Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates 20-21 February 2008

Question: aet 69

Topic: Lending Shares

Hansard Page: E121-E122

Senator MURRAY asked:

Senator MURRAY—On the same point, can I ask a question? Lending shares has more than one aspect; there are two that I know of. One is lending them in the exercise of third-party margin dealing on the stock market. But the other is lending for the purposes of providing a third party the power to vote those shares or to exercise a vote in takeovers or in particularly important votes on companies. I think this whole area needs close examination by the authorities and I will raise it with ASIC, because the shares that are being dealt with in this manner are held by institutions that are given a mandate by their superannuants, who usually choose a particular stream of investment. To me that implies a fiduciary duty for particular types and classes of shares. I do not think the lending process falls within the broad ethical—and I will use the word in a legal sense, not in a moral sense—ambit of superannuation funds holding assets on behalf of the superannuants themselves. If you have not examined that issue before, I would appreciate your perhaps thinking about it and coming back to us with a view as to whether it is an area that needs further inquiry by Treasury. I am receiving market information that a lot of this is going on under the surface and it is not well reported or well understood, but it is known to be happening.

Mr Murphy—I will take that onboard.

Answer:

What is share lending?
The lending of stock for different purposes (for a fee) has been in the market for some time.
In share lending, securities are transferred temporarily from the lender to the borrower. Under the contract, the borrower must return at the end of the period replacement securities that are equivalent in number and type. This means that, at the end of the period, the lender retains the exact same portfolio as before. This is why the arrangement is considered economically as a loan but legally the lender transfers absolute ownership of the original securities to the borrower. (see John C King, *Securities Lending of Equity Securities in Australia* , Mallesons Stephen Jaques, 2005, iv-v).

Reasons for share lending – equity securities
There are two different markets for share lending in equity securities. The principal type of transaction relates to where the borrower wants to obtain access to the securities (‘securities driven’). A less common transaction is where the lender uses the securities as collateral to borrow cash. Here the borrower is not seeking to obtain particular securities and generally the securities’ lender chooses the securities to be provided.

According to the Australian Securities Lending Association (ASLA), generally the reasons for borrowing shares include:

- Borrowing for margin requirements

This is where a borrower needs to meet margin requirements, and does so by borrowing securities rather than depositing cash. This often occurs in the equity options market where borrowing securities to meet margin requirements is cheaper than depositing cash.

- Market making and proprietary trading

According to ASLA, market makers (such as investment banks and broker-dealers) and proprietary traders are the largest borrowers of stock in Australia. They undertake the majority of securities lending transactions in this country.

These traders then sell stock for any number of reasons, most of which are hedging related. Hedging reduces the risk of adverse price movements in a security, by taking an offsetting position in a related security, such as an option or a short sale.

- Borrowing for Failed Trades

Trades are required to be settled within a certain timeframe. On the ASX exchange listed markets this is the T + 3 arrangements, which means at the end of three days after the trade date. Trades will fail if securities are not available, and therefore short term may borrowing occur for this reason. This will mean the trader will not breach the rules about settling trades on time and be subject to fines or disciplinary action (noting if a participant does not settle transactions completed on the ASX market, the Australian Clearing House will step in and settle the transaction).

- Intermediary Brokers

Intermediaries act between lenders and borrowers. Institutions may lend stock to one or two intermediaries who then on-lend to many more counterparties. This saves administration and limits credit risks.

Superannuation funds and share lending

The market in scrip lending by superannuation funds has developed over a number of years, such that the standard loans are well collateralised and pose no risk to the lender. The Australian Prudential Regulation Authority examined this practice in the past and did not consider it to pose a prudential risk to superannuation funds or their investments.

Superannuation fund trustees have a fiduciary and legislative obligation to make investments in their members' best interests. The fiduciary obligation could be expected to involve trustees reviewing the appropriateness of investment practices, such as scrip lending, as market conditions change. There is evidence that trustees are undertaking such reviews. However, imposing investment controls or directions on funds to handle their investments in particular ways would limit the ability of trustees to maximise returns to members and hence their retirement savings. This would impact on the long term adequacy of retirement incomes and lead to increased Government outlays on the age pension.

Exercising voting rights

As outlined above, legal title does pass from the lender to the borrower during the period of the borrowing. This also means that voting rights are transferred during the period. However, as the lender will receive equivalent securities, they still retain the risk and exposure to the marketplace for the securities. Contractual arrangements would govern the terms of the lending arrangement, and generally unless otherwise agreed with the borrower, the lender has the right to recall the securities. Therefore the lender could recall the securities to vote.

Conclusion

The Government is closely monitoring the issues arising out of market volatility, continues to work with the regulators, and will fine tune the regulatory framework as required to ensure the market is fair and properly informed. As outlined above, there is evidence that trustees are reviewing the appropriateness of their investment practices such as scrip lending, in light of their fiduciary and legislative obligation to make investments in their members' best interests.