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Fiona Laidlaw
Senior Lawyer, Corporations
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001

Email: Fiona.Laidlaw@asic.gov.au

Dear Ms Laidlaw

Consultation Paper 319: Securities lending by agents and substantial holding disclosure

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on *Consultation Paper 319: Securities lending by agents and substantial holding disclosure* (the Consultation/the Consultation Paper). AFMA's membership includes many firms who participate in providing prime brokerage and agent securities lending services. We are interested to support improvements to the regulatory framework particularly where these drive efficiencies in business practices.

AFMA supports ASIC's proposal to replace the current class order (CO 11/272) with a legislative instrument made under subsection 673(1) of the *Corporations Act 2001* (Corporations Act). These are long standing arrangements and it is entirely appropriate that they are moved to a permanent status by modifying the law under ASIC's delegated power.

We also support ASIC's intention to clarify the requirements for agent lenders and to ensure there are appropriate exemptions made that are a good fit for agent lenders and include these in the legislative instrument.

AFMA as a markets-based association, and in order to ensure markets are trusted and well informed, supports the appropriate provision to markets of high-quality information.

AFMA also supports ASIC's view with regard to the appropriate interpretation of sections 608 and 609 of the Corporations Act and their implications for the associated substantial holding disclosure requirements given the current regulatory framework, however, we do support some further exemptions for agent lenders that would adjust the application of these sections. We discuss the reasons for these adjustments below.

We caution against reading too much into the scope of drafting of section 608. As has been the standard practice that is reflected in many parts of the Corporations Act and elsewhere section 608 is drafted broadly in order that there is little scope for novel arrangements to be found that avoid the provisions and accompanying obligations.

This overly broad application was never intended to hold or to be read as a guide to the appropriate scope of 'relevant interest', it was designed to be reduced by subsequent restrictions, first in section 609 and subsequently by the powers afforded to ASIC.

This process of refinement has over the years been achieved by various other instruments including the class orders and instruments issued by ASIC. These have allowed sensible and efficient outcomes consistent with the requirements of the ASIC Act. ASIC's very first legislated obligation is to find such efficiencies and reductions in business costs:

> "maintain, facilitate and improve the performance of the financial system **and the entities within that system** in the interests of commercial certainty, **reducing business costs**, and the efficiency and development of the economy" Australian Securities Investment Commission Act Part 1 Division 1 Section 1 (2) (a) [emphasis added]

We are firmly of the view that in light of ASIC's purpose in the Act and the relevant facts we will outline below it is appropriate to extend the exemptions currently in place to remove agent lenders entirely from the relevant interest and hence substantial holding disclosure requirements.

Benefit of substantial reports from agent lenders

AFMA holds that reporting by agent lenders will be not just of no value to the market and investors, but will actually be detrimental. Investors and the market more generally are not interested in the holdings of those with only technical or administrative 'relevant interests' and their reporting confounds actual data of interest, which is that from holders with substantive control over companies.

We see no arguments for keeping agent lenders within the obligations *based on the value of the substantial holding disclosures* because these reports would not be a benefit and would instead impose a cost on investors and the market to remove the noise they would create.

This consultation should be of benefit to ASIC in providing information directly from the industry on the value of information on substantial holdings from the lenders themselves. The industry view as represented by AFMA is that this information is either of no value or actually detracts from investor understanding.

We agree that s671B is important for market integrity in a broad sense, but this does not mean that all information that could be caught by this section can contribute to market integrity.

We disagree that substantial holding information *from agent lenders* can be important especially when a listed entity is subject to a control transaction. This is not consistent with the feedback we

have received. The clear view from industry is that this information will not contribute to market integrity.

We believe this feedback should address the responses in Table 1 (our response in italics):

> Similarly, s671B is important for market integrity in a broad sense and not solely for the control of listed entities.
>
> *The information provided by agent lenders will not assist the market.*
>
> Substantial holding disclosure by agent lenders and other intermediaries can be important, especially when a listed entity is subject to a control transaction.
>
> *This is not consistent with the feedback we have received from the industry.*
>
> An agent lender's substantial holding disclosure will not usually duplicate the client's disclosure (because they have different relevant interests). The nature of the agent lender's interest should be made clear.
>
> *While it is true the reporting may vary the information provided, it is still of no assistance to the market.*

Arguments from the current structure of sections 608 and 609

As noted, we support ASIC's view that the current structure of sections 608 and 609 are properly read to include agent lenders as currently drafted. However, its crucial to bear in mind that section 608 was drafted broadly in order to capture as much activity as possible to prevent avoidance. As is common in much of the Corporations Act the expectation of the drafters was that exemptions to the general rule would have to be made as demonstrated by the delegated powers given to ASIC to alter the law in the light of practice and future market developments, which were not foreseeable to the drafters. As such we do not view it as appropriate to rely on the current drafting of these sections as a basis for limiting determining what other refinements might be appropriate.

We believe this feedback should address the responses in Table 1 (our response in italics):

> The relevant interest provisions are intended to have a broad application, as evidenced by the drafting of s608 and the narrow exceptions available in s609. For this reason, we rarely grant an exemption from s608.
>
> *The broad drafting in s608 is consistent with other parts of the Corporations Act (e.g. the definition of 'derivative') and require multiple exceptions and reliefs to avoid illogical and inefficient outcomes and to fit standard business practices in a sensible way. Under these circumstances the drafting style of section 608 should not be a reason to rarely grant exemptions. Exceptions should continue to be granted where the logic suggests they are consistent with the underlying aims of the policy.*

Section 609 only exempts bare trustees. Other trustees who owe a fiduciary duty to beneficiaries are not exempt from the relevant interest provisions. This shows that fiduciary obligations are not a sufficient reason to grant a broad exemption.

Similarly, other intermediaries involved in securities lending are subject to AFS licensee obligations, but do not have an exemption from the relevant interest provisions under s609 or ASIC legislative relief.

This response by ASIC is to the specific objections that agent lenders owe fiduciary and other obligations flowing from their licence, the response reflects the present state of exemptions and does not respond to the total risk profile created by the combination of the fiduciary duties, the licence obligations, and the wider context of what the powers of the agent lender are actually for. Taken together these factors should build confidence that the powers are legally and contractually restricted to be not of a character to be of concern or interest for investors or the wider market.

Further, from a policy perspective ASIC's proposal to penalise these contract terms with substantial and risky obligations will create business incentives for agent lenders not to have recall optionality in place. It is important to note that this is not in the interests of clients or the market. Even proscribed limited optionality could be disadvantageous to clients in the event of an unexpected development which the agent lender would currently with the catch all provisions be in a position to assist. ASIC's proposals should, consistent with the requirements of the ASIC Act, improve the efficiency and effectiveness of business processes.

We consider it is appropriate to assess legislative relief based on a person's legal rights, rather than representations as to how those rights are exercised in practice. The exercise of legal rights can be inconsistent across industry participants and can change over time. Based on the authorisation agreements we have reviewed, an agent lender's discretion over loaned securities and collateral securities (i.e. to terminate securities loans) is broad and not subject to restrictions.

The same policy reasoning applied above also applies to this concern. ASIC's assessment should look to avoid creating incentives for outcomes (no or very limited discretion to recall) that are disadvantageous to clients.

Further, this reasoning does not acknowledge the substantive commercial relations at play. In a market-based economy these forces are real, stable over time and should be factored into calculations about the motivations for firms and individuals and what this means for the practical reality of arrangements. The possibility that a legal clause in a contract put there for the protection of clients could in theory be used against them should face some measure of discounting when it is noted that the agent lender is providing a service to the lender for which it is, and wishes to continue to be, compensated, and is operating a business with a reputation it wishes to preserve.

We decline to put forward an opinion on the arguments from analogy, our view is that a balanced view of the totality of the arrangements between agent lenders and their lending clients will support the view that the capture of agent lenders in section 608 is on technical and not substantive grounds.

We have noted the lack of benefit to the market from reporting. We also note that requiring reporting will result in substantial costs for agent lenders. Lenders will be required to constantly monitor and report changes based on actions of others, for no gain to the market.

The incurrence of costs for no benefit is, by definition, inefficient. Increasing business costs, decreasing efficiency and harming the entities that make up the financial system is inconsistent with the requirements of the ASIC Act.

We respond to the specific questions in the consultation below:

> B1Q1 Do you have any comments on the terms of the deferral relief in proposed s609(10C)?

While this proposal is preferable to no relief as per the discussion above our preference is for agent lenders not to have a relevant interest at any point.

> B1Q2 Will the proposed deferral relief make substantial holding disclosure more practical for agent lenders?

The proposal is far more achievable than no relief, given the need to track each principal lender's trading activities including through related parties in individual securities if no relief at all is given, a challenging task.

> B1Q3 Will the proposed deferral relief deprive the market of useful information about an agent's relevant interest in lending pool securities?

No. There will be no useful information lost through the delay proposed both for reasons paralleling those relevant to prime brokers and that the reporting entity is the agent lender.

> B1Q4 Will proposed s609(10C) cover most agent lending arrangements? If not, please explain why not and what type of agent lending arrangements will not be covered.

The responses we have received suggest they will, however, we note the possibility there may be arrangements of which we are not aware.

> B1Q5 Proposed s609(10C) refers to the agent providing services to the lender 'as part of carrying on a custodial business'. Does the definition of 'custodial business' in proposed s609(10E) adequately describe the business of agent lenders? If not, please explain why not.

No, we see a flaw in the current construction. It is important that the definition be amended to separate agent lending services from custodial business. The two are not necessarily connected and we are aware of examples where the agent lender does not act as custodian and receives the securities

from the custodian only on receipt of a borrow request. We presume the intent was not to exclude circumstances such as this.

> B1Q6 Our proposed relief (including proposed s609(10C) and 671B(4B)) uses the term 'authorisation agreement', which is defined in proposed s671B(4C). Will our proposed definition of authorisation agreement cover most agreements used by agent lenders? If not, please explain how the definition should be amended.

While the proposed definition is aligned with typical agreements we do not agree that the case has been made for such prescriptive restraints on the construction of contracts.

In a market-based economy parties should be generally free to contract with each as they see fit, particularly where both parties are wholesale entities and there is no retail element to the transaction. For this freedom to work in practice as well as in theory there needs to be flexibility in contractual arrangements that will be acceptable. Regulation can prevent innovation and ultimately have an impact on the competitiveness of the Australian economy.

> B2Q1 Do you have any comments on our proposal to modify s608 so that an agent lender retains a relevant interest in loaned securities when its client retains a relevant interest due to notional s608(8A)?

We do not agree with this proposal.

As noted above we see extending the relief for agent lenders as the course most consistent with the ASIC Act's requirements when implementing exemptions and relief in relation to section 608.

Please refer to earlier in this letter for our full arguments on this topic.

> B2Q2 Will this make substantial holding disclosure more practical for an agent lender?

No, AFMA holds it will not in comparison to granting more general relief.

> B3Q1 Do you have any comments on our proposal to give agent lenders relief from the need to disclose consideration relating to a substantial holding under proposed s671B(3B)?

AFMA supports a more general relief provision. Noting this relief from disclosing consideration is appropriate due to the nature of securities lending transactions.

> B3Q2 Will our proposal to give relief under proposed s671B(4B), so that authorisation agreements do not need to be attached to a substantial holding notice, make compliance with s671B(4) easier?

While noting our response to B3Q1, yes, providing some relief will make compliance less difficult.

> B3Q3 Is proposed s671B(4B) likely to deprive the market of useful information?

No.

> B3Q4 Our proposed relief is conditional on the substantial holder providing ASIC or the listed entity with a copy of the full documentation on request. Is this reasonable?

It is inappropriate to require the disclosure as a matter of course of the documentation. ASIC can request disclosure under its existing powers if required.

> B3Q5 Unlike other securities lending agreements, we understand there are no standard authorisation agreements for agency arrangements. Should our relief be conditional on the agent lender posting the form of agreement it uses on its website?

AFMA disagrees with a requirement to publish commercially sensitive information about private contracts in order to gain relief from an unnecessary regulatory burden.

> B4Q1 Do you consider that we should give a broader exemption from s608 so that an agent lender does not acquire a relevant interest in any securities under authorisation agreements? Please address the issues set out in paragraphs 43–44 and in Table 1.

Yes, AFMA supports the provisions of a broader exemption from section 608 so that an agent lender does not acquire a relevant interest in any securities under authorisation agreements. Not exempting agent lenders from the relevant interest requirements will create a substantial, difficult and inefficient regulatory burden for no gain to the market.

Please see our responses in the letter above to ASIC's responses in Table 1.

Similarly, our discussion in the letter above deals with the concerns raised in paragraphs 43-44. To this we would add that the statement in paragraph 43 that "An exemption from s608 would allow an agent lender to have power over the disposal of 20% or more of a listed entity's voting securities" goes to the heart of the issue. The 'power' is technical, administrative and its use against the wishes of the client is constrained by the forces in a market economy. The proposal is at risk of missing the larger picture of the risks at stake and in doing so creating an unnecessary burden for the market and ultimately investors.

In relation to paragraph 44 we again note that the information is not of use to the market and may contribute to noise that can be confusing for those not very familiar with the intricate workings of the industry.

> B4Q2 Do you consider that we should grant an exemption from s671B for loaned securities and collateral securities so that agent lenders are still subject to s606 for these securities, but do not need to disclose substantial holdings?

No. AFMA supports an exemption from section 606 as well for agent lenders on the same grounds that support a substantial reporting exemption.

B4Q3 Would an exemption from s671B for these securities deprive the market of useful information about agent lenders' substantial holdings?

No. Reporting on an agent lender's holdings could result in more confusion than clarity.

B5Q1 How do agent lenders comply with diverse international disclosure obligations? For example, do agent lenders need to monitor holdings on a jurisdiction-specific basis to comply with various international requirements?

We have not been advised of any requirements in this regard.

B5Q2 What systems do agent lenders have for monitoring their holdings and transactions for complying with international regulatory requirements? Can these systems be used for compliance with Ch 6C obligations?

Firms have not advised us of any systems that could be used for used locally. Local firms do not have access to such systems.

B5Q3 What systems do agent lenders currently have for monitoring their holdings and transactions in Australia: (a) to comply with substantial holding requirements; or (b) for other purposes (e.g. compliance with contractual obligations or AFS licence obligations)?

There are a wide range of systems some commercial and some proprietary that are used by our members.

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We thank you for considering our comments and welcome further dialogue on the issues raised.

Yours sincerely

Director of Policy and Professionalism