, no one prime broker would have the full picture of the activities of its client, so several prime brokers could be disclosing the relevant interest in the same pool of shares.

(e) Any transaction of securities available for loan by, or on behalf of, the client will result in a change in the prime broker's relevant interest. This leads to compliance difficulties, as the prime broker may not be aware of the client's transactions (e.g. where a trade is executed by an unrelated broker, or where securities are transferred into or out of custody for non-lending purposes).

61 Given the issues raised, we sought additional feedback on possible relief to allow a prime broker to disregard its relevant interest that arises from its borrowing rights in its assessment of compliance with s671B of the Corporations Act. The relief would only be available if the prime broker did not borrow securities from its client.

62 We received unanimous support for this relief:

(a) It was submitted that the majority of initial, cessation and subsequent change disclosure notices lodged by prime brokers are generated primarily by holdings and/or movements in securities held by prime brokerage clients, and that if some relief was given to prime brokers, the substantial holding notifications by prime brokers would decrease by 50–75%.

(b) Generally, prime brokers do not have a business need to exercise their right to borrow many of the client-owned securities. The total number of shares rehypothecated as a percentage of total client holdings may typically not be much more than 10%, and borrowing may not occur in over 75% of the names.

(c) Disclosure of substantial shareholding of prime broker client holdings does not enhance market transparency. Investors without a close understanding of the market may be misled by the inclusion of available prime broker positions.

(d) Market transparency would be improved by reducing the double-counting distortion that is currently taking place whenever both prime brokers and their clients lodge substantial holding notices that arise from, or are mainly attributed to, the same block of shares. The double-counting distortion is further exacerbated by the fact that many of the subsequent change notices submitted by prime brokers are due to increases or reductions in client-owned securities that result from executing account transfer-in or transfer-out instructions on behalf of clients.

(e) Consideration of relief from the relevant interest provisions should be applicable to all intermediaries involved in securities lending, such as prime brokers and custodians.

(f) As prime brokers are required to include all client-owned securities, prime brokers must devote considerable time and resources in identifying, tracing and reporting large volumes of client-owned securities that will never be used, despite the standard right-of-use clause included in prime broking agreements.

(g) If a client uses several prime brokers, no one prime broker would have the full picture of the activities of its client, so several prime brokers could be disclosing the relevant interest in the same pool of shares. A hedge fund may maintain relationships with a number of prime brokers for several reasons, including to reduce counterparty risk.

(h) The quality of information disclosed to the market will be improved. Only positions that are actually borrowed from the prime broker's clients should be disclosed. A number of respondents contended that market participants would benefit from the increase in market transparency resulting from having substantial holding notices focus on holdings actually owned by the substantial shareholder and exclude the double counting of the same block of shares.

63 One respondent noted that prime broking creates the capacity to deal with the disposal of large amounts of securities. Where particular securities, which are part of a participant's prime broking business, are combined with those held by the participant in its proprietary account, there is scope for a prime broker to act in a way that impacts corporate control. However, the respondent contended that, in their experience, this occurs so rarely that the benefit of disclosing the information to the market is greatly outweighed by the burden of doing so.

ASIC's response

We consider that where prime brokers assume rights to borrow or rehypothecate any securities credited to their client's account, these rights give rise to a relevant interest in the client's securities.

However, we have given relief so that a prime broker or custodian operating a securities lending program can defer taking into account any relevant interests arising from their prime broking activities, only for the purposes of ensuring their compliance with the substantial holding disclosure regime: see [CO 11/272]. This relief is only available if the prime broker does not exercise its right to borrow. If it does exercise this right, it must take into account the relevant interest arising from the borrowing.

Collateral

64 Some respondents submitted that the question of collateral should also be clarified and, if necessary, exempted from the substantial shareholding provisions by way of relief. They contended that there should be no difference between the treatment of collateral and the treatment of security for any other financial advance, and that there appears to be some doubt as to whether it is correct to say that the financial accommodation exception in s609(1) does not apply.

65 To support this view, it was submitted that lenders do not presently consider collateral securities in relation to their substantial holdings. It was also noted that collateral is merely used for security and is changed at short notice for a range of reasons (e.g. collateral is returned to the provider for corporate actions and replaced by other collateral or, by default, the collateral would be sold immediately to cover positions with any balance returned to the borrower).

66 In paragraph 25 of CP 107, we expressed the view that a relevant interest is likely to be obtained by a lender over collateral securities.

ASIC's response

We have issued guidance confirming our view that, in the usual course, a lender will acquire a relevant interest in the collateral securities: see RG 222.28.

Suggestions for specific relief

67 In CP 107, we welcomed suggestions for specific relief that ASIC should consider to improve compliance with the provisions while still achieving market transparency of substantial holdings and mitigating the risk of avoidance or the risk of warehousing.

68 We received a number of submissions suggesting types of relief with the purpose of removing some transactions from triggering a substantial holding notification requirement. These are summarised below.

Excluding certain relevant interests

69 Some respondents contended that information made available to the market needs to be succinct, clear and useful. The usefulness of substantial holdings disclosures in connection with securities lending can, however, be clouded by the lodgement of multiple substantial holding notices over the same parcel of shares. For example, the law may require that the on-lending of securities where the lender has the right to recall the securities means the lender retains an interest in the securities, even though those same securities may be transferred to another party or even multiple parties.

70 In this context, a number of respondents submitted that we should give relief to exclude certain briefly held relevant interests. A number of different options were given:

(a) Some respondents suggested that the lender should not have to lodge a substantial holding notice where the commitment to borrow securities from the underlying lender and to on-lend the securities to the borrower all occur on the same day, irrespective of when the physical settlement of the transactions take place (i.e. disclosure should be made on a net basis). It was also submitted that borrowed stock would then only need to be disclosed (if above the threshold) if it was not on-lent after a certain period (related to the settlement cycle). Some submissions indicated that a condition to this, to the effect that the disposing party must not have an intention to vote and did not vote the securities, was appropriate. One respondent suggested that this could be done by way of the lodgement of a 'cleansing notice' type approach (i.e. a single page end-of-trading-day disclosure obligation).

(b) Relevant interests of securities lending intermediaries should be ignored, except where an intermediary remains 'long' in a borrowed security (known as 'excess stock borrow'). It was noted that, if intermediaries are not excluded from the disclosure regime, then based on ASIC's proposed requirements that intermediaries record a relevant interest in every securities lending transaction they intermediate, many intermediaries would have to scale back their securities lending intermediary activities, for fear of breaching takeover thresholds. Without such intermediaries, it would be difficult for the securities lending market to operate efficiently as most borrowers rely on the intermediaries to source lenders for the stock they wish to borrow.

(c) Relevant interests should be excluded where their acquisition is associated with a corresponding short sale. It was submitted that the motivation of an investor that acquires a substantial holding by

borrowing in order to complete a short sale is quite different from that of an investor who acquires a long position for the purposes of holding the investment over time or as part of a takeover strategy. An obligation to report a transitory substantial holding on the way to achieving a covered short sale seems contrary to the purpose for which the substantial holding obligation was imposed. The short seller has no takeover, controlling or voting aspirations. Respondents also contended that a potentially greater concern is that reporting a substantial holding ahead of a short sale could mislead the market, by suggesting that a substantial long position is being taken by a party, when in fact the opposite—to 'short' the security—is intended.

71 Regarding the appropriateness of this type of relief, respondents submitted that the simplification would not compromise market transparency, as it would eliminate a significant proportion of transactions having no bearing on corporate control from the requirement to be disclosed in a substantial holding notice. Indeed, some respondents noted that such a measure would add to market transparency by eliminating a great deal of 'noise', and would in all probability lead to less confusion in the market arising from a misunderstanding as to the significance of these transactions. If a party was seeking to warehouse securities, they would not be able to achieve this by on-lending or selling the securities within the settlement cycle.

Matched borrowing and lending transactions for intermediaries

72 Given the initial feedback received, we sought additional feedback on relief to allow relevant interests to be disregarded for s671B purposes only where those relevant interests arise from a 'matched' securities lending transaction occurring within the same trading day. That is, where a securities intermediary borrows securities and on-lends those securities within the same trading day in the ordinary course of its business, then the relevant interests arising from the borrowing transaction may be disregarded by the intermediary in its assessment of compliance with s671B (to the extent borrowing and lending transactions match).

73 While we received support for considering broader securities lending relief, significant concern was expressed that our suggested relief did not go far enough or would not achieve sufficient benefits.

74 The feedback we received included:

(a) the suggested relief was a step in the right direction, but it did not meet the practical issue that arises when transactions are 'booked' with the intention of matching, which may or may not be on the same day. There could be a series of days that a security is borrowed in anticipation of being lent out. It was therefore suggested that relevant interest should

be based on the physical net holding at a given date, irrespective of when the borrowing and lending are entered into;

(b) direct lenders should be permitted under the relief to exclude all securities on loan from their substantial holding calculations, regardless of source and whether or not it was done on a matched basis;

(c) 'matching' is not required under the legal agreements governing securities lending and therefore the matching requirement was questioned; and

(d) it would be essential that the proposed relief apply to both the substantial holder and takeover regimes.

75 As an alternative, it was suggested that:

(a) in general, the ultimate lender and ultimate borrower of securities subject to a securities lending arrangement are the parties that should be required to recognise and, if applicable, report a relevant interest in the relevant securities, as they ultimately control the rights attaching to the securities;

(b) relief and/or clarification is required about the position of securities lending intermediaries. Specifically, a securities lending intermediary should only be required to recognise a relevant interest in securities subject to a securities lending arrangement on a net physical basis and, therefore, disregard any relevant interest in securities that are on-lent. This relief would alleviate multiple reporting of relevant interests in the same securities by different participants. The netting of positions should not be subject to a time test; and

(c) collateral securities provided should be treated in a similar manner. That is, the end recipient of those securities is the party that should be required to recognise and, if applicable, report a relevant interest in the collateral securities, subject to clarification with respect to reporting requirements.

76 It was also noted that if we were to give some form of matched transactions relief, it would be problematic because of the need to adjust systems and calculations, and that if ASIC were to limit this relief to matched borrowing and lending transactions only, there are potential cost implications associated with updating current systems to automate any matching trade. Such costs would outweigh the benefit of the proposed relief.

Ordinary course securities lending and prime broking transactions

77 One respondent contended that ordinary course securities lending and prime broking transactions should be exempted from the substantial holding

disclosure regime, as these transactions do not affect control outcomes for the relevant entity. Instead information should be provided on the following:

(a) for the party that lends securities, on the existence of (as opposed to the detail on) securities lending which would take a substantial holder below a disclosure trigger point (e.g. 5% or a 1% change);

(b) in both lending and borrowing transactions, the number of securities involved; and

(c) the scheduled return date for the securities (or, if open-ended, then that fact).

ASIC's response

We consider disclosure of substantial holdings, including those arising wholly or partly from securities lending, to be important for an informed market. It is also consistent with the substantial holding regime that multiple substantial holders may notify relevant interests amounting to a substantial holding over the same parcel of shares. We consider that it would not achieve the purpose of the provisions to exempt certain securities lending transactions from consideration.

Appendix: List of non-confidential respondents

- Australian Bankers Association
- Australian Custodial Services Association Limited
- Australian Financial Markets Association
- Australasian Investor Relations Association
- Invesco Australia Limited
- Law Council of Australia
- National Australia Bank Limited
- QBE Insurance Group Limited
- Riskmetrics Australia
- Securities & Derivatives Industry Association