

SECURITIES LENDING AND REPO COMMITTEE

Thursday 22 June 2006

Bank of England

MINUTES

Attendees

David Rule	Bank of England, Chairman
David Roberts	ACI/RBS
Anthony Littleton	APACS
Alex Merriman	BBA
Tony Hibbit	Cater Allen
Alistair Robson	Deutsche Bank
Robert Fair	Euroclear
Warren Alsop	Euroclear
Cameron Dunn	European Repo Council/Merrill Lynch
Christian Krohn	Financial Services Authority
Margot Marshall	Financial Services Authority
Barbara Pung	ICMA
Heidi Bosshard	ICMA
Laurence Marshall	ISLA/UBS
Richard Steele	ISLA/JP Morgan
John Burke	LCH.Clearnet
John Serocold	London Investment Banking Association
Ian Fox	London Money Markets Association/ HBOS
Dagmar Banton	London Stock Exchange
Joyce Martindale	National Association of Pension Funds/Railpen
Mark Austen	TBMA
John Richmond-Scott	Bank of England, Secretary
Also present:	
Paul Tucker	Bank of England
John Rippon	Bank of England

1 Introduction

The chairman welcomed Warren Alsop (Euroclear), Heidi Bosshard (ICMA) and Laurence Marshall (ISLA) to their first meeting. He thanked Margot Marshall (FSA) and Barbara Pung (ICMA), who were leaving SLRC, for their contributions.

2 Minutes of the previous meeting on 30 November 2005.

The FSA had requested a small amendment to the previous minutes on point 7 regarding best execution. The revised minutes were agreed and had been circulated. Minutes from previous SLRC meetings are available at www.bankofengland.co.uk/markets/slrc.htm

3 LCH.Clearnet Gilts DBV service.

John Burke (LCH.Clearnet) updated the group on the Gilts DBV service. The cut-off time for receiving DBV trades in LCH would be 14.30 and LCH would transmit net DBV instructions to CREST by 14.45.

A shape-size of £250mn would be introduced to increase settlement efficiency. To avoid the risk of members being forced to receive a partial delivery late in the afternoon, LCH.Clearnet would maintain a float of £250mn of bonds within the DBV system that could be used to make up any deliveries, that would otherwise be partialled, to the required size. With this process in place, partial deliveries were likely to be exceptional.

Mr Burke confirmed that member testing was planned to start as scheduled in September 2006 but that this would be contingent on the completion of SSE trialling on CREST. Mr Burke offered to provide further explanation of the Sterling GC product to SLRC members outside the meeting.

4 Euroclear Consultation Paper – Securities financing and settlement windows on the Single Platform.

Robert Fair updated the group on securities financing on the Single Platform. Mr Fair confirmed that the Single Platform would provide a revaluation process for securities lending and borrowing, although it was likely that the default would be to opt out. The Single Platform would also automatically generate securities loan return legs as is currently the case

in CREST and Euroclear France. Based on feedback from the consultation, Euroclear were also considering how to ensure lenders had more control over the return of securities out on loan.

Under the Single Platform, there would continue to be a conflict in some areas between ISO standards and market practice, for example surrounding return leg auto generation and the management of roll-overs/early returns. Euroclear would continue to discuss with ISO how to reconcile the standards with market practice.

A service description for securities financing would be published at end July 2006, including a description of the overnight DBV service that would continue in the UK. Euro DBV, of which the level of transactions on CREST was low, would not be offered on the Single Platform due the incompatibility of DVP with DBV settlement windows under TARGET 2. Mr Fair confirmed that the service description could still be subject to further comments and amendments, and that Euroclear were still happy to discuss the subject with market participants.

Mr Fair commented that the introduction of a term DBV product (as opposed to a term-trade constructed as a series of overnight DBVs) would be considered as a service enhancement, separately from the harmonisation process. The effect of introducing a term DBV on liquidity was unclear, and could depend, inter alia, on specific decisions regarding the substitution of collateral mechanism.

The group discussed the usefulness of a term DBV product. It was thought the majority of repos/loans backed by DBV were overnight. Members thought that the Bank's Open Market Operations would be likely to account for a high proportion of term transactions currently collateralised by DBVs that could benefit from a term product. Euroclear could not easily distinguish 'term' (i.e. a series of overnight DBVs) from overnight DBV trades currently on CREST. The group also mentioned it would be useful to see how the introduction of the LCH.Clearnet Repoclear product affected liquidity flows. It was thought there could also be demand from equity borrowers for a term DBV product. It was concluded that further analysis of this issue would be required.

Mr Fair provided a summary of three final consultations on the Single Platform: Market Discipline; Transaction Reporting; and Miscellaneous (capturing all outstanding issues). Mr Fair commented that there were no items of direct relevance to securities lending or repo. A few issues were highlighted: Market Discipline looked at whether a discipline regime should be introduced in the Dutch and Belgian markets; Transaction Reporting mentioned possible MiFID-related changes that could be brought into CREST before the Single Platform, but was mainly focused on possible extension of the service to other group markets post-MiFID; and Miscellaneous covered, inter alia, harmonisation of bond stripping and reconstitution.

5 Updating the Equity and Gilt Repo Codes

John Rippon reported that he was now resuming work on the revision of the Codes. The Codes were nearly 10 years old and the revisions would take account of developments over the past decade, including developments in market infrastructure and regulatory changes. He thought that quite a lot of the broad principles in the original Code could still be maintained with suitable updating.

Mr Rule asked if the Committee thought that the Codes were still useful. Mr Rippon noted that the Gilt Repo Code was originally drawn up with the aim of trying to avoid some of the problems that had arisen in overseas repo markets; and, although some of the points in the Code might now seem fairly obvious as good practice, market contacts suggested that their embodiment in a Code was still useful and valued. The Committee agreed.

Committee members said that the case for maintaining an Equity Repo Code was less clear-cut, given the smaller size of this market compared with the much bigger equity securities lending market. Mr Rule suggested that the sub-group's work concentrated first on the gilt repo market; and that the Committee considered later whether the Equity Repo Code still needed maintaining at all.

Mr Rule asked whether developments in the gilt repo market infrastructure pointed to specific good practice requirements in relation to such infrastructure. Mr Burke gave the example that the Code could include conduct required by dealers when a trade missed the CCP deadline for receipt.

Mr Rippon envisaged setting up a sub-group to help take this work forward, and asked that Committee members would contact him if they wanted to participate. He also said that he would also ask members of the Sterling Money Market Liaison Group and its Operations sub-group to join the sub-group in view of their interest in repo. Mr Rippon said that he would circulate a first draft of the revised Gilt Repo Code for comment at the beginning of September. The aim was to finalise the revised Code by early 2007.

6 Transparency Directive

Christian Krohn (FSA) summarised the Transparency Directive Consultation Paper proposal regarding securities lending. This would exempt lenders from making major shareholding disclosures by allowing them to treat their right to recall lent stock as an 'acquisition' to be set-off against their lending/'disposal' of the stock. Mr Krohn informed the Committee that FSA was encountering some resistance to this proposal from lawyers rather than practitioners on the grounds that the company law provisions on which it was based were not clear and could be interpreted as requiring disclosure. The SLRC agreed that the proposal to net disposals against right of recall was sensible and would be welcomed by practitioners.

It was confirmed that notification requirements would still apply to securities borrowers. Committee members thought this would be unlikely to be problematic from an operational perspective. However, double-counting would occur where the share acquisition had been notified by both the borrower and the beneficial owner. Mr Krohn commented that the consultation would close at end June and a feedback statement and final rules would be issued in October.

7 Basel II and disclosure by agent-lenders

Richard Steele outlined some changes to disclosure requirements under Basel II for securities lending. Borrowers would require significant counterparty and transactional data in order to calculate their exposure to each lending principal and arrive at an estimated capital requirement. Agents, such as custodian banks, that lend on behalf of multiple beneficial owners would have to identify the individual lenders in each transaction, since the inability to

compute these exposures accurately would mean that borrowers may lose the ability to net exposures for regulatory capital purposes.

An ISLA subcommittee was looking at the impact of these changes and, with the support of LIBA and ICMA, would issue a survey in the next few months to assess further the scale of this issue and make recommendations. There were no concerns currently about the readiness of the market for Basel II.

The Committee discussed the details of disclosure requirements. It was thought that disclosure of beneficial owner name, jurisdiction, form of legal agreement etc would be required. It was understood that collateral would not need to be allocated on a loan-by-loan basis but could be pro-rated.

8 Review of GMSLA

ISLA had begun a review of the GMSLA and separate groups had been set-up to look at legal, tax and operational aspects. The review was a long-term process and was still at a very early stage. ISLA invited any further volunteers in particular for the legal group.

9 Markets in financial instruments directive (MiFID)

Margot Marshall outlined the MiFID implementation timetable and FSA consultation process. The European Parliament had endorsed the Commission's latest draft of Level 2 implementing measures and the European Securities Commission would vote on the measures on the 26 June¹. The final text would be most likely published in the European Official Journal in October.

The FSA had issued a Discussion Paper on Best Execution and a Consultation Paper on organisational systems and controls in May 2006. The consultation period for both would finish end-August. Two papers were planned for July: the Implementing MiFID for Firms and Markets CP, which would cover provisions including market transparency and transaction reporting; and an informal paper on client categorisation, which would be issued as a basis for

¹ The European Securities Committee unanimously approved the draft on 27 June.
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discussion. A CP on Reforming Conduct of Business (COB) regulation would be issued in October.

The group discussed the scope of Best Execution and in what circumstances securities lending would constitute an execution of client orders. Client Classification would be an important consideration as the duty does not apply when dealing with Eligible Counterparties. Entities that were not automatically Eligible Counterparties under MiFID may be treated as such if the firm acting on their behalf obtained their consent to do so and depending on the rules of the member state in which they were established. It was thought securities lending would not be greatly affected by the rules, but that further clarification should be sought. Ms Marshall encouraged the group to provide any feedback on the Best Execution DP and on Client Classification issues to Diego Escanero at the FSA.

Regarding the FSA's work on bond transparency, Christian Krohn informed the Committee that a feedback statement was due out in the first half of July. Mr Krohn indicated that it was likely to conclude that there was no evidence of significant market failure but that some buy-side firms felt that the market could benefit from more post-trade information. Mr Krohn also mentioned the recent trade association publications on European government bond and corporate bond markets as well as the European Commission's recent launch of a review on transparency in non-equity instruments.

10 UK Working Group harmonised corporate action standards

Alex Merriman informed the Committee that a working group had been established, based around CREST's stock events working group, with additional representation from APACS, LSE, DTI and the FSA, to address the cross-border inefficiencies relating to corporate actions processing identified by the Giovannini Group. The working group would look at issues such as full dematerialisation and electronic payment of dividends covering Gilt and equity markets where relevant. The working group had met for the first time in May and would meet again in July. An initial gap analysis showed the UK market already complied with a large proportion of the recommendations. Mr Merriman would keep the group informed of any developments that could impact upon securities lending or repo.

11 Status on harmonisation of legal opinions

The Chairman introduced the issue. In principle, there was agreement to harmonise the currently separate legal opinion gathering exercises for the GMRA and the securities lending agreements. It was envisaged that there would be a move to a subscription-based model and the funding details would be agreed by the relevant trade associations (ICMA, ISLA & TBMA) and the netting subgroup. It was intended for the harmonised process to be in place for the 2007 update. Mr Rule suggested that the trade associations meet shortly to review further the funding issue. ICMA would address the issue at its board meeting in September.

12 SLRC Netting sub-group: SLRC Netting legal opinions

John Serocold updated the Committee on legal opinions on securities lending agreements. Several developments were highlighted: the Kuwait opinion had now been released to members; opinions for two new jurisdictions (Dubai and the Czech Republic) were being looked at; the SLRC netting subgroup would need to discuss potentially extending opinions to cover additional types of counterparties; some possible changes to the UK tax addendum were also being considered.

13 GMRA: updated legal opinions

Barbara Pung (ICMA) updated the SLRC on GMRA-related issues. ICMA was currently updating the legal opinions on the GMRA in 52 jurisdictions, 24 of these jointly with TBMA. As in previous years, ICMA intended to publish the updated opinions by the end of March 2007. The Annex to these minutes contains further details of individual jurisdictions.

14 Any other business

The Chairman informed the group that a box on the SLRC had been published in the Bank's summer Quarterly Bulletin and thanked members for their contributions.

The International Corporate Governance Network (ICGN) conference would take place in July.

Annex - ICMA's update report on GMRA related matters

1. Legal opinions on the GMRA

1.1 2006 update opinions

On April 3, 2006 ICMA had notified the entire membership that it had completed the annual opinions update by publishing updated legal opinions on the GMRA for 52 jurisdictions on their website. In 24 jurisdictions this exercise was conducted jointly with TBMA.

To date ICMA was aware of prospective changes in law in certain jurisdictions which were due to take effect during 2006. These jurisdictions were Abu Dhabi, Austria, Bahrain, Belgium, the British Virgin Islands, Canada, the Cayman Islands, Germany, Greece, Guernsey, Ireland, Italy, Japan, Jersey, Latvia, the Netherlands, the Netherlands Antilles, Portugal, Singapore, South Korea, Sweden, Switzerland and the USA. When the relevant changes to the law take effect ICMA would ask counsel to confirm that these changes would not have an adverse effect on the conclusions in the respective opinions.

New and updated opinions are accessible for members on ICMA's website.

1.2 Scope of the 2006 update opinions

The 2006 opinions all covered both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole. The opinions also addressed the issue of recharacterisation risk (in respect of both the transfer of securities and the transfer of margin).

As with the existing opinions the 2006 opinions covered companies, banks and securities dealers. However, based on a recommendation of its European repo committee, ICMA had decided to extend the scope of the opinions for the following 21

jurisdictions also to cover insurance companies, hedge funds and mutual funds as parties to the GMRA: Austria, Belgium, British Virgin Islands, Canada, Cayman Islands, Denmark, England, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Scotland, Sweden, Spain, Switzerland and the USA (excluding insurance companies).

Both the UK Financial Services Authority (FSA) and the German Financial Supervisory Authority (BaFin) recognised the effect of netting provisions for regulatory capital and large exposure requirements provided that a legal opinion had been obtained which confirmed the enforceability of the netting provisions of the GMRA and met certain other requirements. The 2006 opinions enabled members to fulfil these regulatory requirements.

The opinions covered the 1995 and 2000 versions of the GMRA as well as the GMRA 1995 amended by the Amendment Agreement to the GMRA 1995.

1.3 New opinions being sought for the Czech Republic, Slovakia and Slovenia

ICMA was currently reviewing initial drafts of a new opinion for Slovakia and Slovenia.

A revised draft of a new opinion for the Czech Republic recently provided by local counsel was being reviewed by ICMA.

TBMA had not yet confirmed whether it would join ICMA in obtaining these new opinions and share the costs with ICMA on an equal basis

1.3 New opinions considered for Croatia, Malaysia, and Romania

In relation to Croatia, Malaysia and Romania ICMA was continuing to monitor legal developments with a view to ascertaining at what stage a clean opinion could reasonably be expected for each of these jurisdictions.