

## STOCK LENDING AND REPO COMMITTEE

TUESDAY 8 MAY 2001

MINUTES OF MEETING HELD

AT THE BANK OF ENGLAND

Present:	Neal Hatch	Chairman
	Dagmar Banton	LSE
	Stewart Devine	FSA
	Gerard Fitzpatrick	FSA
	Hugh Gibson	APACS
	Tony Hibbitt	Intermediaries
	Simon Hills	BBA
	Allison Holland	DMO
	Graham Jones	ISLA
	Philip Reichardt	Euroclear
	Steve Russell	IEMRC
	John Serocold	LIBA
	James Tomkinson	ERC
	Inke Nyborg	Bank of England
	Caroline Pitt	Bank of England
	John Rippon	Bank of England
	Nick Talbot	Bank of England, Secretary

1. The chairman noted apologies for absence from John Burke, Toby Davies, Sarah Hobbs, Stephen Priddle, Ian Valentine, Tim Westover and John Whitmore.

### MINUTES OF 13 MARCH MEETING

2. These were agreed as final and have been posted on the Bank of England's Markets website as agreed at: <http://www.bankofengland.co.uk/markets/slr.htm>

### FSA and CODES

3. Mr Fitzpatrick spoke first about the FSMA and the Handbook generally (including the IPC), which were due to come into force at N2 (for which the government has said the target date is the end of November 2001). The provisions to give the FSA rule making powers were due to be passed in the summer, and these would then underpin the Handbook. He did not expect the changes in the legislative

framework or regulatory requirements to lead to material changes for the conduct of legitimate stock lending or repo business. Those carrying on such business would still require authorisation; and he did not consider that revised regulatory requirements would lead to any change in legitimate behaviour in those markets.

4. He noted the approach in the IPC on telephone taping of conversations, as well as customer business and money laundering. He noted that the FSA was reviewing the IPC's guidance on territorial scope - if a deal were booked in London irrespective of where the parties conducted the transaction, then it could still fall under FSA regulation. The outcome depended on a number of factors including whether business could be said to be 'conducted in the UK'.

5. Mr Devine then briefed the Committee about how FSMA market abuse provisions, to be applied in the light of the new Code of Market Code, might be relevant to stock lending and repo markets. The provisions on abusive squeezes in particular seemed of potential relevance to stock lending and repo.

6. It was noted that squeezes occur relatively frequently and are a function of the normal interaction between demand and supply via the price mechanism. In order to distinguish between this type of 'normal/acceptable' squeeze and one that may be abusive, the FSA have drawn up a list of guidelines that they will focus on in determining whether to investigate a particular episode. The key issues are:

- whether the episode represents a planned strategy by market participants i.e. there must be a deliberate purpose behind the action;
- the extent of the episode's impact on a particular exchange and the contracts traded there i.e. the extent of the damage to the market and to confidence;
- and, whether the episode adversely affects the delivery mechanism.

7. The market abuse regime applies to 'qualifying investments', that is securities 'traded on' a prescribed market (e.g. those established under the rules of a Recognised Investment Exchange) and certain related products, e.g. investments whose subject matter is a qualifying investment (e.g. gilts futures - where the subject matter is gilts). Transactions in securities which are traded OTC (e.g. gilt repo) but are also traded on a prescribed market (cash gilts) will also be caught by the regime. Although an investment need technically only trade under the rules of an exchange once to qualify as being "traded on" for the purpose of the market abuse regime, it was unlikely that the price formation mechanisms on an exchange would be harmed if an investment had not traded on exchange recently or only in small business.

8. Mr Devine accepted that because the market abuse provisions were new (in particular the provisions on abusive squeezes), it could be difficult for market participants to gauge the FSA's likely response to a particular episode. The FSA had, however, attempted to assist market participants by providing as much clarification as possible through the use of examples in the COMC. And the FSA might issue further guidance ahead of N2.
9. Mr Devine agreed that it was difficult to imagine an abusive squeeze in the gilt repo market because the use of the DMO's standing facility could relieve the squeeze. Mr Devine also agreed that it was not easy to identify any clear examples of abusive squeezes in the recent history of UK financial markets, particularly those of interest to the SLRC. The more obvious examples were in the commodities markets (e.g. the Sumitomo case).
10. The issue of what is permissible ahead of a new issue launch in equities, bonds and convertibles is currently being reviewed by the FSA. A practitioner group is to be consulted over issues such as icing and pre-borrowing.
11. Mr Tomkinson raised the issue of market fragmentation over differing rules for different jurisdictions. For example, the Euro-Bobl squeeze allegedly took place through a European bank trading a European instrument on a European exchange and hence was not subject to FSA rules. Mr Jones noted that even though there was no direct impact to FSA regulated markets, there could have been an indirect impact through a loss of confidence. Mr Reichardt said that the increased popularity of remote access meant that while markets were still spread globally, player concentration was increasing; he wondered how the FSA would take account of this. Mr Devine said that the regime covered "all qualifying instruments traded on a prescribed market" and that more generally, regulators were aiming to try and reconcile their different approaches; he hoped the COMC would become the model answer.
12. Mr Devine noted the FESCO work on market abuse.

### **BASLE and Capital Adequacy Directive**

13. Following on from the discussion at the March meeting regarding the potential effect of the proposed new capital rules on the stock lending and repo market, Mr

Hills said that the BBA, ISDA and LIBA had had a series of meetings in order to formulate a response.

14. This group, chaired by Deborah Chesworth (and who has now moved from LIBA to the FSA), propose that stock lending and repo be treated as collateralised loans and hence be exempt from these capital rules. Specifically they propose:

- Collateral to be treated as a special instrument;
- The removal of haircuts on the value of collateral;
- A widening of the asset classes that are exempt from haircuts;
- And a reduction on the holding period from 10 to 5 days.

15. Mr Hills asked the SLRC whether the committee wished to support the work of this group or whether the group should send their response under the auspices of the BBA/ISDA/LIBA group. No decision was reached but Mr Hills agreed to send a copy of the group's proposed paper to the Chairman.

#### **NETTING SUB-GROUP**

16. Mr Jones briefed the committee on the sub-group's April meeting.

17. The OSLA and GESLA updating exercise was progressing as planned. For the GMSLA, most of the Original List opinions had been, or would very shortly be, finalised. The English opinion was being updated by Clifford Chance to take account of agency transactions and the Insolvency Act 2000. Mr Jones said that at a recent ISLA meeting, there had been some concern over the slow take-up of the GMSLA. It was felt this was due to the current unavailability of netting opinions; as such the sub-group was keen to press ahead with the GMSLA opinions exercise.

18. The sub-group had also discussed whether it was worthwhile to produce a summary template for the various jurisdictions, showing whether the netting opinions were favourable or not. Freshfields had highlighted the potential risks to this – that of omitting certain information – and hence the group will consider the issue further.

19. A discussion took place on whether the opinions should ask explicitly about recharacterisation. However since any opinion that concludes that netting is

enforceable should theoretically have taken account of recharacterisation, Freshfields will check the instructions to counsel on this point.

20. Mr Hills asked whether there had been any take-up of the Euromaster agreement; the Committee said no.

#### **EUROPEAN REPO COUNCIL**

21. Mr Tomkinson said the next ERC meeting would be on May 14 in Brussels; any comments on the agenda (circulated ahead of this meeting) would be welcomed.

22. Mr Tomkinson also noted that the ERC had discussed fails and in particular the squeeze on the Euro-Bobl future. The ERC aim to produce a set of guidelines for procedures on fails.

23. The ERC are to co-sign a letter with LIBA asking for more information on how the BASLE Committee's proposals on capital adequacy will operate.

#### **DATE OF NEXT MEETING**

24. The next meeting will take place on Tuesday 12 June.

**BANK OF ENGLAND      MAY 2001**