Global Framework for ESG and Securities Lending

Second Edition
6 March 2023



ABOUT GASLA

The Global Alliance of Securities Lending Associations (GASLA) provides a single voice across global securities lending markets, advocating for transparent and standardised practices that support efficient, liquid, and sustainable capital markets, including considerations of Environmental, Social and Governance (ESG) factors.

Through active collaboration, GASLA seeks to enable positive and impactful engagement with stakeholders, including regulators, policymakers and standard-setting bodies across all regions.

GASLA was formed with inclusivity as a core principle and welcomes further engagement with financial markets associations globally.

GASLA IS COMPRISED OF FIVE FOUNDING MEMBERS:

- Canadian Securities Lending Association
- International Securities Lending Association
- Pan Asia Securities Lending Association
- Risk Management Association
- South African Securities Lending Association

INTRODUCTION

- The Global Framework for ESG and Securities Lending (GFESL) has been created by GASLA for the benefit of global securities lending participants. It is intended to provide a framework of considerations for lenders to evaluate when lending securities in the context of their ESG policies.
- The GFESL is not intended to form comprehensive guidance and should be read alongside a lender's own legal, tax and regulatory advice and form a component of a lender's broader due diligence process.
- The GFESL has been drafted on the basis of several studies and surveys commissioned by GASLA's member associations since 2020. These support the general view that ESG considerations and securities lending transactions are compatible, when lenders take steps to ensure that their lending programme is coherent with their sustainable investment strategy.
- GASLA has identified five key considerations, which are covered by GFESL. These are: voting rights, collateral management, lending over record date, the facilitation of short selling and transparency in the lending chain.
- This second edition of GFESL builds on and replaces the first edition published by PASLA and the RMA in May 2021. It will be further adapted to address new regulations and evolving market practice in respect of ESG and securities lending globally.

"Securities lending plays an important role in the market and provides investors with additional income. We do not consider securities lending as being incompatible with ESG, as securities lending arrangements can be tailored to meet the ESG objectives of the lending and borrowing parties…where applicable, a firm should clarify its securities-lending policy and the steps it takes to ensure this is coherent with its sustainable investment strategy."

The UK Financial Conduct Authority, October 2022 [1]

VOTING RIGHTS

VOTING RIGHTS



KEY CONSIDERATIONS

- Lenders of securities have a number of fiduciary duties to balance, including stewardship obligations to engage with companies through methods such as voting and, separately, the duty to generate shareholder returns.
- Lenders have different mandates on stewardship and voting in alignment with their own investment policies and therefore it is not pragmatic to prescribe a single approach to voting and recall in the context of securities lending.
- Lenders should develop a recall policy for their securities lending programme which is communicated to their agent lender. It is currently not standard practice for lenders to recall all lent securities before every corporate event. Instead, it is pragmatic for lenders to evaluate the materiality of the vote versus the potential securities lending revenues that would be foregone when making decisions on whether to recall securities or lend them.
- There is currently a lack of consistent and timely information regarding proxy record dates in several markets. Limited data on voting dates and AGM agendas is a challenge at present.
- GASLA notes that engaging in securities lending should never impede a lender's ability to vote and that securities are always recallable under market standard lending contracts, unless a lender has specifically entered into a bespoke contractual arrangement to forego recall capabilities for a prescribed period.

LEGAL AND REGULATORY CONTEXT

- Standard legal contracts governing securities lending activity, including the Global Master Securities Lending Agreement[2], incorporate warranties from borrowers to demonstrate that they are not entering into a transaction for the primary purpose of voting.
- This is also reflected by market guidelines such as the Bank of England's Money Markets Code[3] in the UK and Japan's Corporate Governance and Stewardship Codes. Regulation T in the US specifies the conditions under which a borrower may engage in a lending transaction. The rule, known as "the permitted purpose requirement," allows for the borrowing of securities solely for the purpose of making delivery for short sales, or failure to receive securities required for a delivery and other similar situations. Thus, it is not permitted for securities to be borrowed for the primary purpose of voting.[4]
- Under the US' Investment Company Act[5], form NP-X has in 2023 been amended to require funds to disclose the number of shares voted or instructed to be cast, as well as the number of shares loaned but not recalled. This will enable investors to more effectively monitor funds' involvement in the governance activities of their investments.

VOTING RIGHTS

PRACTICAL GUIDE



GASLA paper on Voting Practices and Shareholder Engagement (Nov 2021) [6]

1. Recall policy

Assess or develop a recall policy based on ESG considerations in a proxy voting framework.

2. Materiality

Identify the types of resolutions on which to vote, by company and by issue.

3. Defining parameters

Set out any other parameters that would trigger a recall or the restriction of lending, such as a significant ESG-related vote. Decisions may require the use of specialist ESG teams/advisors.

4. Impact

Consider whether the voting outcome would result in material financial or non-financial impact to the lender.

5. Minimum standards

Consider setting a minimum standard framework for proxy recalls, depending on market and liquidity conditions.

6. Title

When wishing to vote, lenders should ensure they have title to all securities in scope, which may require initiating a recall through the agent lender.

7. Communicate

Clearly convey recall policies to agent lenders/end users on recall policies to ensure alignment of execution terms.

8. Borrowing to vote

It is not acceptable practice to borrow securities or retain collateral for the sole purpose of accumulating and/or exercising vote rights.

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NON-CASH COLLATERAL, CASH REINVESTMENT & REUSE

KEY CONSIDERATIONS
NON-CASH COLLATERAL AND CASH REINVESTMENT

- Lenders may decide whether and to what extent they will align their universe of acceptable collateral with the ESG approach adopted for their core investment portfolios. This analysis should consider the primary purpose of collateral as a risk mitigant, and should ensure that collateral is adequately diversified to serve the purpose of effective risk management, in line with the lender's credit risk evaluation.
- If lenders restrict the eligibility of non-cash collateral either at the sector level by excluding certain areas of industry or at an individual security level, they should also consider local regulatory expectations.
- This may be relevant when certain regulators may expect greater shareholder engagement on ESG issues, for example through voting, as opposed to negative collateral screening or divestment.
- If lenders' investment portfolios take an ESG integration approach rather than an exclusionary one, lenders could consider applying the same criteria to cash re-investment practices as they would for non-cash collateral eligibility.



International Securities Lending Association: Applicability of ESG to Collateral in the context of Securities Lending



PRACTICAL GUIDANCE

While GASLA considers it essential that ESG-related risks should be considered in all aspects of an asset owner or managers' investment portfolio, it should be recognised that collateral guidelines should also be adequately diversified with a key aim of properly mitigating credit risk, as well as ensuring collateral is liquid and can be realised in the event of default.

This approach will assist in mitigating the risk of creating stranded assets in the market and support an orderly transition in respect of environmental factors in particular. On this basis:

- Where lenders wish to embed ESG principles into their collateral management, they should work with their credit teams and ESG specialists in setting acceptable tolerance levels and evaluating appropriate diversification of collateral guidelines. Lenders should then ensure clear communication of their tolerance levels and collateral requirements to agents and collateral managers, where applicable.
- In the absence of global common standards for screening and categorising ESG collateral due to the nature of bespoke ESG policies, lenders could explore using ESG collateral sets aligned to ESG indices available in the market, though they may need to consider applying a customised overlay to align with their own ESG policies. It is important to note, however, that increased customisation will impact securities lending performance, including utilisation and revenue.
- Lenders and agents may use third party ESG data providers to evaluate collateral through an ESG lens. Lenders should understand the methodologies utilised by the ESG data provider to determine whether these meet the requirements of their own sustainable investment policies.
- Lenders may seek to establish alignment between their own ESG guidelines that govern their core investment portfolio and their approach to cash re-investment. In the EU, lenders should consider the extent to which they may be subject to the disclosure requirements of the Sustainable Finance Disclosure Regulation (SFDR).[7]

REUSE OF NON-CASH COLLATERAL

KEY CONSIDERATIONS

- Reuse of collateral can add market liquidity as well as increase returns for lenders who receive and control collateral. Reuse increases the supply of available securities on the market that can be used for short-term financing, transaction clearing or transforming the credit quality of the securities held.
- However, some market participants believe that reuse of collateral increases operational risk by creating additional lending transactions from the received collateral. As such, some lenders may prohibit reuse within their securities lending programmes.
- To address these concerns, in the EU, reuse of collateral is reportable under the Securities Financing Transaction Regulation (SFTR).
- Under the EU's Securities Financing Transaction Regulation (SFTR) –Reuse is defined as 'the use by a receiving counterparty, in its own name and on its own account or on the account of another counterparty, including any natural person, of financial instruments received under a collateral arrangement.' [8]

PRACTICAL GUIDANCE

- Lenders and agents should incorporate clear guidelines on reuse of collateral into securities lending programmes.

LENDING OVER RECORD DATE

LENDING OVER RECORD DATE

KEY CONSIDERATIONS

- Securities lending activity across multiple jurisdictions can result in different tax obligations for the various participants in the lending chain.
- As a result, lending securities across borders over record date can result in securities being transferred from a participant covering a short position that is resident in a jurisdiction with a higher withholding tax rate, to a participant resident in a jurisdiction with a lower withholding tax rate.
- Tax rules are complex and nuanced between various domestic governmental authorities responsible for the administration of taxes. Lenders should always take independent tax advice to evaluate their securities lending programme parameters.

LEGAL AND REGULATORY CONTEXT

- Numerous legislative and regulatory regimes have been introduced in many markets that require participants to implement robust tax governance frameworks. These are aimed at identifying, preventing and reporting potential tax abuses.
- These regulations include but are not limited to;
  - EU Directive on cross-border tax arrangements known as DAC6[9]
  - UK Corporate Criminal Offence of failing to prevent the Facilitation of Tax Evasion[10] & The Bank of England Money Market Code[3]
  - General Anti Avoidance Rules (GAAR) which empowers global revenue authorities[11]
  - International Organisation for Economic Cooperation and Development's (OECD) Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting known as MLI.[12]
- Many market participants have specialist in house tax, legal and compliance control functions, which review and advise on such business activities to ensure adequate controls are implemented to address tax risks.

PRACTICAL GUIDANCE

- Ensure compliance with the spirit of the law as well as the letter of the law for tax related regulations and initiatives across global jurisdictions.
- Seek counsel from in-house / external tax advisors and experts where possible
- Market participants should ensure that there are adequate systems in place to identify manufactured payments for tax purposes, in accordance with the relevant regulations of the jurisdiction.
- When engaging in securities lending, it is important to be aware of tax rules in multiple jurisdictions, in respect of cross border transactions.

FACILITATING PARTICIPATION IN THE SHORT SIDE OF THE MARKET

KEY CONSIDERATIONS

- There have been some misconceptions in the market around ESG and securities lending, which facilitates the short side of the market.
- When conducted properly in accordance with relevant laws and regulations, there are several benefits of short-selling to capital markets.
- There is also a role for regulated and transparent short-selling in the context of ESG:
  - Short-selling can be used to hedge a portfolio's exposure to ESG related risks, including climate change
  - Short-selling for real world impact can incentivise changes in corporate behaviour
  - Short-sellers can expose fraudulent activity including greenwashing
  - Naked short-selling (the practice of short selling without first borrowing securities or confirming that they can be borrowed) is illegal in most jurisdictions

'Short selling plays a healthy role in the proper functioning of financial markets. It provides essential liquidity to markets which drives investment in firms, emboldens economic growth, and helps ensure investors pay the right price when investing in shares. Short selling is also essential to enable investors to manage risks in their portfolios by hedging against their investments.'

His Majesty's Treasury, United Kingdom[13]

FACILITATING PARTICIPATION IN THE SHORT SIDE OF THE MARKET



[Risk Management Association: Addressing Misconceptions in Securities Lending (Apr 2022)]



[The United Nations Principles for Responsible Investment Review of Shorting and Responsible Investment]

LEGAL AND REGULATORY CONTEXT

- Numerous legislative regimes have been introduced to build a governance and reporting framework around covered short selling.
- In Europe, Short Selling rules fall under the EU Short Selling Regulation and certain aspects of Credit Default Swaps[14]
- As a result of Brexit, the UK Treasury has launched a Call for evidence for a review on Short Selling rules, as part of the government's programme to repeal and replace retained EU law.
- In Hong Kong there is a mature framework for 'covered' short sales of designated securities. Short-sellers must confirm they have borrowed stock before executing the sale, comply with an 'up-tick' rule and file monthly reports on their short positions.

PRACTICAL GUIDANCE

- It is market practice, and in most jurisdictions, a regulatory requirement under relevant short selling law, to only engage in 'covered' short selling.
- The definition of 'covered' short sell varies by market but generally means that, before sending the short sell order, the short seller has satisfied any regulatory requirements to identify (and, in some regimes, hold or borrow) shares to settle their short sale.
- Naked short selling is not permitted practice.
- Agent lenders in some European jurisdictions may provide 'locate' lists to borrowers. This is where a borrower is seeking the availability of inventory and ensure they have taken appropriate measures to have reasonable expectation that settlement of a short sale can be effected, when its due.
- It is a regulatory requirement in some jurisdictions that the broker, or third party used to locate shares, must be a legally separate entity from the seller.
- Borrowers should ensure compliance with the spirit as well as the letter of the law with regards to the disclosure requirements of short positions, across global jurisdictions.

TRANSPARENCY IN THE LENDING CHAIN

TRANSPARENCY IN THE LENDING CHAIN

KEY CONSIDERATIONS

- Lenders have sought greater visibility over the purpose for which their securities are being borrowed and any onward lending transactions.
- In most markets, all participants in a securities lending chain will be regulated financial institutions, facing some level of ESG expectations from their stakeholders.

LEGAL AND REGULATORY CONTEXT

- Securities lending transactions involve a transfer of title of lent securities from the lender to the borrower (The GMSLA Pledge Agreement 2018 provides security interest over collateral only)[16]. Therefore once securities have been lent, the lender does not have legal or beneficial ownership or control of the securities.
- Transparency with regard to onward lending is not available to lenders in any jurisdiction.
- However, lenders can take comfort from the regulatory transparency in place in some jurisdictions, such as disclosure driven by the European Union's Securities Financing Transaction Regulation (SFTR). This has enhanced the transparency of securities lending transactions to the regulator in Europe, while the SEC seeks the same goal through the US' proposed rule 10C-1.
- In the EU, the Shareholder Rights Directive II (SRD II)[17] provides Issuers of securities with transparency about their shareholders at any time, including lent positions. Recital 12 of SRD II states that "It is…important that the asset manager reports on its policy on securities lending and how it is applied to fulfil its engagement activities, particularly at the time of the general meeting of the investee company".
- Whole exchange-based securities finance markets in Asia Pacific, such as Taiwan and Korea, ensure regulators have visibility over participants in securities lending transactions.

PRACTICAL GUIDANCE

- GASLA's objective is to ensure that regulators and issuers have access to the transparency they require. Our member associations work with local regulators and policy makers, to ensure that they are satisfied with the transparency within the market.
- Lenders, via their agents, can consider implementing effective minimum standards, reflecting their corporate-level sustainability framework with regards to selecting their direct counterparties and thereby embed their ESG policies into their 'approved' borrower lists.
- Approval of counterparties will vary by lender, according to their own ESG policies and assessments of ESG-related risk, which they should convey to their agent lender when reviewing approved borrower lists.
- All parties should ensure compliance with regional regulations and spirit of the law

DISCLAIMER

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APPENDIX

[1] https://www.fca.org.uk/publication/consultation/cp22-20.pdf - Page 29

[2] https://www.islaemea.org/gmsla-title-transfer/gmsla-2010-agreements/ - Clause 14(e)

[3] https://www.bankofengland.co.uk/markets/money-markets-committee-and-uk-money-markets-code

[4] https://www.federalreserve.gov/boarddocs/press/boardacts/1997/199712232/R-0905.pdf

[5] https://www.govinfo.gov/content/pkg/FR-2022-12-22/pdf/2022-24292.pdf

[6] https://www.islaemea.org/wp-content/uploads/2021/11/GASLA-Voting-Practices-Shareholder-Engagement_November2021.pdf

[7] https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en

[8] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32015R2365 – Article 3(12)

[9] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32018L0822

[10] https://www.gov.uk/government/publications/corporate-offences-for-failing-to-prevent-criminal-facilitation-of-tax-evasion

[11] https://www.imf.org/en/Publications/Tax-Law-Technical-Note/Issues/2016/12/31/Introducing-a-General-Anti-Avoidance-Rule-GAAR-Ensuring-That-a-GAAR-Achieves-Its-Purpose-43662

[12] https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

[13] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1129031/SSR_CfE_-_Official_Publication__FINAL_.pdf - Page 6

[14] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0236&from=EN

[15] https://www.sec.gov/news/statement/gensler-statement-rules-increase-transparency-short-sale-activity-022522

[16] https://www.islaemea.org/gmsla-security-interest/gmsla-security-interest-agreements/

[17] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828