December 2004

SECURITIES BORROWING AND LENDING CODE OF GUIDANCE

Contents

A INTRODUCTION

1. This Code, which has been drawn up by the Securities Lending and Repo Committee, a committee of market practitioners, sets out, for guidance, a summary of the basic procedures which UK-based participants in securities lending/borrowing of both UK domestic and overseas securities observe as a matter of good practice. It is derived from current practices observed by leading participants in the securities lending/borrowing market and will be kept under regular review.

2. The Code is intended to apply to all participants in the securities borrowing and lending market, including beneficial owners, pension and other fund managers and trustees or, as appropriate, their agents or advisors. The Code applies to participants even when a function has been outsourced, for example to a custodian. All participants, including all relevant staff of participant firms, are expected to be familiar with and understand the Code (including the UK Annex -see paragraph 6 below). All participants or, as appropriate, their agents or advisors should undertake to refresh their understanding of the Code on at least an annual basis and ensure that new recruits to the market, including newly appointed trustees, are made aware of the existence of the Code and its relevance to their responsibilities.

3. The Code does not in any way replace existing regulatory requirements or firms' internal systems of management control: adherence to the Code should therefore not be regarded as affecting the need for all participants to observe existing UK regulatory requirements and to satisfy themselves independently that adequate internal controls are being exercised over all aspects of their participation in securities lending/borrowing. The Code is not intended to override or conflict with the internal rules of individual settlement systems in respect of relevant borrowing or lending transactions.

4. This version of the Code supersedes that agreed by the Committee in December 2000. It has been approved by the Committee to come into immediate effect.

5. The Code has been written in plain English with the avoidance, where possible, of jargon, in order to be accessible to as wide a readership as possible.

6. The Code should be read in conjunction with the UK Annex to the Code (first issued on 11 May 2004 and updated in December 2004) which is intended to assist market participants in applying the Code to transactions involving UK securities. The code can also be read in conjunction with *An Introduction to Securities Lending* (published in March 2004) which provides a description of the securities lending market and was commissioned by the Securities Lending and Repo Committee, The Association of Corporate Treasurers, the British Bankers' Association, the International Securities Lending Association, and the London Stock Exchange. This is available on the websites of the commissioning organisations.

Coverage of the Code

7. This Code is intended to apply to the full range of securities lending transactions, including loans of gilt-edged securities (see paragraph A8 below), by all UK-based participants – i.e. by principals making markets and trading; brokers intermediating in the securities lending market; end users lending stock from their own portfolio; and agents (such as fund managers and custodians) undertaking stock lending business on behalf of their principal clients. Most participants are *market professionals* who are active in both the domestic and international markets, generally transacting under the Global Master Securities Lending Agreement, which is referred to in this Code as the "Securities Lending Legal Agreement", or its predecessors (described in B5 of this Code).

8. The Gilt Repo Code of Best Practice, drawn up by a working party of market practitioners and regulators under the Chairmanship of the Bank of England, is also relevant to stock borrowing and lending transactions involving gilt-edged securities.

9. The words "lending", "borrowing", "collateral" and related expressions used in this Code reflect market terminology. Under English law, full title to securities "borrowed" or "lent" and "collateral" provided passes from one party to another, the party obtaining title being obliged to deliver back equivalent securities/collateral. This Code is not intended to apply to transactions in which title to the securities/collateral does not pass.

Regulation

10. Any person who conducts securities borrowing or lending business in the United Kingdom would generally be carrying on a regulated activity in terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and therefore would have to be authorised and supervised under that Act. Individuals involved in securities borrowing and lending may be subject to the FSA's approved persons regime. The securities borrowers or lenders would, as authorised persons, be subject to the provisions of the FSA Handbook, including the Inter-Professional Conduct chapter of the Market Conduct Sourcebook; and they would also have to have regard to the market abuse provisions of the Financial Services and Markets Act 2000 and the related Code of Market Conduct issued by the FSA. The Conduct of Business Sourcebook may require a beneficial owner's consent to stock lending on its account. The FSA Handbook contains rules, guidance, and other provisions relevant to the conduct of the firm concerned in meeting the FSA's High Level Standards.

11. Providers of electronic trading platforms, used by some participants in the securities borrowing and lending market, may be regulated as the operators of Alternative Trading Systems (ATSs), which have a dedicated regulatory regime in the United Kingdom set out in section MAR5 of the FSA Handbook.

12. Securities borrowing and lending activities are also subject to regulation in other member states of the European Union given the general regulatory requirements of the Investment Services Directive. Firms incorporated and authorised in one member state may conduct stock borrowing and lending activities in other member states under the passport arrangements, although they may be subject to local conduct of business rules.

Queries or complaints

13. Questions on this Code or the UK Annex, or proposals for change or improvements to either, should be addressed to the Secretary to the Securities Lending and Repo Committee, c/o the Bank of England. Additional copies can also be obtained from this source/or from the Bank of England's or the International Securities Lending Association's website.

14. The regulatory authorities are not responsible for the enforcement of this Code although participants may wish to make them aware of possible misconduct in the securities lending market; it will, of course, be for those authorities to consider what action if any, they should take under their own rules in response to such information. Neither the regulatory authorities nor the Securities Lending and Repo Committee can undertake to act as arbitrator in the event of disputes between participants.

B STANDARDS

1 General Standards

1.1 The UK's wholesale financial markets have a reputation for the professionalism of the firms that participate in them and of their employees. All participants in the securities lending market have a common interest in maintaining this reputation. They also have a common interest in ensuring that the securities lending market operates in a sound and orderly manner. To achieve these aims, it is essential that firms and their staff adopt prudent practices, act at all times with integrity, and observe the highest standards of market conduct. The following paragraphs cover aspects of this.

1.1.1 Participants should act with due skill, care and diligence; to this end, staff should be properly trained in the practices of the securities borrowing and lending market and be familiar with this Code.

1.1.2 Participants must accept responsibility for the actions of their staff.

1.1.3 Market professionals should pay particular attention to ensuring fair treatment for and between clients who are not also market professionals where conflicts of interest cannot be avoided.

1.1.4 Participants in securities borrowing and lending should at all times treat the names of parties to transactions as confidential to the parties involved.

1.2 In order for the benefits from the securities borrowing and lending market to accrue generally to market participants, it is essential that securities lending activity does not distort the market either in borrowing/lending or in the securities themselves. To this end, participants in the securities lending market must not in any circumstances enter into transactions or holding arrangements designed to limit the availability of a specific stock or with the intention creating a false or distorted market in the underlying securities. In this connection, market participants should comply with relevant regulatory provisions on market abuse whether under the Financial Securities and Markets Act 2000 or otherwise.

1.3 Participants in the securities borrowing and lending market have a general responsibility to ensure that their activities do not cause market disruption through fails, or lead to reputational damage to the market. Although there are circumstances in which it is legitimate or necessary for a participant to take a naked (no securities borrow in place) short position, market participants are generally discouraged from selling a security short before they have put in place arrangements, whether in the securities lending market or otherwise, to ensure that they will be able to fulfil their delivery obligations.

2 Preliminary Issues

2.1 All participants should ensure that there are no legal obstacles to their undertaking securities borrowing and lending transactions and that, where necessary, they have all relevant permissions from their regulatory authorities. They should become familiar with the rules, procedures and conventions of each market in which they will operate and should be aware that differences in national market infrastructure can have significant implications for the business and its associated risks. Participants should ensure that they have established – and fully understand – their tax position in relation to securities lending transactions. Such transactions should be carried out in accordance with the relevant market and tax regulations.

2.2 Participants should be familiar with the settlement systems and functionalities that they use for the transfer of securities and the associated payments.

2.3 Where relevant, participants should ensure that they have appropriate prior authority from the beneficial owners of the securities, or from a party suitably authorised by the beneficial owners, for the securities to be lent. Beneficial owners should understand the implications when securities are lent.

2.4 Participants should ensure that they have adequate systems and controls for the business they intend to undertake. These should include the following items.

2.4.1 Participants should establish, retain and periodically update their documentation so that it is adequate to cover the types of transactions that are to be undertaken.

2.4.2 Management should maintain a list of those authorised to borrow or lend securities on its behalf and should make this list available to its counterparties on request.

2.4.3 Parties should have suitable internal controls designed to ensure that any securities loans have been properly authorised before securities are delivered against an obligation to lend.

2.4.4 Clear and timely records should be available to the management of any party involved in securities lending and borrowing showing, inter alia, the value of securities borrowed/lent, collateral given/taken and, where appropriate any fee income received. This information should be available in aggregate and by counterparty to enable accurate monitoring of credit risk.

2.4.5 Parties in securities lending transactions should monitor their exposure to their counterparties on a real time basis. Appropriate exposure limits should be maintained for all counterparties and, whether part of a group limit or a solo limit for the party concerned, should be reviewed on a regular basis. Particular attention should be paid to any loans which have been made on an uncollateralized basis.

2.4.6 All participants should be alert to possible settlement risks and take steps to ensure that daylight exposure is recognised and properly controlled; this should include controls on the replacement or renewal of collateral. Where securities and collateral do not move within the same settlement system or country, particular care should be exercised to ensure that value for security is provided in a timely fashion to minimise daylight exposure and settlement/ counterparty risk. This may include requirements for the pre-delivery of collateral in appropriate cases.

2.4.7 There should be adequate systems to account, for tax purposes, for any manufactured payments in accordance with the relevant regulations. Participants need to be aware that, for certain types of securities or collateral, the tax rules of jurisdictions other than the UK may also be relevant.

2.5 The following paragraphs cover procedures which should be undertaken before entering into securities borrowing and lending transactions with a new counterparty.

2.5.1 Parties in a securities lending transaction should disclose to their counterparty the capacity – principal or agent – in which they are acting and should also ensure that they are clear as to the capacity of their counterparty. Where the lender is an agent, the parties should agree appropriate arrangements for the identity of the principals on whom the risk is taken to be established before each deal is done, at least by means of an agreed identification code.

2.5.2 Participants should ensure that they have agreed documentation, and have assured themselves of its effectiveness, particularly, for example, in respect of non-UK incorporated counterparties, and that they, or a competent person, have undertaken a thorough credit assessment of the counterparty. Where lenders ask, for example, custodians to undertake credit assessment on their behalf this should be reflected in the agreement.

2.5.3 Participants need to establish whether their counterparty is a member of any relevant exchange as this may mean that they are subject to particular rules which could affect the way in which they deal with certain events during a securities loan.

2.6 Before dealing for the first time with a client who is not a market professional, market professionals should either confirm that the client is already aware of this Code (including the UK Annex) and its key contents, or draw them to the client's attention. All parties should have a clear understanding of where the risks lie.

2.6.1 Market professionals should check whether the new client has a copy of this Code and if not, either send them a copy or refer them to the Bank of England's or the International Securities Lending Association's website.

2.6.2 Such participants should inform the new client, if they are new to securities borrowing and lending, that the Code recommends that:

- Transactions should be under the Securities Lending Legal Agreement or equivalent;
- Transactions should be marked-to-market regularly and recollateralised as appropriate;
- Participants should take possession of securities or collateral or use an independent third party;
- Clients should be reminded that it is for them to decide whether to seek independent advice.

2.6.3 Such participants should also inform the client that there could be tax consequences from entering into securities borrowing and lending transactions, in particular, with regard to dividends and manufactured dividends, on which they might need to seek professional advice.

2.6.4 Where such participants will be borrowing securities from clients – whether as a final borrower or intermediary – they should make it clear to the lender that any voting rights will be transferred along with title to the securities and the client is not therefore entitled to exercise any such rights until the securities are redelivered to it. They may also wish to consider explaining the client's entitlements in relation to any benefits on loaned securities.

3 Agents

3.1 Before dealing with a client for the first time, agents should either confirm that the client is already aware of this Code and its key contents, or draw them to

the client's attention. Agents should represent clearly the nature of the arrangements and the capacity in which they are acting. There should be a clear legal agreement, which may form part of the standard fund management or custody agreement, authorising the agent to lend securities, setting down the terms on which the securities may be lent and specifying the collateral that may be taken.

3.2 An agent must obtain the necessary prior written authority from the beneficial owners of the securities, or from a party suitably authorised by the beneficial owners, to undertake securities lending.

3.3 An agent should inform the beneficial owners that securities lending involves the absolute transfer of title and that securities on loan cannot therefore be voted by the lender unless they are recalled. They may also wish to consider explaining the client's entitlements in relation to any benefits on loaned securities. (See also C 7 below on voting and corporate actions.)

3.4 Where a lender is acting through an agent, there should be an agreed arrangement between agent and principal for the safeguarding of collateral and the allocation of any earnings on that collateral.

3.5 Where a participant is acting as an agent for more than one principal, a clear system for determining which principals' securities are on loan should be established. There should also be a clear system for determining any allocation of collateral between the particular lenders and for defining their entitlements.

3.6 An agent should make regular reports to clients, providing them with a full explanation of the securities lending activity carried out on their behalf.

4 Brokers

4.1 As well as dealing direct or through an agent, participants may also wish to trade through broking intermediaries: (a) matched principals – participants acting in that capacity are acting as principals; and (b) name-passing or name give-up brokers.

4.2 Market participants may now use electronic trading platforms, which in the United Kingdom may be regulated by the Financial Services Authority as Alternative Trading Systems operators.

4.3 The following paragraphs deal with those matters which are particularly relevant to securities lending business involving name-passing brokers.

4.3.1 Name-passing brokers in securities lending:

- do not act as principal to a deal;
- only quote firm prices substantiated by a market principal participant;

- only receive payment for successfully bringing counterparties together in the form of brokerage which is freely negotiated;
- pass the names immediately, when a bid is "hit" or an offer "lifted".

4.3.2 While principals and brokers share equal responsibility for maintaining confidentiality, name-passing brokers must exercise particular care. They should ensure that the identity of parties to a transaction is disclosed only after the bid is "hit" or offer "lifted", which may be on a conditional basis (subject to the prospective counterparty being one with whom the participant can deal), and then only to the parties involved.

5 Legal Agreement

5.1 All securities lending transactions should be subject to a written legal agreement between the parties concerned. Standard agreements should be used wherever possible.

5.2 The Global Master Securities Lending Agreement (GMSLA) has been developed as a market standard for securities lending. It was drafted with a view to compliance with English law and covers the matters which a legal agreement ought to cover for securities lending transactions. The Global Master Securities Lending Agreement is referred to in this Code as the "Securities Lending Legal Agreement".

5.3 An English law opinion has been obtained on the Securities Lending Legal Agreement. It confirms that the provisions on close out and netting of outstanding transactions should generally be effective in a UK insolvency; and that the other provisions of the agreement will take effect in accordance with their terms under English law.

5.4 It is strongly recommended that participants entering into a new securities borrowing and lending relationship adopt the Securities Lending Legal Agreement, although they may wish to vary some of its provisions to suit their particular circumstances. Parties to existing securities lending relationships are likely to have entered into one or both of its predecessor agreements – the Master Equity and Fixed Income Stock Lending Agreement (MEFISLA) and the Overseas Securities Lenders' Agreement (OSLA) – which were drafted with similar objectives in mind. Other forms of legal agreement may also be effective.

5.5 Participants should consider the need to undertake their own assessment of the legal effectiveness of their agreement, particularly if they have varied important provisions of the Securities Lending Legal Agreement or if the circumstances in which it is to be used are not straightforward. Participants will need in particular to consider taking legal opinions on whether a legal agreement will be given effect in accordance with its terms where the counterparty is incorporated in another country. In this connection a sub-group of the Securities Lending and Repo Committee co-ordinates work to obtain legal opinions on netting and re-characterisation risk as regards securities lending agreements (OSLA, GMSLA) used in different jurisdictions. The

implementation of the EU Collateral Directive will help to ensure that parties can be confident that securities lending and repo transactions within the area of the European Union will be given effect in accordance with the terms of the relevant legal agreement.

5.6 The following items in this Code should normally be covered by the legal agreement (but the legal agreement will also contain other provisions outside the scope of this Code):

- the capacities – principal or agent – in which the parties are acting;
- where relevant, confirmation that an agent has appropriate prior authority from the beneficial owners, or a party suitably authorised by the beneficial owners, for the securities to be lent;
- the absolute transfer of title to securities and collateral (including any securities transferred through substitution or mark to market adjustment of collateral);
- daily marking-to-market of transactions;
- acceptable forms of collateral and margin percentages (alternatively, these matters may be agreed at the time of the loan and included in the relevant confirmation);
- arrangements for delivery of collateral and for the maintenance of margin whenever the mark to market reveals a material change of value;
- provisions clarifying the rights of the parties regarding substitution of collateral;
- the treatment of dividend payments and other rights in respect of securities and collateral including, for example, the timing of any payments;
- arrangements for dealing with corporate actions;
- procedures for calling securities and arrangements if called securities cannot be delivered;
- clear specification of the events of default and the consequential rights and obligations of the counterparties;
- full set-off of claims between the counterparties in the event of default;
- the governing law and jurisdiction for the agreement.

6 Custody

6.1 Custody is an important aspect of securities borrowing and lending. Taking possession of the securities or collateral or using a third party custodian removes one important potential element of the credit risks involved – that, while in possession of the securities/collateral, the other party defaults and that ownership of the securities/collateral subsequently cannot be proved because of administrative error or fraud. This section covers this and other issues relating to custody.

6.1.1 Participants need to ensure that securities loan transactions are identified, where necessary, as such to their custodian. Participants should also take steps to satisfy themselves that their custodian's segregation arrangements are appropriate to the particular circumstances of their activities.

6.1.2 Securities and collateral, including where relevant margin, should be delivered to the account of the counterparty or his agent or a designated third party.

6.1.3 Before agreeing to arrangements in which securities/collateral are left with the other party to the transaction ("hold in custody"), participants need to consider whether they are content to accept such arrangements and why these are prudent. They should consider the credit standing of the other party very carefully. They also need to assure themselves that the other party has appropriate, independently audited, systems and controls for segregating and monitoring securities/collateral. There is a general presumption that "hold in custody" should be avoided save in exceptional circumstances.

7 Collateral/margin

7.1 Securities loans should, where possible, be made on a collateralised basis against collateral acceptable to the lender, as specified in the agreement or agreed by the parties prior to the loan.

7.2 The collateral should be delivered to the account of the lender or his agent or a designated third party.

7.3 The collateral taken should normally include a margin over the value of the loan which should be specified in the agreement. Alternatively, if this is acceptable to both parties, the margin could be agreed at the time of the loan, when it should also be included in the relevant confirmation.

7.4 The agreement should provide for the collateral to be adjusted whenever there is a material change in the value of the currency or securities involved in the transaction and for the original margin to be restored.

7.5 The loan and the collateral should be marked-to-market on a daily basis, and more frequently if the need arises.

8 Default and Close-out

8.1 Parties to a transaction should seek to satisfy themselves that the legal agreement will allow their claims to be offset immediately against the claims of their counterparty in the event of default. In jurisdictions where such provisions are not widely used or may not be enforceable, participants should consider whether it is possible to negotiate alternative arrangements to manage their credit exposures. Agreements drafted under English law should, unless otherwise stated, be based on the close-out and netting clauses contained in the Securities Lending Legal Agreement. Particular care will need to be taken in the case of agreements involving lending through an agent.

8.2 Some events, such as insolvency, may be automatic events of default under the legal agreement whilst others may trigger one party's right to declare an event of default against the other. In these latter cases, participants need to

recognise that the decisions to declare a default is a major one. Senior management of any participant faced with this decision should weigh carefully whether the event which triggers the right requires such action, or is a technical problem which can be resolved in other ways.

8.3 Once a decision to declare a default has been taken, it is important, in the interests of the participant, the defaulting party and the market, that the process be carried out carefully. In particular:

- the non-defaulting party should do everything within its power to ensure that the default market values used in the close-out calculations are, and can be shown to be, fair; and
- if the non-defaulting party decides to buy or sell securities consequent to the close-out, it should make every effort to do so without unnecessarily disrupting the market.

9 Confirmations

9.1 Trading platforms' use of electronic communication has made separate confirmations unnecessary in many cases. But confirmations remain relevant in cases where there is no electronic communication associated with the original agreement to trade. Paragraphs 9.2 to 9.4 set out the main principles relating to confirmations.

9.2 Market professionals should ensure that a written or electronic confirmation is issued, whenever possible on the day of the trade.

9.3 Where material changes, such as collateral adjustments or substitutions of collateral, occur during the life of the transaction, these should be agreed between the parties and may also be confirmed, should either party wish it. Where appropriate this may be done via a cross reference to the original loan.

9.4 Participants should ensure that any confirmations they receive are checked carefully as soon as possible, normally on the day of receipt, and that any queries on their terms are promptly conveyed back to the issuer.

C MARKET PRACTICE

1 Introduction

1.1 This part of the Code deals with matters of market practice for securities lending. In some areas, it also includes explanatory notes (in italic text) in order to provide further information about the context or rationale for certain market practices.

1.2 There are good reasons for preferring the approaches set out below rather than others – over and above the convenience to all market participants of the reduction in confusion and complexity which a market-wide approach delivers. Nevertheless, these market practices may not be appropriate to specific counterparties or circumstances. Where, after due consideration, a

participant considers that any particular practice is not appropriate, they should reach agreement with their counterparty either prior to commencing any trading (reflecting such agreement in the legal documentation or otherwise) or at the time of each trade.

1.3 It is inevitable that market practices will evolve and this Code can reflect them only at a particular point in time. The practices in this part of the Code will be kept under review by the Securities Lending and Repo Committee.

2 Before dealing with a new counterparty

2.1 Part B of this Code refers to various matters specifically relating to securities lending which need to be considered before entering into securities borrowing/lending transactions with a new counterparty. These include the considerations set out in paragraphs B2.4 and B2.5 (new relationships), section B5 (legal agreement between lender and borrower).

2.2 There are other practical details which will need to be agreed before transactions are undertaken, usually in negotiating the legal agreement. These matters include:

- acceptable collateral, margin levels and the collateral method to be used;
- collateralisation following dividends and other corporate events;
- approach to daylight and settlement exposures, and pre-delivery of collateral;
- business day conventions;
- notice periods for voting, elections, recalls and substitutions;
- where the lender is acting as agent, the information to be provided about the underlying principals and the allocation of stock lent/collateral between them;
- pricing sources for marking to market and currency conversions;
- settlement arrangements;
- designated offices;
- the parties' tax status and manufactured dividend entitlements.

2.3 It is important, for the purposes of delivery/redelivery of securities and collateral and various notice periods, that there should be a clear agreement between the parties about the meaning of "business days". Participants may wish to vary the usual business day convention to suit their particular circumstances and this would need to be reflected in the legal agreement.

The Securities Lending Legal agreement defines a Business Day as a "day other than a Saturday or Sunday on which banks and securities markets are open for business generally in each [place of business specified in the agreement] and, in relation to the delivery or redelivery of [securities or collateral] ... the place where .. [they] are to be delivered". Thus, for example, a UK public holiday would not be a Business Day for any purpose under the definition in the Securities Lending Legal Agreement if the parties had specified the UK as a place of business, and an American public holiday would not be a Business Day for the purposes of delivery or redelivery of US securities.

2.4 Participants will also need to agree the time zone in which business days are to be measured. The norm is to use the time zone in which the loaned securities or collateral are traded. Similarly, participants will need to reach an understanding about the latest time on a business day at which a notice or call should be issued in order to be treated as having been given on that day. Market practice is that notices etc should be given before the close of the relevant market; it should be noted that this may well be earlier than the end of the business day.

2.5 The relationship between lender and borrower – and the individual transactions between them – will also be facilitated if there is a clear understanding of each party's attitudes to certain events which may occur during a stock loan. Such matters include:

- voting on securities lent or collateral given;
- elections and other corporate actions on stock lent or collateral given;
- substitutions of collateral;
- intra-day marking to market.

3 At point of trade

3.1 At the point of trade, participants will need to agree:

- the essential economic terms of the transaction, in particular the securities to be lent, rate and term;
- any of the matters set out in section C2 above to the extent that they have not previously been dealt with, for example acceptable collateral and margin percentages; and
- any non-standard features of the particular transaction.

4 Confirmations

4.1 Confirmations may be unnecessary if participants use electronic trading platforms. But any loan confirmations will normally contain the following information:

- contract date;
- loaned securities (type, ISIN or other identifying number and quantity);
- lender (underlying principal unless otherwise agreed);
- borrower (as for lender);
- delivery date;
- acceptable collateral and margin percentages (if not specified in the legal agreement);
- term (termination date for term transactions or terminable on demand);
- rates applicable to loaned securities;
- rates applicable to cash collateral;
- lender's settlement system and account;
- borrower's settlement system and account;

- lender's bank account details;
- borrower's bank account details.

5 Delivery/re-delivery

5.1 Parties should be aware of the procedures for calling securities: the rights and obligations of each party should be clearly established.

5.2 Any party wishing to return or recall securities on loan should have regard to the possible implications for its counterparty and should therefore notify them as soon as possible. Where a lender intends to recall loaned securities in order to meet part of a sale or delivery obligation on a larger transaction, it is good practice, if possible, to consider whether the larger sale or delivery obligation can be shaped or partialled so as to avoid any prospect of the whole transaction failing if the borrower cannot redeliver the loaned securities at the designated time.

5.3 There should be explicit agreement between the parties on the arrangements to be followed if called securities cannot be delivered. The parties should also consider whether arrangements are necessary in order to deal with the possibility of securities or collateral being redelivered too late in the day to enable the recipient to meet an onward delivery obligation.

5.4 Parties should ensure that they are aware of the procedures to be followed in the event of failed deals in all markets in which stock is lent: the rights and obligations of each party should be clearly established.

5.5 The legal agreement between participants may provide for the transferee to obtain financial redress if the transferor fails to redeliver borrowed securities or collateral at the designated time. It is advisable for participants to consider and agree at the outset of a new relationship how any such provisions will operate in the event of a failure to redeliver. Such amounts will typically include:

- interest and overdraft costs which have arisen from the transferee's need to finance an acquisition from an alternative source;
- fines and other penalties suffered by the transferee as a result of its inability to settle an onward delivery obligation;
- costs passed back to the transferee because its counterparty has bought-in securities to cover a failed onward delivery.

Other forms of potential cost may or may not be covered by the terms of the legal agreement. Where, as a result of the transferor's failure to redeliver securities or collateral, the transferee fails to meet a sale or delivery obligation in respect of a larger onward transaction, the norm is for the transferee to seek to recover only that proportion of the costs suffered which relates to the securities/collateral which the transferor has failed to return.

The Securities Lending Legal Agreement provides for the transferee to recover the following costs resulting from the transferor's failure to redeliver securities or collateral:

- *direct interest, overdraft and similar costs and expenses incurred except those arising from its negligence or wilful default and any indirect or consequential losses;*
- *costs reasonably and properly incurred as a result of the transferee's failure to meet its sale or delivery obligations;*
- *total costs and expenses reasonably incurred by the transferee as a result of a buy-in exercised against it.*

5.6 Where such a claim is to be made, the transferee should inform the transferor promptly of that fact and should also provide notification as soon as possible of the amount due and the basis on which it has been calculated so that the transaction can be settled on a timely basis. The transferee should provide appropriate evidence to support the calculations as soon as possible thereafter.

6 Collateral/margin/marking-to-market

6.1 The required collateral margin will be negotiated between the parties at a level which reflects both their assessment of the counterparty's creditworthiness and the market risks involved in the transaction.

6.2 The norm is for transactions to be marked-to-market on the basis of end of previous day closing prices in the relevant market. Counterparties' credit exposures will also fluctuate intraday as market prices move and there may therefore be particular circumstances (such as exceptional price movements) in which further valuations and collateral adjustments will be undertaken on an intra-day basis. Participants will need to agree at the outset whether, and in what circumstances, such intra-day adjustments are to be undertaken, and the pricing sources and delivery mechanisms to be used.

> *The Securities Lending and Legal Agreement, for example, allows the "latest available" price to be used as the market value where, in the "reasonable opinion" of either party, "there has been an exceptional movement in the price of the asset in question" since the close of business on the previous business day. It is advisable for the parties to agree in advance what would constitute an "exceptional movement" in either percentage or absolute terms.*

6.3 The degree of exposure which a counterparty would regard as material, and which would trigger a call for collateral to be provided or returned, will be agreed in advance with the other counterparty. The point at which a net market to market value becomes "material" is itself a credit judgement. This includes the possibility of the two parties agreeing to daily collateral adjustments, irrespective of the size of the exposure that has arisen.

6.4 Participants will need to agree at the outset how any dividends and other corporate events on borrowed securities or collateral are to be dealt with in the

valuation. It is advisable for participants to consider the credit exposures which may arise as a result of such events. Where their assessment indicates that adjustments to the normal calculation may be needed in order to match their particular risk appetite they may wish to negotiate such arrangements with their counterparty.

The Securities Lending Legal Agreement provides for the valuation of both securities and collateral to include:

- *accrued income;*
- *dividend or interest payments declared but not yet due by the issuer; and*
- *dividends paid in the form of securities.*

But not other rights and assets arising from the securities or collateral.

6.5 Borrowers should exercise reasonable care in determining the time at which a substitution call is to be made, bearing in mind that some lenders (particularly principal traders and brokers) may not be in possession of the collateral. They are therefore encouraged to give lenders as much notice as possible of a substitution. Where a borrower intends to recall and substitute collateral in order to meet part of a sale or delivery obligation on a larger transaction, it is good practice, if possible, to consider whether the larger sale or delivery obligation can be shaped or partial led so as to avoid any prospect of the whole transaction failing if the lender cannot redeliver the collateral at the designated time.

7 Dividends, voting, corporate actions etc

7.1 Arrangements should be made to compensate the lender of securities (or giver of collateral) for any dividend or interest payment due while a particular security is on loan (or collateral is held by the lender). These arrangements should make each party's obligations clear including, for example, the timing of any payments.

7.2 Participants should ensure that any tax due on manufactured dividends is properly accounted for in accordance with the relevant regulations.

7.3 Securities lending involves the absolute transfer of title to both the securities lent and the collateral taken and any voting rights are transferred along with title. Securities must therefore be recalled by the lender, or collateral substituted by the borrower, if they wish to exercise the voting rights attaching to particular securities. It is in the interests of both parties to a securities lending relationship to understand each other's attitudes to voting from the outset.

7.4 A person could borrow shares in order to be able to exercise the voting rights and influence the voting decision at a particular meeting of the company concerned. There is a consensus, however, in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for

example, an AGM or EGM. Lenders should also consider their corporate governance responsibilities before lending stock over a period in which an AGM or an EGM is expected to be held. Beneficial owners need to ensure that any agents they have made responsible for voting and for securities lending act in co-ordinated way.

7.5 Lenders need to be aware that if they lend their entire holding of a particular security, they may cease to receive information about corporate events in relation to it.

7.6 The arrangements to be followed in the event of a rights issue or other corporate action should be clearly established by all parties before a security loan is made, with due recognition of local market rules and practice and any deadlines imposed by the various parties' local agents or custodians.

8 Putting securities on hold

8.1 Putting securities "on hold" (sometimes also known as "icing" stock) is the practice by holders of securities of reserving them at the request of a second party against the latter's anticipated need to take delivery at a later date in a securities loan (or similar) transaction. Prospective borrowers may wish securities to be put on hold so as to be assured that they will be available for borrowing before entering into the trade against which it will need to be delivered. Lenders will consider whether to offer such facilities to a prospective counterparty as part of the overall arrangement which they negotiate.

8.2 When a lender is asked to put securities on hold, he is under no obligation to quote a rate for any subsequent loan. If the party requesting the hold wishes to obtain a firm rate, he needs to make that clear to the lender at the outset. In the absence of any specific agreement to the contrary, any rate quoted by a lender is regarded as indicative only.

8.3 If the party which has requested the hold wishes to roll it over, standard practice is to contact the holder of the securities by 9.00am; in the absence of any agreement to the contrary between the parties, the arrangement will terminate at that time unless it has been rolled over. When a hold is rolled over, the parties will need to consider whether any rate quoted needs to be re-negotiated.

8.4 Holds are generally open to challenge, in that the party making the request only has a first option on the securities, were another party to approach the holder with a firm borrowing (or other) proposition. When a hold is challenged, the holder should inform the party for whom the securities have been held of that fact and the latter will need to decide whether or not to take the securities at that time. If he wishes to do so, he should notify the holder in the case of gilts within 5 minutes of having been informed of the challenge, in the case of UK equities 15 minutes, and in the case of overseas securities 30 minutes, unless a longer time has been agreed. If no such notification is received by the holder within the relevant time, he is free to transact with the

party which made the challenge although before doing so, as a matter of good practice, the holder would normally contact the party for whom securities have been held again to give him a final opportunity to take the securities. When putting securities on hold, the parties will need to agree whether there is a latest time during the business day at which the holder can initiate this process following a challenge.

8.5 "Pay to hold" arrangements, under which the holder receives a fee for putting the stock on hold, are contractual arrangements and are not therefore open to challenge.

9 Term trades

9.1 The generic description "term trade" is used in the securities lending market to describe a wide range of arrangements and there is therefore considerable scope for misunderstanding between participants if the precise details of the transaction are not agreed at the beginning. The following paragraphs set out the main matters to be considered.

9.1.1 The parties need to agree whether the term of the loan is fixed or indicative. If the term is fixed there will be no obligation on the lender to accept early return of the stock or on the borrower to comply with a recall request.

9.1.2 In the case of cash collateral transactions, the parties need to establish whether it is the amount of the specific securities which is fixed or the overall value.

9.1.3 In agreeing the rate, the parties will take into account whether or not the term is fixed and the permissibility of returns and recalls.

9.1.4 Where appropriate, they will also need to reach agreement on the procedures for adjusting the rate if securities are returned early by the borrower or for compensating the borrower in the event of an early recall by the lender.

ANNEX : GLOSSARY

Accrued interest Coupon interest that is earned on a bond from the last coupon date to the present date.

Agent A party to a loan transaction that acts on behalf of a client. The agent typically does not take risk in a transaction.

All-in dividend The sum of the ***manufactured dividend*** plus the fee to be paid by the borrower to the lender, expressed as a percentage of the dividend on the stock on loan.

All-in price Market price of a bond, plus accured interest. Generally rounded to the nearest 0.01. Also known as 'dirty price'

Basis point One one-hundredth of a percentage, or 0.01%

Bearer securities Securities that are not registered to a particular party on the books of the issuing company and hence are payable to the party that is in possession of them.

Beneficial Owner A party which is entitled to the rights of ownership of property. In the context of securities, the term is usually used to distinguish this party from the registered holder (a nominee for example) which holds the securities in trust for the beneficial owner.

Benefit Any entitlement due to a stock or share holder as a result of purchasing or holding securities, including the right to any dividend, rights issue, scrip issue etc made by the issuer. In the case of loaned securities or ***collateral***, benefits are passed back to the lender or borrower (as appropriate), usually by way of a ***manufactured dividend*** or the return of ***equivalent*** securities or ***collateral***.

BMA The Bond Market Association – is a US-based industry organisation of participants involved in certain sectors of the bond markets. The BMA establishes non-binding standards of business conduct in the US fixed-income securities markets. Formerly known as the Public Securities Association or ***PSA.***

Broker A person whose role is to act as a intermediary in transactions between sellers / lenders and buyers / borrowers. The broker may either put one party in touch with the other (a name passing or name give-up broker) or act as a matched principal in two transactions, one for the purchase, the other for the sale, or vice versa.

Buy-in The practice whereby a lender of securities enters the open market to buy securities to replace those that have not been

returned by a borrower. Strict market practices govern buy-ins. Buy-ins may be enforced by market authorities in some jurisdictions.

Buy/Sell,Sell/Buy Types of bond transactions that, in economic substance, replicate ***reverse repos***, and ***repos*** respectively. These transactions consist of a purchase (or sale) of a security versus cash with a forward commitment to sell back (or buy back) the securities. Used as an alternative to ***repos/reverses.***

Carry Difference between interest return on securities held and financing costs. ***Negative carry***: net cost incurred when financing cost exceeds yield on securities that are being financed. ***Positive carry***: net gain earned when financing cost is less than yield on financed securities.

Cash-orientated repo Transaction motivated by the need of one party to invest cash and the need of the other to borrow.

Cash trade A non-financing purchase or sale of securities.

Clear To complete a trade, ie when the seller delivers securities and the buyer delivers funds in correct form. A trade fails when proper delivery requirements are not satisfied.

Close-out (and) Netting An arrangement to settle all existing obligations to and claims on a counterparty falling under that arrangement by one single net payment, immediately upon the occurrence of a defined event of default.

Collateral Securities or cash delivered by a borrower to a lender to support a loan of securities or cash.

Contract for Differences (CFD) An OTC derivative transaction that enables one party to gain economic exposure to the price movement of a security (bull or bear). Writers of CFDs hedge by taking positions in the underlying securities, making efficient securities financing or borrowing key.

Corporate Action A ***corporate action*** is a corporate event in relation to which the holder of the security must or may make an election or take some other action in order to secure his entitlement or to secure it in a particular form (see also ***equivalent***)

Corporate Event An event in relation to a security as a result of which the holder will be or may become entitled to:

- A ***benefit*** (dividend, rights issue etc); or
- securities other than those which he held prior to that event (takeover offer, scheme or arrangement, conversion, redemption etc). This type of corporate event is also known as a ***stock situation.***

A ***corporate action*** is a corporate event in relation to which the holder of the security must or may make an election or take some other action in order to secure his entitlement or to secure it in a particular form (see also ***equivalent***)

Conduit borrower See ***Intermediary***.

Custodian An entity that holds securities of any type for investors, effects receipts and deliveries and supplies appropriate reporting.

Daylight Exposure The period in the day when one party to a trade has a temporary credit exposure to the other due to one party having settled before the other. It would normally mean that the loan had settled but the delivery of ***collateral*** would settle at a later time (although there would also be exposure if settlement happened in reverse). The period extends from the point of settlement of the first side of the trade to the time of settlement of the other. It occurs because the two sides of the trade are not linked in many settlement systems or settlement of loan and ***collateral*** take place in different systems, possibly in different time zones.

Deliver-out Repo 'Standard' two-party repo, where the party receiving cash delivers bonds to the cash provider.

Delivery by Value (DBV) A mechanism in some settlement systems (including CREST) whereby a member may borrow or lend cash versus overnight ***collateral***. The system automatically selects and delivers securities meeting predefined criteria to the value of the cash (plus a margin) from the account of the cash borrower to the account of the cash lender and reverses the transaction the following morning.

Delivery Versus Payment (DvP) The simultaneous delivery of securities against payment of funds within a securities settlement system.

Distributions Entitlements arising on securities that are loaned out, eg dividends, interest and non-cash distributions.

ERISA The Employee Retirement Income Security Act, a US, law governing private US pension plan activity, introduced in 1974 and amended in 1981 to permit plans to lend securities in accordance with specific guidelines.

Equivalent (securities or collateral) A term meaning that the securities or ***collateral*** returned must be of an identical type, nominal value, description and amount to those originally provided. If, during the term of a loan, there is a ***corporate action*** in relation to loaned securities or ***collateral***, the lender or borrower (as appropriate) is normally entitled to specify at that time the form in which he wishes to receive equivalent securities or ***collateral*** on termination of the loan. The legal agreement will also specify the form in which equivalent securities or ***collateral*** are to be returned in the case of other ***corporate events***.

Escrow See T***riparty.***

Fail/failed delivery The failure to deliver cash or securities in time for the settlement of a transaction.

Free-of-payment delivery Delivery of securities with no corresponding payment of funds.

G7 The Group of Seven, i.e USA, France, Japan, United Kingdom, Germany, Italy and Canada.

G10 The Group of Ten, i.e USA, France, Japan, United Kingdom, Germany, Italy, Canada, the Netherlands, Sweden and Switzerland.

General Collateral (GC) Securities that are not ***special*** in the market and may be used, typically, simply to *collateral*ise cash borrowings. Also known as stock ***collateral.***

Gilt-Edged Securities (Gilts) United Kingdom government bonds.

Gilt-Edged Securities Lending Agreement (GESLA) see **Master Gilt Edged Securities Lending Agreement.**

Global Master Securities Lending Agreements (GMSLA) The Global Master Securities Lending Agreement has been developed as a market standard for securities lending of bonds and equities internationally. It was drafted with a view to complying with English law.

Gross-paying Securities Securities on which interest or other distributions are paid without any taxes being withheld.

Haircut Initial margin on a ***repo*** transaction. Generally expressed as a percentage of the market price.

Hard/hot stock A particular security that is in high demand in relation to its availability in the market and thus relatively expensive to borrow. See also ***specials***.

Hedge fund A specialist investment fund that engages in trading and hedging strategies, frequently using leverage.

Hold in custody An arrangement under which securities (***collateral***) are not physically delivered to the borrower (lender) but are simply segregated by the lender (borrower) in an internal customer account.

Icing / putting Stock on hold The practice whereby a lender holds securities at a borrower's request in anticipation of that borrower taking delivery.

Indemnity A form of guarantee or insurance, frequently offered by agents. Terms vary significantly and the value of the indemnity does also.

Interdealer broker Agent or intermediary that is paid a commission to bring buyers and sellers together. The broker's commission may be paid either by the initiator of the transaction or by both counterparts.

Intermediary A party that borrows a security in order to on-deliver it to a client, rather than borrowing it for its own in-house needs. Also known as a ***Conduit borrower.***

International Securities Lending Association (ISLA) The trade association for securities lending market practitioners.

International Securities Markets Association (ISMA) The Zurich-based International Securities Market Association is the self-regulatory organisation and trade association for the international securities market. ISMA sets standards of business conduct in the global securities markets, advises regulators on market practices and provides educational opportunities for market participants.

London Investment Banking (LIBA) The principal trade association in the UK for firms active in the investment banking and securities industry. LIBA members are generally borrowers and intermediaries in the stock lending market.

Manufactured dividend When securities that have been lent out to pay a cash dividend, the borrower of the securities is generally contractually obligated to the lender of the securities. This payment "pass-through" is known as a manufactured dividend.

Margin, initial Refers to the excess of cash over securities or securities over cash in a repo/reverse repo, sell and buyback/buy and sellback or securities lending transaction. One party may require an initial margin due to the perceived credit risk of the counterpart.

Margin variation Once a repo or securities lending transaction has settled, the variation margin refers to the band within which the value of the security used as ***collateral*** may fluctuate before triggering a margin call. Variation margin may be expressed either in percentage or absolute currency terms.

Margin call A request by one party in a transaction for the initial margin to be reinstated or to restore the original cash/securities ratio to parity.

Mark- to-market The act of revaluing the securities ***collateral*** in a **repo** or securities lending transaction to current market values. Standard practice is to mark-to-market daily.

Market value The value of loan securities or ***collateral*** as determined using the last (or latest available) sale price on the principal exchange where the instrument was traded or, if not so traded, using the most recent bid or offered prices.

Master Equity and Fixed Income Stock Lending Agreement (MEFISLA) This was developed as a market standard agreement under English law for stock lending prior to the creation of the **Global Master Securities Lending Agreement**. It has a legal opinion from Queen's Counsel and has been mainly, but not exclusively, used for lending UK securities excluding **Gilts**.

Master Gilt Edged Stock Lending Agreement (GESLA) The agreement was developed as a market standard exclusively for lending UK gilt-edged securities. It was drafted with a view to complying with English law and has a legal opinion from Queen's Counsel.

Matched / Mismatched Book Refers to the interest rate arbitrage book that a **repo** trader may run. By matching or mismatching maturities, rates, currencies, or margins, the **repo** trader takes market risk in search of returns.

Net-paying Securities Securities on which interest or other distributions are paid net of withholding taxes.

Open Transactions Trades done with no fixed maturity date

Overseas Securities Lenders' Agreement (OSLA) The agreement was developed as a market standard for stock lending prior to the creation of the **Global Master Securities Lending Agreement.** It was drafted with a view to complying with English law and has a legal opinion from Queen's Counsel. Intended for use by UK- based parties lending overseas securities (i.e. excluding UK securities and **gilts**), it has since become the most widely used global master agreement.

Pair off The netting of cash and securities in the settlement of two trades in the same security for the same value date. Pairing off allows for settlement of net differences.

Partialling Market practice or a specific agreement between counterparties which allows a part delivery against an obligation to deliver securities.

Pay for hold/ pay to hold The practice of paying a fee to the lender to hold securities for a particular borrower until the borrower is able to take delivery.

Prime brokerage A service offered to clients, typically hedge funds, by investment banks to support their trading, investment and hedging activities. The service includes clearing, custody, securities lending and financing arrangements.

Principal A party to a loan transaction that acts on its own behalf or substitutes its own risk for that of its client when trading.

Proprietary trading Trading activity conducted by a securities firm for its own account rather than for its clients.

PSA Public Securities Association The former name of the **BMA**.

Rebate rate The interest paid on the cash side of a securities lending transaction. A rebate rate of interest implies a fee for the loan of securities and is therefore regarded as a discounted rate of interest.

Recall A request by a lender for the return of securities from a borrower.

Repo Transaction whereby one party sells securities to another party and agrees to repurchase the securities at a future date at a fixed price.

Repo Rate The interest rate paid on the cash side of a **repo / reverse** transaction.

Repo (or reverse) to maturity A repo or reverse repo that matures on the maturity date of the security being traded.

Repricing Occurs when the market value of a security in a repo or securities lending transaction changes and the parties to the transaction agree to adjust the amount of securities or cash in a transaction to the correct margin level.

Return Occurs when the borrower of securities returns them to the lender.

Revaluation (Reval) *See* ***repricing***

Reverse Repo Transaction whereby one party purchases securities from another party and agrees to resell the securities at a future date at a fixed price.

Roll To renew a trade at its maturity.

Securities – Orientated Repo Trade Transaction motivated by the desire of one counterpart to borrow securities and of the other to lend them. See also **Cash-oriented repo trade.**

Shaping A practice whereby a delivery of a large amount of a security may be made in several smaller blocks so as to reduce the potential consequences of a fail. May be especially useful where partialling is not acceptable.

Specials Securities that for several reasons are sought after in the market by borrowers. Holders of special securities will be able to earn incremental income on the securities by lending them out via repo, sell/buy, or securities lending transactions.

Spot Standard non-dollar repo settlement two business days forward. A money market convention.

Securities Lending And Repo Committee (SLRC) A UK based committee of international repo and securities lending market practitioners, chaired and administered by the Bank of England.

Securities Lending Legal Agreement See Global Master Securities Lending Agreement.

Stock Situation See ***corporate event***

TBMA/ISMA Global Master Repurchase Agreement

(GMRA) The market-standard document used for **repo** trading. The GMRA, whose original November 1992 version was based on the **PSA** Master Repurchase Agreement, was revised in November 1995 and again in October 2000.

Term trades Transactions with a fixed maturity date.

Third-party lending System whereby an institution lends directly to a borrower and retains decision making power, while all administration (settlement, ***collateral***, monitoring, and so on) is handled by a third party, such as a global custodian.

Triparty The provision of ***collateral*** management services, including marking to market repricing and delivery, by a third party. Also known as ***escrow***.

Triparty Repo Repo used for funding / investment purposes in which the trading counterparts deliver bonds and cash to an independent ***custodian*** bank or central securities depository (the 'Tri Party ***custodian***'). The triparty ***custodian*** is responsible for ensuring the maintenance of adequate ***collateral*** value, both at the outset of a trade and over its term. It also marks the ***collateral*** to market daily and makes ***margin calls*** on either counterpart, as required. Tri Party Repo reduces the operational and systems barriers to participating in the ***repo*** markets.