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24 November 2008

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Sir/Madam,

Re: ***Variation of the Financial Stability Standard for Securities Settlement Facilities: Disclosure of Equities Securities Lending***

BACKGROUND ON ACSA

The Australian Custodial Services Association (ACSA) represents the interests of the custodial services industry in Australia and appreciates the opportunity to comment on the *Proposed Variation of the Financial Stability Standard for Securities Settlement Facilities: Disclosure of Equities Securities Lending*.

ACSA is a company limited by guarantee and currently represents members holding securities in excess of \$1.3 trillion in custody and administration, and employing in excess of 3,000 people. All ACSA members either hold an Australian financial services license under which they are authorised to provide custodial or depository services, or are authorised representatives of such licensees.

ACSA member clients comprise persons who fall within the definition of 'professional investor' under the Corporations Act. The entities for whom members of ACSA act largely comprise other financial services licensees, such as responsible entities of managed investment schemes, trustees of wholesale unit trusts, trustees of public offer, industry and corporate superannuation funds, life insurance companies and general insurers, together with listed companies, federal and state governments and government agencies, global custodians, international banks and other major financial institutions.

The traditional custody product comprises the core services of safekeeping and settlement, namely the receipt and delivery of securities and cash to settle client directed trades. However, most custodians will also provide portfolio administration services (which can include valuation, unit pricing, unit registry, regulatory and tax reporting, portfolio analysis and performance measurement) together with other services such as foreign exchange and securities lending.

One key characteristic of the provision of custodial or depository services is that the custodian is bound under the terms of its contract with the client to only act in accordance with the instructions of its clients or their authorised agents and representatives. The role of the custodian is thus akin to that of a bare trustee or directed agent.

DISCUSSION PAPER

ACSA would like to provide comment to the RBA in regards to the reliability of the data the RBA has proposed the system operator gather from Participants, the operational limitations and timeliness of the implementation and possible alternatives to the RBA proposal.

Following discussions with the RBA on 20 November, we understand the objectives for amending the Financial Stability Standard to be:

- Assist the system operator in managing the settlement process and gaining a better understanding of the inter-dependencies of settlement flows relating to Securities Lending.
- RBA wishes to create greater transparency among participants by publication of data on the aggregate accumulated outstanding on-loan position by stock.
- Also useful for regulators and system operators to have at hand the ratio of on loan positions relative to market turnover.

Reliability of Data

Although the RBA has noted that it is only interested in gathering cross-participant securities lending related transactions, ACSA would like to draw the RBA's attention to the large volume of securities lending transactions that take place within a custodian's own books that will not be captured. i.e. when a custodian receives both the securities loan and securities borrow transactions from two clients on its own books, the transaction will not be reported to CHESSE. These transactions themselves may not even be reported to the local custodian as securities loan transactions. Although it is difficult to quantify the volume of transactions that are processed within a custodian's internal records, ACSA participants agree that the volumes are significant. If these transactions are not gathered, the system operator and importantly all market participants cannot rely on the accuracy of data collected.

Not all custodians run their own securities lending desk. Many clients of local custodians appoint a third party to arrange the loans, in which case the custodian would not necessarily be aware of the lending transaction. These transactions are instructed to the local custodian as simple Deliver (Receive) Versus Payment or Deliver (Receive) Free transactions. Information to the extent that the transaction is a securities loan is not generally provided. Participants are limited to what they can provide to system operators by the information provided in turn by their clients.

Enforceability

The RBA has advised they intend to make the disclosure by way of the ASTC amending the settlement rules with which participants must comply. The underlying client (local or offshore) instructing the custodian does not have a direct relationship with a system operator. Some custodians (even if they have an on- shore presence) do not have a direct relationship with a system operator (their subcustodian or its nominee would be the participant). By passing this requirement onto a settlement participant such as a custodian it may then be requisite on that custodian to make enquiries of every one of its thousands of daily settlement transactions as to whether each or any was related to a securities lending transaction if that data was not readily apparent. The ramifications of this when extrapolated to industry level are not insignificant. Settlement delays and fails would increase substantially as information lacking relevant data at first glance would need to be checked with clients prior to settlement.

Conversely if settlement participants are not required to provide this data through mandatory means, then the accuracy of the data itself must come into question.

Intermediary Lending

Discussions with the RBA suggest that it is the intention that the market operator will request custodians to flag "Initiating" loans, report them to CHES and any subsequent on-loan as such so they can track the chain of inter-related transactions of the initial loan. Alternative to this is the suggestion that "known agent lenders" are assumed to only have initiating loans and are tracked accordingly.

Operationally it is not possible to distinguish between agent and intermediary transactions in the case where the custodian as a participant is not directly involved in securities lending and its underlying clients are. All instructions sent to CHES from the participant only identify the transaction as from the participant ID (PID). As the transaction is only identified at the PID level, it cannot distinguish in the CHES instruction whether the originator of the loan transaction is an "initiating" loan, a "known agent lender" or intermediary loan.

As a result of these operational constraints, intermediary lending has the potential to over-inflate the true quantity of securities that are currently on loan. This may in turn have negative effects on how the liquidity or settlement risk of transacting in a particular security is viewed.

Further, even if participants were required to provide data on loans through mandatory means and loans were identified at the PID level, there may be limits on the usefulness of the data for tracking the chain of inter-related transactions. It is not possible to make an assumption that a particular participant correlates to a single underlying lending program or intermediary. Even if a custodian with a lending program is a participant, its clients may use third party lenders, so the trades identified as loans from that participant would not be directly referable to that participant's own lending program. Some participant custodians do not have a lending program but are sub-custodians for others (and there may be a number) who do have lending programs. The clients of each underlying custodian may also use different third party lenders so their trades that are identified as loans would not be referable to a single lending program.

Initial snapshot

The discussion paper also proposes taking a snapshot of the initial outstanding on-loan positions to provide a starting point and the possibility of reporting on-loan positions on a bi-annual basis. As mentioned previously, custodians are not necessarily engaged directly in lending activity. In addition, custodians who *are* engaged directly in lending activity and third party lenders are not necessarily participants. As such we are seeking clarification as to who would be responsible for initial and ongoing snapshot reporting.

Operational Limitations and Timing

The effect the proposed variations have on participants and their clients is dependant on the details of reporting requirements that will be imposed by the system operator (ASX). Some of the areas ACSA is concerned about and would like to be considered are detailed below:

- *Tagging securities lending related transactions* – The paper mentions that a redundant field in the CHES messaging system may be re-activated to identify securities lending related transactions. Data will need to include whether the transaction relates to an initial loan or a return (partial or full) of an existing loan. There is quite some concern from ACSA as to whether this currently vacant field will become a mandatory matching criteria in the settlement process. If this was to be implemented and this does become a mandatory matching criteria it is highly likely that the volume of failed trades will increase significantly.

- *The use and publication of data (confidentiality and timing)* – All custodians are restricted from releasing any client and trade information unless required by law. If participants were to provide the information to a system operator it would be under the condition that no client specific data is published as we do not see any reason why it should be published. It is ACSA's understanding that the data to be published is at an aggregate level per security only. The timing of publication of the data is also a concern given the possibility of disclosure of trading strategies (particularly for recalls, which are generally indications of a sale by a lender). ACSA recommends a suitable delay in publication of data.
- *Any additional System Operators entering the market* – There has been discussion surrounding additional system operators entering the market for some time. ACSA requests that any amendment to disclosure requirements is a standard across any system operator.
- *Timing* – Although the system operator (ASX) is yet to identify the technical requirements in regards to the activation or amendment of an existing CHES field, ACSA believes the proposed timing of 90 days is unachievable. Once the technical specifications have been advised by the ASX, ACSA would need to approach Swift to ensure a standard Swift field has been identified. Once this field is identified custodians will then be required to educate their clients (and who in turn would need to educate their underlying clients) on this new requirement with probable IT enhancements from those clients and also the custodian's own internal systems. The changes that need to be implemented would not be limited to Swift and CHES and would extend down the chain from the participant. There may be a number of sub-custodial steps in the chain from the person engaged in the lending activity through to the eventual participant, and the instructions may flow through a variety of methods and systems. The potential cost and scale of system changes cannot be accurately scoped until such a time as further detail is provided. If disclosure of securities lending transactions is mandated, then ACSA recommends a minimum implementation period of six months, and a non-compulsory grace period to be granted whilst appropriate implementations, system enhancements and client education takes place.

Alternative Arrangements for Disclosure

ACSA believes the responsibilities of disclosure requirements should be split between the objectives set out by the RBA.

Assisting the market operator in managing settlement risk:

Although considerable effort and investment will be required by participants, custodians, their clients, and their underlying client, participants will be able to report securities lending (Securities Loan/Borrow/Loan Return) transactions in a real time environment via the re-activation of a matching field in CHES. This will enable the market operator to be more informed on the chain of Securities Lending transactions and manage the settlement process more effectively.

As this information does not include all internalised securities lending transactions, and double counts on-loan transactions, this information should not be made public as the information may be misleading or misinterpreted by other participants. As such this should only be used by the system operator to for the purposes of backing out transactions should any issues arise with a participant meeting its settlement obligations.

Creating greater transparency among participants by publishing data on an aggregate accumulated on loan position by stock;

Useful for Regulators and system operators to have at hand the ratio of on-loan positions relative to market turnover:

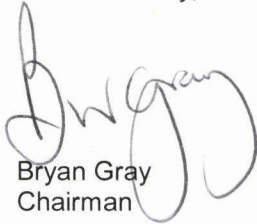
A possible solution to creating greater transparency among participants by publishing aggregate loan positions by stock is introducing an end-of-day daily file to be reported to the system operator by the entities that run a Securities Lending program. As there are a number of confidentiality, operational issues and issues with offshore lenders participating in such activity, ACSA suggest consultation with ASLA on the viability of such an option will be required.

Conclusion

Whilst ACSA supports a stable and efficient Securities Settlement facility, it is of the belief that given the overall settlement success rate in the Australian market, imposing additional reporting requirements on participants by a system operator to publish data that is either incomplete or incorrect would not be beneficial in its current state. ACSA members appreciated the opportunity to meet with Mark Manning and John Simon from the RBA in the process of preparing the submission. We believe that further round table discussions between the RBA, ASX and industry bodies such as ASLA and ACSA to work through the issues highlighted above are required before changes to Standards are made with implementation dates set.

If you wish to discuss any of the matters raised above, please contact either myself on (02) 9250 4660 or Michael Gannon of HSBC on (02) 9006 5336.

Yours faithfully,



Bryan Gray
Chairman