MINISTERIO DE ECONOMÍA, INDUSTRIA Y COMPETITIVIDAD

75 King William Street,
London,
EC4N 7BE

Dear Sirs,
The International Securities Lending Association (ISLA) welcomes the opportunity to comment on the **CONSULTA PÚBLICA PREVIA 25.04.2018**

ISLA is a not-for-profit trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 140 members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than sixteen countries in Europe including Spain, and the rest of the world.

ISLA welcomes the consideration of developing a regulatory framework to enable the implementation of securities lending activity for mutual funds in Spain. Securities lending is increasingly recognised as a critical aspect of well-functioning markets, with regulators recognising both the systemic benefits, but also those to the end investors who can received improved performance from funds that are able to participate in this low risk activity.

In our capacity as the trade association for this industry in Europe, we believe we can help ensure that any regulatory framework that is introduced will help Spanish mutual funds to improve performance and compete in the broader European market, whilst ensuring that the control environment is appropriate and proportionate.

Securities lending provides direct benefits to institutional investors such as pension plans, retail funds (e.g. UCITS) and insurance companies, by enabling such investors to generate low risk incremental returns on their investment portfolios. These returns enhance performance over time and may substantially reduce the costs to long term investors of managing their portfolios. Whilst long term investors value securities lending returns, the clear majority consider the activity to be ancillary to the core investment management process and therefore to some extent discretionary.

At the same time securities lending also provides substantial benefits to the wider capital markets, enabling higher levels of settlement efficiency and increased liquidity and plays an increasingly important role in addressing the demand for collateral in the system as regulators seek to improve market infrastructure and mitigate systemic risk.

Index providers, such as FTSE International, include the existence of a well-functioning securities lending market in their criteria for a country's inclusion in their developed market indices. Recognising its broader benefits, governments around the world have provided exemptions and reliefs for securities lending transactions as well as the transfer of associated collateral, from locally imposed stamp or other similar transfer taxes, VAT, and capital gains tax charges.

Without securities lending it would be prohibitively more expensive and riskier for investment firms to make markets in a wide range of securities, and more difficult for investors to hedge investment positions or engage in trading strategies such as arbitrage. Securities lending is therefore a very important contributor to the functioning of the secondary markets and this has been recognized by academics, regulators and international organisations such as IOSCO

Since the financial crisis there has been a focus on improving the regulatory framework, seeking to protect investors and improve financial markets. In Europe we have seen a number of changes to mutual fund oversight which, in general, we believe has been successful in both clarifying the liabilities of securities lending activity and creating a framework which mitigates risks and encourages an appropriate level of activity. ISLA has worked closely with regulators to help in this process and developed market best practices alongside the regulation to enhance the application of the regulation and enhance risk controls.

The consultation covers many aspects of securities lending and therefore we would like to provide some insight on current market regulation and market practices on the various aspects you have raised. In some cases the regulatory landscape for funds in Europe is overly complex and restrictive, however as an initial framework for consideration we do believe it is comprehensive. ISLA is currently working on a detailed paper discussing some of the specific challenges created by these complexities and we would be delighted to share this with you when it is complete. In the meantime, below is a list of areas that we have covered in this document:

We trust you will find the information useful and informative in your deliberations.
Finally, we would welcome the opportunity to discuss this response, or any other aspect of securities lending, in more detail at your convenience

Yours sincerely

Andrew Dyson
ISLA CEO

Overview of current market structure

Securities Lending is undertaken under a Master agreement, most commonly the Global Master Agreement (GMSLA), developed and maintained by ISLA.

The Master agreement is signed between the two principals to the transactions (lender, or investor and borrower) and covers all lending activity between the two parties.

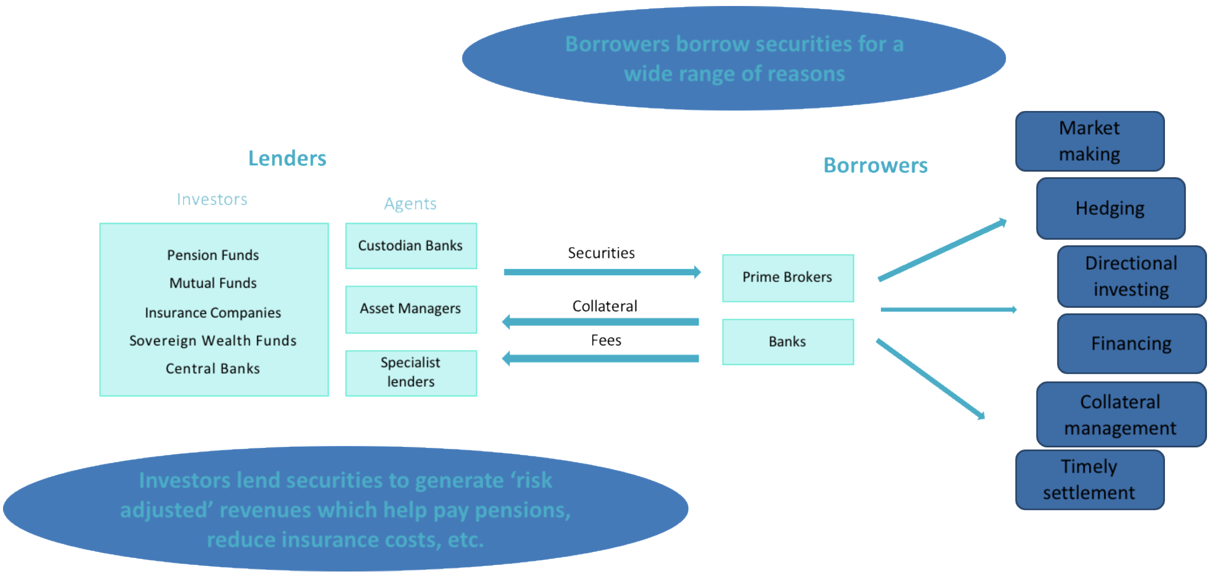
The GMSLA is based on the ability to set-off and net liabilities in the event of one party to the agreement defaulting, and to this end legal and netting opinions are available to cover most European countries and entities, which are maintained by ISLA and made available to member firms who subscribe to the service.

It is common for investors to access the securities lending market via an agent or third-party specialist, referred to as an agent lender. In this case the agent lender signs the Master agreement on behalf of a number of investors and transacts on behalf of the agent within strict parameters set by the investor either as an addendum to existing documentation (such as a custody agreement) or as a separate legally binding contract.

Agents also manage any corporate entitlements that fall due when securities are lent and manage the collection and distribution of fees.

In the case of European mutual funds, the Depository takes a critical role in the role of oversight and decision maker in the process. It is the Depository who defines who the fund is able to lend to, the level of lending and the collateral which is acceptable.

The below graphic illustrates a typical structure in the European markets and highlights some of the reasons to lend and to borrow.



Whilst an Agent lender may facilitate the securities lending activity, it is important to note that the risk is retained by the investor. This is why the Depository must have full oversight and decision making authority.

Prime brokers and banks borrow securities on behalf of their clients, which can be Institutions, Alternative funds or Corporations

Securities are borrowed for a number of reasons, but ultimately they are borrowed to meet a future dated settlement obligation. The borrower may be 'short' to settle a market sale for a number of reasons as detailed in the graphic above.

Market Making: To ensure a stable spread between bid and offer prices, a Market Maker must be assured they can meet their settlement obligations and so utilise securities lending.

Hedging: Many institutions such as Pension funds use securities lending as a tool in Hedging strategies

Directional investing: There are many directional investing strategies that require securities lending, and this is often seen as the most controversial reason to borrow. A fund may take a negative view of a firm and decide to sell short although strategies are far more complex than this. However, this activity aids price discovery and offers institutions who wish to invest in a company, the opportunity to buy at a fair price.

Financing: Increasingly Securities Finance is a critical tool for Financing and Capital Management. Firms are able to "transform" assets into High Quality Liquid Assets ("HQLA") to meet Capital requirement or other Financing requirements

Collateral: With regulation requiring more activity to be undertaken on a collateralised basis, some firms are curtailed because they do not have sufficient, appropriate collateral to meet CCP or Central Bank requirements. Firms are able to lend out ineligible assets and receive eligible collateral to meet their obligations

Timely Settlement: Market liquidity is reliant on timely settlement of transactions. A failing transaction can create a chain of market fails, so the ability to borrow to make timely settlement is critical to a well-functioning settlement process.

European Regulatory landscape

In recent years, Global regulators have increasingly recognised the importance of securities lending in providing liquidity, price discovery and reducing market volatility.

Securities lending supports price discovery and secondary market liquidity for a variety of securities, and is central to financial intermediaries' market making, investment, and risk management strategies [1]

The current European framework for Mutual funds is based on the UCITS IV Directive (2009/65/EC) and has been in force since 13 July 2009.

[1] FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

In 2012, in the midst of the post-crisis regulatory tsunami, the Commission launched a consultation on UCITS, exploring areas to strengthen the UCITS framework, in particular in areas like eligible assets, efficient portfolio management techniques (including securities lending and repo), liquidity management rules and MMFs. However the consultation did not result in a review of the UCITS IV Directive, although some of the points raised were addressed in separate pieces of legislation (notably SFTR and MMF Regulation) or addressed through other work streams (notably the Long Term Investment communication, which in some ways was a precursor to the CMU project).

The UCITS V Directive (2014/91/EU) came into force on 23 July 2014, but only deals with very specific aspects for depositaries, remuneration for managers, and administrative sanctions. However notably for securities lending was Article 22 which was updated from the previous version 'Obligations of a Depositary'.

ESMA's 'Guidelines on ETFs and other UCITS issues' (ESMA/2012/832 - the original guidelines) were effective from 18 Feb 2013 are to be read in conjunction with UCITS IV. The Guidelines are addressed to NCAs who must consider whether to implement them into their relevant domestic rules. Given that a working group of national regulators jointly developed the Guidelines, it is assumed that all NCAs adopted the Guidelines in substantially the ESMA form.

The purpose of the Guidelines is to promote common supervisory approaches and practices in the application of the UCITS directive by competent authorities and also help UCITS management companies by providing clarity.

Since the Guidelines have been implemented, European firms have found some of the requirements challenging to comply with, such as the level of diversification required for collateral and the restrictions on entering into term business. Whilst this may have led to a smaller proportion of available funds being lent, revenue levels have remained strong. As a framework for the industry ISLA, believes that the Guidelines provide a strong risk adverse platform to begin securities lending activity.

Performance

Whilst securities lending is a low risk low return activity, the revenues generated can be significant in respect of comparable fund performance.

According to EFAMA's Quarterly Statistical Release N°72 (Fourth quarter of 2017), the number of UCITS funds at end Q4 2017 stood at 31,974.

UCITS increased by 12.0% to €9,714 billion in 2017 and of the largest UCITS domiciles, Ireland recorded the largest net asset increase (15.9%), followed by Luxembourg, (11.9%), the UK (11.6%) and France (9.8%). Elsewhere in Europe, net assets grew by more than 20 percent, including in Belgium, Hungary, and Poland. Eight domiciles attracted net sales larger than €10 billion. These included Luxembourg, Ireland, the UK, France, Germany, Spain, Italy and Switzerland.

Net assets of UCITS reached EUR 9,714 billion at end Q4 2017, representing an increase of 12% in 2017. UCITS that would traditionally participate in Securities Financing Transactions would predominantly come from Equity and Fixed Income UCITS funds that total EUR 6,367 Billion.

Scope of Mutual funds for securities lending and market access

In the consultation, you consider whether all fund types should be able to participate in securities lending if deemed an appropriate activity.

ISLA believes that all funds should be able to lend and that the suitability and appropriateness of a fund to participate should be decided by the Depository of the fund. Whether a fund is Close ended or Open ended, of indeed an Alternative Investment fund is not the relevant question to ask when deciding a funds suitability for lending.

Many factors will influence the decision including the overall strategy of the fund, the type of assets invested in and the level of redemptions the fund experiences.

If a fund is volatile or has a large turnover in assets it is probably not suitable for lending, although restrictions in the level of lending may help to manage the process.

ISLA believes that the ESMA Guidelines provide a strong basis for this decision process by stating:

> *25.In accordance with Article 11 of the Eligible Assets Directive, UCITS employing efficient portfolio management techniques should make sure that the risks arising from these activities are adequately captured by the risk management process of the UCITS.*
>
> *26.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.*
>
> *34.UCITS entering into efficient portfolio management transactions should take into account these operations when developing their liquidity risk management process in order to ensure they are able to comply at any time with their redemption obligations.*

General Guidelines

> *30.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.*
>
> *34.UCITS entering into efficient portfolio management transactions should take into account these operations when developing their liquidity risk management process in order to ensure they are able to comply at any time with their redemption obligations*
>
> *41.The risk exposures to a counterparty arising from OTC financial derivative transactions and efficient portfolio management techniques should be combined when calculating the counterparty risk limits of Article 52 of UCITS Directive5*

Internal controls environment

In European markets, the controls around securities lending are defined by the Depository, and documented in the agreement with the Agent lender (where applicable), who has complete oversight of the activity and ensures it is undertaken within the controls.

The ESMA Guidelines provide a framework of controls under which the activity is undertaken. These include:

Counterparty Limits on how much a Mutual fund should lend

A counterparty limit framework is provided by the Guidelines by reference to the UCITS Directive

25. The risk exposures to a counterparty arising from OTC financial derivative transactions and efficient portfolio management techniques should be combined when calculating the counterparty risk limits of Article 52 of UCITS Directive5.

(Article 52(1) states:

….

Notwithstanding the individual limits laid down in paragraph 1, a UCITS shall not combine, where this would lead to investment of more than 20 % of its assets in a single body, any of the following:

(a) investments in transferable securities or money market instruments issued by that body;

(b) deposits made with that body; or

(c) exposures arising from OTC derivative transactions undertaken with that body.

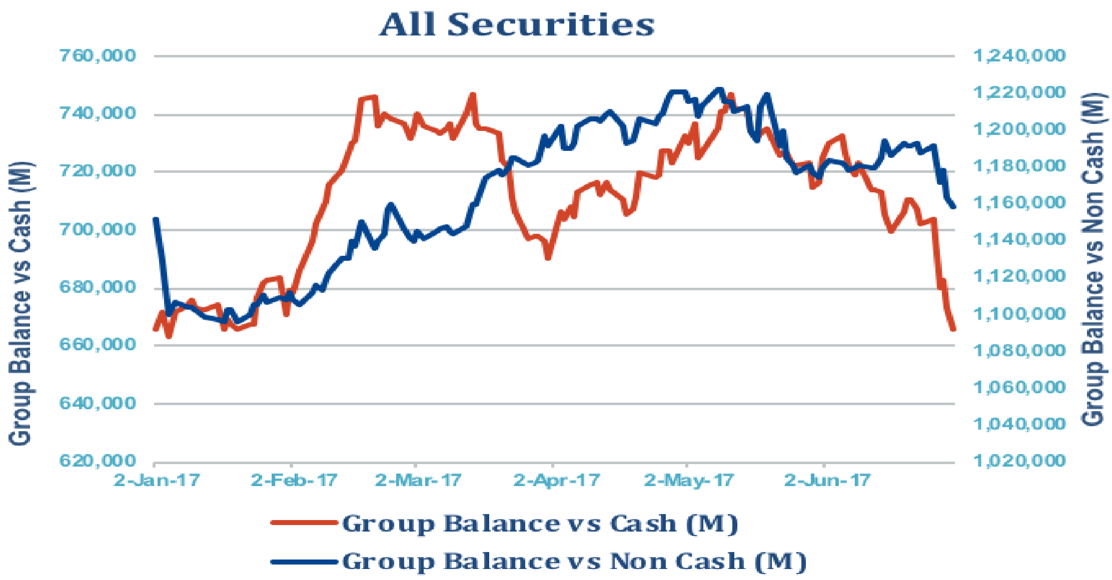
Collateral Management process

Collateral management is recognised across Europe by market counterparties and regulators as a critical risk control that reduces counterparty exposures and protects investors from counterparty defaults. As such much regulation has been written in recent years to strengthen collateral management processes.

In securities lending it is standard market practice to collateralise all loans with collateral exceeding the value lent. This additional collateral is referred to as a haircut and will vary depending on the correlation between asset lent and asset received. Both the Financial Stability Board (FSB) and the BCBS have considered imposing minimum haircut levels to Financing transaction to ensure sensible levels are maintained, although no regulation has been implemented and proposals were below levels applied in practice

In Europe, as globally, non-cash collateral is more dominant than cash collateral, although both methods are utilised.

The graph below shows levels of cash and non-cash collateral globally.



Securities lending collateralisation differs from other market sectors in so much as collateral is re-valued (via a mark to market, and adjusted each day with any collateral movement is transferred on the same day (in most sectors the physical movement of collateral occurs on a next day basis).

Currently most non-cash collateral in Europe is transferred under Title Transfer with legal ownership transferring from giver to receiver, although pledge collateral structures are being developed and are likely to be more prominent in the near future.

The management of collateral, particularly where diversification rules are as complex as they are in Europe, is managed by specialist third party collateral managers, such as Euroclear, Clearstream, BNYM and J P Morgan. These specialists invest in automated solutions which can apply complex eligibility rules and enables lenders to apply complex rules in an automated and controlled manner as well as constantly monitor collateral to ensure ongoing eligibility.

For Mutual funds, the Depository must have oversight of all collateral and takes responsibility for ensuring safe custody.

The Guidelines mirror common standard market practice:

45. A UCITS receiving collateral for at least 30% of its assets should have an appropriate stress testing policy in place to ensure regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS to assess the liquidity risk attached to the collateral. The liquidity stress testing policy should at least prescribe the following: *a) design of stress test scenario analysis including calibration, certification & sensitivity analysis;* *b) empirical approach to impact assessment, including back-testing of liquidity risk estimates;* *c) reporting frequency and limit/loss tolerance threshold/s; and* *d) mitigation actions to reduce loss including haircut policy and gap risk protection.* *46. A UCITS should have in place a clear haircut policy adapted for each class of assets received as col- lateral. When devising the haircut policy, a UCITS should take into account the characteristics of the assets such as the credit standing or the price volatility, as well as the outcome of the stress tests per- formed in accordance with paragraph 47. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.*

Collateral eligibility

In terms of the eligibility of collateral, again, the Guidelines provide a strong framework for regulators to consider;

43.Where a UCITS enters into OTC financial derivative transactions and efficient portfolio management techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times: *a) Liquidity – any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the provisions of Article 56 of the UCITS Directive.* *b) Valuation – collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.* *c) Issuer credit quality–collateral received should be of high quality.* *d) Correlation – the collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty.* *e) 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.

f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.

g) Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.

h) Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

It should be noted that the collateral diversification rules are very complex and have led to some reduction in demand for European funds, whilst not necessarily achieving the objective of mitigating risk. Whilst ISLA agrees that collateral diversification is an important risk control it is not clear, for example, how taking numerous (minimum 6) different issues from one member state guaranteed issuer, aids in mitigating risk.

Cash re-investment

Cash collateral re-investment can mean an increased return from securities lending activity. However the re-investment risk is held by the fund and so can mean increased risk of loss. It is therefore critical that cash re-investment is controlled, and capital protection is central to any investment risk.

Under the UCITS Guidelines, restrictions are given to the cash re-investment process

43.j.Cash collateral received should only be:

- *placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive;*
- *invested in high-quality government bonds;*
- *used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis;*
- *invested in short-term money market funds as defined in the Guidelines on a Common Definition of European Money Market Funds.*

44.Re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral.

Cost allocations

In general market practice is for the agent and the investor to share fees generated from any securities lending activity, rather than the agent to charge a fixed fee for the service. This aligns the agent and investors interests and ensures that the investor does not incur costs above revenues. Fee splits are commercially agreed between the investor and agent and, under the Guidelines, should be disclosed in the prospectus.

It is also common for a Depository to also take a share of the fee to cover the cost of providing it's oversight role, In Europe this has been generally accepted provided the fees charged are reasonable and appropriate.

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

Transparency of activity to investors and regulators

Transparency for investors and regulators has grown exponentially in the last decade, with numerous regulation and requirements being implemented.

Alongside regulation such as Europe's Securities Finance Transaction Regulation ("SFTR"), which requires the risks of collateral to be notified to counterparties, and detailed transaction reporting to be submitted to regulators via Trade Repositories[2], MiFID II requires additional reporting to both regulators and investors.

The guidelines provide very specific requirements for UCITS, and covers both initial information, in the Prospectus, and on-going requirement to ensure investors are fully informed.

28.The 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

[2] Implementation or regulatory reporting under SFTR is expected in early 2020, pending finalisation of the Technical Standards

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.

35.The UCITS' annual report should also contain details of the following:

c) the exposure obtained through efficient portfolio management techniques;

d) the identity of the counterparty(ies) to these efficient portfolio management techniques;

e) the type and amount of collateral received by the UCITS to reduce counterparty exposure; and

f) the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred.

47.The prospectus should also clearly inform investors of the collateral policy of the UCITS. This should include permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, re-investment policy (including the risks arising from the re-investment policy).

48.The UCITS' annual report should contain details of the following in the context of OTC financial derivative transactions and efficient portfolio management techniques:

a. where collateral received from an issuer has exceeded 20% of the NAV of the UCITS, the identity of that issuer; and

b. whether the UCITS has been fully collateralised in securities issued or guaranteed by a Member State.

Economic rights in securities lending

Economic rights are protected whilst securities are on loan by a contractual obligation under the GMSLA for the borrower to return any such entitlement. This extends to all corporate entitlements with the exception of the ability to Vote, as this cannot be manufactured back to the lender.

However, the lender has the right under the GMLSA to call for securities to be returned in a standard market settlement cycle for any reason. This is again a contractual right under the GMSLA

In order to manage the voting rights, most investors develop a policy detailing the circumstances under which they will consider recalling assets and makes this available to counterparties. In Europe it is usually the Depository that develops and enforces such a policy.

A further concern that is often raised is the ability to borrow securities in order to influence a voting situation. However, under the European Transparency Directive, this activity, which would be considered a Market Abuse by most national regulators, can now be monitored as it is a regulatory requirement to notify any Financial Interest is an asset which represents more than 5% of the issue. The broadening of the Directive means it is not possible to build positions through securities lending, or any other market transaction, in order to influence a vote.

The Bank of England recently published The UK Money Markets Code which provides the following guidance and is reflective of standard market practice

> *6.1 Where UK Market Participants will be borrowing securities from clients, whether as a final borrower, intermediary or agent, they should make it clear to the lender and beneficial owner that any voting rights will be transferred along with title to the securities and that the client is not therefore entitled to exercise any such rights until the securities are redelivered to it. Such a UK Market Participant should not be under any obligation to exercise any voting rights.*
>
> *6.2 It is accepted good practice 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.*
>
> *6.3 If a beneficial owner wishes to exercise voting rights, a clear instruction should be provided to their lending agent in sufficient time for the securities to be recalled in time for voting rights to be exercised. If securities are not returned in time, beneficial owners may ask their lending agent to use reasonable efforts to pass on the voting instruction to the borrower of the securities.*
>
> *6.4 Market intermediaries temporarily holding borrowed stock are expected not to exercise any associated voting rights unless instructed to do so, using commercially reasonable efforts, by the original beneficial owner*.