



International Securities Lending Association (ISLA) Operations Market Best Practice Committee

**STATEMENT OF MARKET GUIDANCE:
MANUFACTURED INCOME COLLECTION**

Background

When securities are lent to a borrower, the borrower is contractually bound to pay a manufactured dividend for all announced and paid dividends, at the dividend rate agreed between lender and borrower at the inception of the loan, or as re-negotiated any time thereafter until the loan is closed.

The GMSLA (clause 6.1) states that Manufactured Payments should be paid “on the date of the payment of such Income, or on such other date as the Parties may from time to time agree”. Typical market practice currently is for borrowers to pay lenders after the announced dividend pay date following receipt of a claim letter from the lender. Delayed payments cause financial losses and/or client relationship concerns to the lending agent. Moreover for those lending agents that advance income payment to their clients, any delay in the payment is basically an uncollateralized loan from the lending agent to the borrower.

Actions are outlined below that would improve the current manufactured dividend process. After careful analysis involving input from lenders and borrowers, it has been concluded that the most efficient way of collecting manufactured dividends is if both borrower and lender are taking advantage of the available automated reconciliation platforms.

It should be noted that this paper does not seek to override any existing contractual obligations agreed between parties in their lending agreements but instead seeks to outline PRACTICAL operational best practice measures for the Securities Lending community.

Issues

There are a number of issues around current market practice that have a significant financial impact to lenders in the form of costs to fund dividend payments on market pay date to beneficial owners and the manually-intensive operating procedures.

These issues include:

Fax Claims: Claims are generally sent via fax and borrowers often claim non-receipt, causing duplication of effort and delayed payment.

- Some borrowers insist that “official” hard copy claims are needed prior to payment.

Discrepancies: There are often discrepancies in the share amount, dividend rate, tax rate etc. on the relevant ex-dividend or record date, which coupled with delays in reconciliation, delay payment.

- Tax Rate discrepancies – these problems are usually generated by the inability of the borrower’s front office to act upon dividend rate change letters in a timely manner (i.e. prior to record date).
- Partial payments – borrowers will not pay partial payments, where the lender is looking for an amount different to what the borrower wants to pay.
- Distribution Type discrepancies – Sundry Other Income distributions, Dividend distributions vs Return of Capital, tax free distributions.
- Documentation – borrowers looking for certain tax documentation (e.g. UK borrowers requiring Appendix C/MOD 2).
- Auto-compensation – some sub custodians treat loans as buy/sell activity and process auto-compensation based upon market entitlement.

In order to limit financial exposure and improve overall efficiencies of the manufactured dividend collection process, ISLA are proposing that an automated application be used to identify and reconcile outstanding manufactured income payments.

The proactive and regular usage of a CONTRACT COMPARISON platform has been shown to dramatically reduce a number of operational issues frequently associated with resultant late / delayed payments (e.g. resolution of dividend rate / quantity breaks prior to record date).

Lender Claims

As a matter of good market practice, it is recommended that lenders should submit claims to borrowers between Pay date-5 and Pay date+3 and ideally as close to pay date as possible. Inclusive with the claim, the lender should include all relevant documentation (e.g. Appendix C, residency forms, tax vouchers.)

It is recommended that claim letters be sent electronically using an automated reconciliation platform. Alternatively, e-mail in an Excel and/or PDF format should be used. A standard format is recommended to facilitate future upload to the automated platforms.

The claim should contain the following information:

Security Name, Cusip/Sedol/Isin, Shares, Record Date, Pay Date, Ex-Date,
Dividend Rate/Coupon Rate, Tax Rate, Currency, Amount,
Borrower, Payment Instructions, Lending Agent contact information, Claim
Reference, Comment Field.

The borrower and lender should work together to confirm that the claim was actually received by the borrower. Lender and borrower should also bilaterally agree on the threshold where claims are to be considered de minimis and not sent.

Reconciliation and partial payments

Lenders and borrowers should reconcile outstanding manufactured income payments daily. The recommended method of communication is via an automated reconciliation tool. Alternatively, firms may email an Excel spreadsheet noting all the open claims. In the event that counterparties do not agree on a payment amount, both parties should carry out reconciliation in a reasonable period of time to prevent loss of funds to a lender. Borrower and lender should demonstrate active participation in resolving all reconciliation issues.

If a partial payment can be made to a lender when a difference occurs, for example, when a tax rate difference or share amount difference is causing an exception, the counterparties should bilaterally agree on a partial payment arrangement. On partial payments, all information should be readily available until both borrower and lender have resolved the manufactured dividend even if one of the counterparties no longer shows the claim as being open. Please note that borrower overpayments and aged payables are to be considered an un-reconciled discrepancy to be resolved with the same sense of urgency as all other discrepancies.

Borrower Payments

The borrower should send a pre-notice the day prior to, but no later than payment date, for any manufactured income payment being made to the lender / lending agent. The recommended method of communication is via an automated reconciliation tool. Alternatively, email can be used. The pre-notice should contain the following information. There may also be a requirement for the lender to advise their agent to receive the funds. Failure to do so may lead to the payment being rejected.

Security Name, Cusip/Sedol/Isin, Shares, Record Date, Pay Date, Ex-Date,
Dividend Rate/Coupon Rate, Tax Rate, Currency, Amount, Value Date,
Claim Reference if available, borrower contact information.

The borrower should make the substitute payment on pay-date where possible and, following pay-date, no later than claim receipt date (inclusive of relevant tax documentation) +1 (business days). Borrowers should chase lenders that do not provide timely claims. Bulk payments should be made, as long as information to identify individual claims is provided in the pre-notice. The borrower should provide a valid reason if payment cannot be made (e.g. share position break, tax rate discrepancy, calculation error, loan partially closed). Once payment has been received by the lender, the past due claim should be closed within 48 hours.

In the event that the borrower states that payment has been made but the lender does not recognize receipt, the borrower is responsible for providing a reference number for the payment, allowing the lender to locate payment.

The lenders' non-receipt or unrecognized receipt of payment should have no effect on the billing obligation to the borrower.

Claiming for Loss of Funds

In the event that a borrower does not pay manufactured income payments or holds back any undisputed funds from payment, the borrower will be liable for any claims, due to loss of funds on the actual amount due. When executing a claim for compensation,

multiple factors will be taken into consideration. Below are the recommended criteria for compensation claims, however any of the criteria can be changed/deleted based upon borrower/lender bilateral agreements. Recommended criteria:

\$1,000 will be the minimum claim value sent to a borrower or as bilaterally agreed and can incorporate **multiple income items** where relevant pay dates allow.

- Loss of funds claims can be issued from **the later of pay date or income claim receipt date** and within 30 days of value date of the manufactured income receipt.
- \$1,000 will be the minimum claim value sent to a borrower or as bilaterally agreed and can incorporate **multiple income items** where relevant pay dates allow.
- **It should be recognized that this claims process also applies to income due to borrowers on pledged collateral.**
- It is recognized that issuance of individual claims is time consuming, consequently on a bilateral basis alternative methods of calculating incurred costs and subsequent claims can be agreed e.g. claims based on an aggregate balance carried over an agreed period of time.

Exclusive lending agreements – it is common, that when exclusive agreements are in place, the borrowing counterparty is responsible for ensuring all client costs, including loss compensation, are fully funded.

Summary

- It is recommended that Manufactured Income claims should be communicated via industry standard vendor comparison tools negating the need for individual hard copy claims.
 - In the absence of the above, a standard Excel or PDF format communicated via e-mail is acceptable.
- The borrower should make the substitute payment on pay-date where possible and, following pay-date, no later than claim receipt date (inclusive of relevant tax documentation) +1 (business days).
- Payments should be pre-advised to the lender (where applicable the lenders agent should be advised to receive).
- As a matter of good market practice, claims should be “issued” by lenders to borrowers between pay-date -5 and pay-date +3.
- Use of contract comparison tools is recommended to reduce the number of reconciliation breaks.
- All supporting documentation should be sent to the borrower in pdf format at the same time the claim is communicated.
- Reconciliation should be carried out proactively with relevant commentary supporting identified breaks.
- Paid claims should be removed promptly from the outstanding claims reconciliation to avoid unnecessary re-work.
- Loss of funds claims for late settlement of manufactured income payments should be bilaterally agreed.