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ISLA Response to Public Consultation on the Draft Ministerial Order Regulating the Loan of Securities - September 2024

1. **Need for the regulation: Do you consider it necessary to allow Spanish investment institutions to engage in securities lending?**

Yes. As described in the introduction to the consultation, there are several benefits to allowing Spanish investment institutions to engage in securities lending, including benefits to Spanish capital markets, as well as the real economy. Some of these benefits include:

- The provision of secondary market liquidity of securities
- Increasing long-term investor returns on security portfolios
- Raising finance against long term investments
- Meeting prudential regulatory obligations such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) under the EU's Capital Requirements Regulation, helping to both manage and reduce systemic risk
- Sourcing and delivering collateral for regulatory margin requirements under the EU's Uncleared Margin Rules (**UMR**);
- Facilitating Market Making activities of financial institutions, giving them ready access to securities that they may not be holding; market makers who are continuously looking for securities to buy and sell can enhance market liquidity. Their ability to borrow securities on a continuous and regular basis, helps them to meet customer demand for securities.
- Facilitating settlement obligations and increasing operational efficiency, particularly in light of the EU's Central Securities Depository Regulation (**CSDR**), that penalises the late settlement of securities. Market participants can temporarily borrow securities to help reduce settlement fails. ISLA believes that there will be increased demand to borrow securities as a result of the future move to T+1 in Europe, as settlement obligations will need to be met in a shorter time period. Using securities lending to meet settlement obligations will not only advance post trade inefficiencies but also reduce systemic risk by reducing exposures over the settlement period. In a recent consultation, ESMA stated[1] that 'securities borrowing is usually the easier way to prevent or resolve a settlement fail caused by the lack of securities'.

In January 2024, BME Group, Bolsas y Mercados Españoles released a whitepaper with 56 measures to boost the competitiveness of Spanish Capital Markets. One of the key actions was to allow the securities lending operations of collective investment institutions, highlighting that Spain was the only country in Europe that has not developed legislation to facilitate it, putting the jurisdiction at a major competitive disadvantage when compared to other EU Member States. According to data provided to ISLA from S&P Global Market Intelligence[2], over the past 5 years, UCITS in Europe have generated approximately 3bn EUR from securities lending.

Currently across Europe, funds that allow securities lending, are providing benefits to the underlying investors, including retail and pension-holders, thus securities lending is benefiting the real economy. The additional income generated from securities lending can help to offset a funds management fees. This can

[1] https://www.esma.europa.eu/press-news/esma-news/esma-consults-potential-changes-csdr-penalty-mechanism

[2] https://www.spglobal.com/marketintelligence/en/

improve the overall performance of the investment portfolio, for the benefit of its end-users, such as pensioners. For example, the emergence of low-cost retail investment products in recent years, such as zero fee tracker funds, is in part due to management costs being supported and offset by revenue gained from securities lending. As such, securities lending also stimulates retail investment flowing into capital markets, an important objective of the EU's Capital Markets Union and Retail Investment Strategy. This was also recently outlined as a key priority for Europe in Mario Draghi's report[3] on the future of European competitiveness. Allowing Spanish funds to engage in securities lending will not only put them on a level playing field with other EU Member States, but also globally.

A report[4] by State Street in February 2023, analyses 20 academic studies and their methodologies to understanding securities lending's impact on fund performance and market functionality. The report states that *'the weight of empirical evidence finds that securities lending improves fund performance by contributing to net investment income and reducing tracking error without detracting from share value.'*

The EU's UCITS Directive 2009/65/EC[5] Article 51 (2) states that *'Member States may authorise UCITS to employ techniques and instruments relating to transferable securities and money market instruments under the conditions and within the limits which they lay down provided that such techniques and instruments are used for the purpose of efficient portfolio management'.* An ESMA report from May 2022 found that *'the most common EPM techniques used by UCITS managers are securities lending' amongst other products such as repurchase agreements.*

Referencing the benefits of securities lending more broadly to the economy, Banco de España makes available for lending their securities, as part of the European Central Banks Public Sector Purchase Program (**PSPP**) to ensure market liquidity. The ECB guide titled; What is Securities Lending? states that '*securities lending is to help the financial markets keep functioning smoothly*'.[6]

In conclusion, ISLA sees no reason why Spanish investment institutions should not be allowed to engage in securities lending. In order for the Spanish capital market to increase in size and liquidity, securities lending and borrowing must be proactively supported.

2. Lender:

2.1 To which categories of IICs do you consider it appropriate to allow this activity? Mark with an X all the categories that you believe should have access to this operation:

X ☐ Open general regime IICs

X ☐ Closed general regime IICs

[3] https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en
[4] https://www.statestreet.com/web/insights/articles/documents/securities-lending-to-lend-or-not-to-lend.pdf
[5] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0065
[6] https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/securities_lending.en.html

X ☐ Freedom of investment IICs

X ☐ Others. Specify which:

2.2 Do you consider that there are other institutional investors that should be able to develop securities lending operations? If so, which ones?

In other jurisdictions, it is common for other types of institutional investors to engage in securities lending such as; pension funds, mutual funds (including UCITS), insurance funds, Sovereign Wealth Funds and central banks.

3. **Borrower: Should requirements be imposed on the borrowing entity in relation to its supervisory regime, solvency level, or the state in which it may be domiciled?**

Collective Investment Schemes fund managers have a fiduciary duty to act in the best interest of their investors, this includes ensuring that any securities lending activities are carried out in a way that does not compromise the fund's investment objectives or expose the investors to undue risks. It is the primary onus of the fund manager i.e., the lender, to have robust risk management procedures in place, including assessing the creditworthiness of the borrowers and ensuring that appropriate collateral is obtained to mitigate the risk of default and insolvency. Lenders may utilise an agent for these purposes and conduct their securities lending in the market through an agency lending programme, which must incorporate a strong risk management framework, including assessment of the borrower creditworthiness which should take into account whether or not they are a regulated entity subject to their own supervisory regime, their solvency level and their place of domicile. This helps fund managers to ensure that securities lending activities are conducted in a responsible and transparent manner.

Lending is usually conducted using the Global Master Securities Lending Agreement (GMSLA)[7]. ISLA supports and has provided this standard legal framework that is recognised by regulators for over 20 years. ISLA also obtains legal opinions that are updated on an annual basis, to ensure the enforceability of netting provisions. The standard agreement provides protection to the lender in the event of borrower default. It outlines the terms and conditions of the lending arrangement, including provisions that address the consequences of a borrower's default.

Key protections for the lender under the GMSLA include:

- **Collateral Requirements:** The borrower is typically required to provide collateral to the lender, which is marked to market daily and can be used to cover certain losses incurred in the event of a default.
- **Liquidation Rights:** The lender may have the right to liquidate the collateral to recover its losses.
- **Termination Rights:** The lender may have the right to terminate the lending agreement and demand the return of the securities if the borrower defaults.
- **Damages:** The lender may be entitled to seek damages from the borrower for any losses suffered due to the default.

[7] https://www.islaemea.org/gmsla-title-transfer/

It's important to note that the specific terms of the GMSLA can vary depending on the negotiation between the lender and the borrower.

With regards to other requirements of borrowers, the GMSLA under Clause 14(e) Borrowers Warranties – states that '*where acting as a Borrower: it is not entering into a Loan for the primary purpose of obtaining or exercising voting rights in respect of the Loaned Securities.'*

ISLA does not feel it necessary to impose bespoke legislative requirements on the borrowing entity, as this is not found in other jurisdictions that allow securities lending from funds, and ISLA feels that it would put Spain at a competitive disadvantage if there were to be additional requirements placed on the borrower.

ISLA, as the leading association for securities lending market participants, maintains a Best Practice Handbook[8], that is based on market consensus and provides guidance to market participants. As an example, in the UK, the Bank of England has created a Money Markets Code[9], which is a voluntary code of conduct written by market participants and endorsed by the Bank. The code sets out standards and the best practice expected from UK Market Participants in the deposit, repo and securities lending markets. One suggestion could be, that instead of issuing prescriptive legislation, that the Bank of Spain or the CNMV adopts a similar code for securities lending practices in Spain, developed in consultation with local and global market participants to ensure adherence.

4. Requirements regarding the securities subject to the loan

4.1 Should only securities recognised as such by Law 6/2023, of March 17, on Securities Markets and Investment Services (LMVSI) be allowed?

ISLA would advocate that to maintain a standard across the EU, the types of securities that are allowable should be consistent with those instruments referred to in Article 2(1)n of the UCITS Directive (*Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities*).

Article 2, (1)n

'transferable securities' means:

(i) shares in companies and other securities equivalent to shares in companies (shares);
(ii) bonds and other forms of securitised debt (debt securities);
(iii) any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

Securities subject to a loan are most commonly, equities, bonds, including both government and corporate bonds, and ETF's.

[8] https://www.islaemea.org/isla-best-practice-handbook/
[9] https://www.bankofengland.co.uk/-/media/boe/files/markets/money-markets-committee/uk-money-markets-code.pdf

4.2 Should the lending of securities other than those recognized in the LMVSI be allowed? If so, which ones?

It is not current market practice for any other types of securities, other than those mentioned in response to 4.1, to be subject to a securities loan.

4.3 Should specific conditions be required regarding ownership and title to the securities? If so, which ones?

ISLA does not believe that any specific conditions should be required in regulation. ISLA would instead recommend reference to the mechanics within the Global Master Securities Lending Agreement. Under the GMSLA the lender is required to have full right and title to the securities it wishes to lend.

[Under the Global Master Securities Lending Agreement (2010) Title Transfer, which is recognised and referenced by ESMA in UCITS guidelines, the **Lender** transfers all of its right, title, and interest in a specified security/securities to another party, the **Borrower**. The Loaned Securities become the property of the Borrower. At the end of the Loan, the Borrower transfers all of its right, title, and interest in equivalent securities back to the Lender. Whilst the Lender does not retain proprietary interest in the Loaned Securities following the transfer, it does have a contractual right to the delivery of the Equivalent Securities. As a result, the transfer under the Loan will result in the Lender ceasing to be the beneficial owner of the Loaned Securities and the Borrower will obtain beneficial ownership of the Loaned Securities. This transfer is sometimes referred to as an "outright transfer". It is important to note that additional contractual arrangements between the Lender and Borrower may enable the Lender to recall securities at any time, e.g., for the purposes of voting. Although the Lender ceases to enjoy beneficial ownership of the Loaned Securities, it retains a complete economic exposure to them (since the Borrower is obligated to deliver Equivalent Securities at maturity of the Loan).]

5. **Settlement: Should the parties have the freedom to regulate the timing of settlement, or should it be established that the transaction can be settled at any time at the request of either party?**

ISLA would promote maintaining alignment with the UCITS guidelines at an EU level. The 2014 ESMA guidelines[10] for competent authorities and UCITS management companies, in Section 10 Efficient Portfolio Management Techniques, (30) states that: *A UCITS should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.*

In addition, the Global Master Securities Lending Agreement 2010[11], Clause 8.1 contemplates the Lender's right to terminate a loan:

'Subject to paragraph 11 and the terms of the relevant Loan, Lender shall be entitled to terminate a Loan and to call for the delivery of all or any Equivalent Securities at any time by giving notice on any Business Day of not less than the standard settlement time for such Equivalent Securities on the exchange or in the clearing organisation through which the Loaned Securities were originally delivered. Borrower shall deliver such Equivalent Securities not later than the expiry of such notice in accordance with Lender's instructions.'

[10] https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf
[11] https://www.islaemea.org/wp-content/uploads/2019/03/GMSLA_2010_amendments_July_2012-1.pdf

6. Collateral:

6.1 What aspects related to collateral would be desirable to regulate, if any? Mark with an X those aspects that you consider necessary to regulate:

☐ ~~Minimum required collateral level~~

☐ ~~Timing and manner of delivery~~

☐ ~~Issues related to updating the collateral~~

☐ ~~Types of assets eligible as collateral~~

☐ ~~Requirements regarding ownership and availability~~

ISLA does not believe that any of the above aspects should be regulated. It is established market practice that the value of the collateral provided by the borrower is normally greater than the value of the borrowed securities, providing additional protection for the lender i.e., margin/haircut. The exchange of collateral is an important means of risk reduction in the securities lending transaction, and therefore the level of over-collateralisation will reflect the characteristics of the trade. ISLA believes it should be left to market participants to determine relevant haircuts/ margin.

A significant amount of securities lending activity in the market is conducted using a Triparty Collateral Manager (TCM) which serves as an intermediary in securities lending transactions. TCM's facilitate the efficient and secure management of collateral between the lender and borrower. A Collateral Agreement is a legal agreement that would normally outline the terms and conditions governing the collateral posted by a borrower in a securities lending transaction and reflects the obligations of the parties under the GMSLA.

The Collateral Agreement specifies:

- **Types of Collateral:** What types of assets can be used as collateral (e.g., cash, government bonds, other securities).
- **Collateral Requirements:** The amount of collateral required to be posted.
- **Valuation Methods:** How the value of the collateral will be determined.
- **Margin Calls:** The circumstances under which the borrower must provide additional collateral.
- **Liquidation Procedures:** The procedures for liquidating the collateral if the borrower defaults on their obligations.
- **Interest Rates:** The interest rate that will be charged on any margin calls or other amounts owed by the borrower.

ISLA would recommend maintaining alignment with the ESMA 2014 guidelines as described above, Section X11 - Management of collateral for OTC financial derivative transactions and efficient portfolio management techniques, (43)[12].

[12] https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf

Essentially, the Collateral Agreement and ESMA guidelines already provide a framework for managing the collateral and addressing any potential issues that may arise during the lifecycle of the lending transaction. ISLA would see it as a potential competitive disadvantage to Spanish funds if the above aspects were to be stringently regulated.

6.2 Should the possibility of reusing the assets received as collateral be regulated? If so, what types of assets and what requirements or conditions should be established in this regard?

ISLA would propose that policy makers refer to Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards to depositary functions, remuneration policies and sanctions[13], Recital 19

'The assets held in custody by the depositary should not be reused by the depositary, or by a third party to which the custody function has been delegated, for their own account. Certain conditions should apply to the reuse of assets for the account of the UCITS'

And Article 22 (7)

'The assets held in custody by the depositary shall not be reused by the depositary, or by any third party to which the custody function has been delegated, for their own account. Reuse comprises any transaction of assets held in custody including, but not limited to, transferring, pledging, selling and lending. The assets held in custody by the depositary are allowed to be reused only where:

(a) the reuse of the assets is executed for the account of the UCITS;

(b) the depositary is carrying out the instructions of the management company on behalf of the UCITS; (c) the reuse is for the benefit of the UCITS and in the interest of the unit holders; and

(d) the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement.

The market value of the collateral shall, at all times, amount to at least the market value of the reused assets plus a premium.'

ISLA would also refer policy makers to the ESMA 2014 guidelines, Section X11 - Management of collateral for OTC financial derivative transactions and efficient portfolio management techniques, 43(i) and 43(j).

Furthermore, Article 15 of the EU Securities Financing Transaction Regulation (SFTR) also contemplates reuse of financial instruments received under a collateral arrangement.

6.3 Should the new Order regulate the actions that IICs should or may take in connection with its investment policy or the composition of its portfolio, as a consequence of the enforcement of collateral?

ISLA would refer policy makers to the terms of the standard Global Master Securities Lending Agreement 2010, with regards to what happens with collateral in the event of default of the borrower. ISLA does not

[13] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&qid=1494001122337&from=EN

deem it necessary to prescribe this in regulation. [The terms of the standard GMSLA sets out what happens with collateral in the event of default.]

7. Other issues related to the loan agreement:

7.1 Should the exercise of the economic rights associated with the transferred securities be regulated?

No, this governed via the industry standard legal agreement (GMSLA). ISLA supports and maintains the Global Master Securities Lending Agreement - GMSLA 2010 Title Transfer and the GMSLA 2018 Security interest over collateral[14].

7.2 Should other matters be regulated, such as the possible hiring of specialized agents or the allocation of costs related to the lending of securities to IICs?

The 2014 ESMA Guidelines on UCITS, states that: (28) *'UCITS should disclose in the prospectus the policy regarding direct and indirect operational costs/fees arising from efficient portfolio management techniques that may be deducted from the revenue delivered to the UCITS. These costs and fees should not include hidden revenue. The UCITS should disclose the identity of the entity(ies) to which the direct and indirect costs and fees are paid and indicate if these are related parties to the UCITS management company or the depositary.*

(29) All the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS.

There are various models for specialised lending agents in the securities financing market that policy makers should be aware of, when considering securities lending:

- Direct Lending – An asset manager appoints an in-house securities lending agent or affiliate. The in-house lending agent acts on behalf of the UCITS and lends their securities directly to borrowers.
- Custodial Agency Lending - Most large custodian banks offer agency lending services for their custody clients. In this model, the custodian of the UCITS is appointed as lending agent to lend UCITS' securities to borrowers.
- Third Party Lending - A lending agent other than the UCITS' custodian (or depositary) is appointed to lend the UCITS' securities.

Similar to fees for other investment management services, securities lending fees are negotiated between the relevant parties, taking into consideration a number of factors. It is imperative that securities lending transactions be treated in the same manner as other capital markets products, which permit costs to be negotiated commercially between the relevant parties. It is important to bear in mind that securities lending fees are not deducted from the UCITS' assets. Instead, the fees paid to the lending agent are deducted from the additional gross income that is generated from the securities lending transaction. The securities lending programmes offered by agents differ in service level, investor protection and returns generated.

8. Requirements relating to the securities lending policy of investment institutions:

[14] https://www.islaemea.org/legal-services/

8.1 What should be the appropriate maximum limit for the assets which can be lent by the IICs, calculated as a percentage of the market value thereof, against the whole estate of the IIC?

ISLA would promote maintaining alignment with the UCITS regulations and guidelines at an EU level on securities lending policy matters rather than impose bespoke legislative requirements for Spain.

8.2 Should other safeguards be specified in relation to the investment policy or redemption requests? If so, which ones?

Article 34 of the 2014 ESMA Guidelines on UCITS states that a UCITS should take into account the operations set out in Section 10 Efficient Portfolio Management Techniques when developing their liquidity risk management process in order to ensure they are able to comply at any time with their redemption obligations. This includes ensuring they are able to recall securities or terminate agreements.

8.3 What minimum degree of counterparty diversification should be required?

Generally, assets received by a UCITS as a result of engaging in efficient portfolio management techniques are treated as collateral.

Article 43 (e) of the 2014 ESMA Guidelines on UCITS sets out requirements for collateral diversification (asset concentration) which also references exposure to different counterparties as follows:

'Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets, and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this sub-paragraph, a UCITS may be fully collateralised in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' net asset value. UCITS that intend to be fully collateralised in securities issued or guaranteed by a Member State should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral for more than 20% of their net asset value.'

ISLA does not believe that there should be a minimum degree of counterparty diversification outlined in the regulation however, it is important to note that overreliance on a small number of borrowers or a limited set of securities may expose the lender to concentration risk. In order to mitigate this, market participants should diversify their lending activities across multiple borrowers and securities and avoid excessive exposure to a single counterparty or security.

8.4 Regarding the internal control procedures that management companies and, where applicable, investment companies must have in relation to securities lending, select the areas that these procedures should cover:

☐ ~~Selection of counterparties~~

☐ ~~Sufficiency and diversification of collateral~~

☐ ~~Related party transactions~~

☐ ~~Others~~

Article 11 of the Eligible Assets Directive of 19 March 2007 requires that the risks for techniques and instruments for the purpose of efficient portfolio management are adequately captured by the risk management process of the UCITS, which is the responsibility of the fund manager.

Article 27 of the 2014 ESMA Guidelines states:

'In accordance with paragraph 24 of the Guidelines on Eligible Assets for Investment by UCITS, techniques and instruments relating to transferable securities and money market instruments should not a) result in a change of the declared investment objective of the UCITS; or b) add substantial supplementary risks in comparison to the original risk policy as described in its sales documents.'

ISLA supports responsible securities lending and has been working with a broad range of market participants to drive best practice and the integration of corporate governance policies around voting and stewardship under securities lending arrangements. In November 2021, in conjunction with other regional securities lending associations, ISLA published a guide[15] on Voting Practices and Shareholder Engagement. The Bank of England Money Markets Code as referenced previously, sets out practices for voting rights on securities lending, and in Chapter 4, states that it is accepted good practice that securities should not be borrowed for the purpose of exercising voting rights.

As already stated above, the GMSLA under Clause 14(e) Borrowers Warranties – also provides that '*where acting as a Borrower: it is not entering into a Loan for the primary purpose of obtaining or exercising voting rights in respect of the Loaned Securities.'*

[15] https://www.islaemea.org/thought-leadership/gasla-best-practice-voting-guide/