STOCK LENDING AND REPO COMMITTEE

TUESDAY 9 OCTOBER 2001

MINUTES OF MEETING HELD

AT THE BANK OF ENGLAND

Present:	John Rippon	Acting Chairman
	Dagmar Banton	LSE
	Krystyna Beck	LIBA
	Michael Chadwick	Intermediaries
	Andy Clayton	ISLA
	Toby Davies	CRESTCo
	Malcolm Ewen	Intermediaries
	Hugh Gibson	APACS
	Tony Hibbitt	Intermediaries
	Simon Hills	BBA
	Mark Hutchings	ISLA
	Graham Jones	Intermediaries
	Andy Murfin	FSA
	Mike Ness	DMO
	Jens Pohland	Bond Market Association
	Scott Rankin	Bond Market Association
	Philip Reichardt	Euroclear
	John Serocold	LIBA
	David Sly	Inland Revenue
	Alan Storey	Intermediaries
	James Tomkinson	ERC
	Tim Westover	MMLG
	Barry Harrison	Bank of England
	Caroline Pitt	Bank of England
	Stephen Priddle	Bank of England
	Nick Talbot	Bank of England, Secretary

The acting Chairman Mr Rippon noted apologies for absence from Neal Hatch and Guy Simpkin. He also noted that while at the last meeting, it had been decided that the Committee should move to quarterly meetings to allow for a more considered debate on issues, the events of September 11 as well as certain press articles regarding stock lending had meant that a meeting this month was indeed timely.

MINUTES OF SEPTEMBER 11 MEETING

1 Mr Rippon said that Bank members of the Committee were still considering these minutes. They will be circulated to the Committee as a whole for consideration in due course. Previous meetings' minutes are available at: http://www.bankofengland.co.uk/markets/slrc.htm

AFTERMATH OF NY ATTACKS – IMPLICATIONS FOR STOCK LENDING AND REPO

2. Mrs Pitt detailed the Bank's view of how the US and UK's market infrastructure – in particular payments and settlement arrangements - had coped with the events of September 11. The Bank had kept in touch with its usual contacts in exchanges and clearing houses and with the FSA, as well as market participants. A help line was set up to provide assistance to those who did not have regular Bank contacts; so far limited use had been made of this help line. Operational issues were referred to the office of the Executive Director, Market Operations.

3. The overall perception was that the financial market infrastructure in the US had coped well. All US markets except fed fund transfers were closed on Tuesday 11 and Wednesday 12, with derivatives (excluding those relating to equities) and bond markets re-opening on Thursday 13 and equity markets on Monday 17. The high-value payment system remained fully operational.

4. The US Depository and Clearing Corporation settlement system settled record volumes on Thursday 20 because of high trading volumes three days earlier, and these were settled comfortably. The Government Securities Clearing Corporation had some delays in processing the clearing of bond trades (mainly because of problems with one major participant) but these have largely been resolved. There were initially difficulties in the commercial paper market because of its short-term nature, and these contributed to some liquidity difficulties; again these problems were solved fairly quickly.

5. The SEC, CFTC and NASDAQ all made short term changes to their regulations in an attempt to minimise market disruption and not place additional burdens on companies in the short term. The SEC's have subsequently been extended and expire on October 12.

6. In the US repo market, volumes declined at first but have since recovered somewhat. Cantor Fitzgerald, who lost around 700 of its 1000 US staff in the attacks, was the dominant intermediary in the US repo market.

7. Bank of New York, which is the world's largest custodian and a major cash correspondent for dollar payments, was also affected given that its operations were concentrated around the World Trade Centre area. Telecom connectivity was lost and BoNY had difficulty processing payment instructions which contributed to some market liquidity problems and problems at GSCC. These problems have mostly been resolved now.

8. It is understood that most firms are operating from contingency sites and may do so for some time. Around the World Trade Centre site, power and telecoms have been reconnected although there are still network problems.

9. The Bank and the Federal Reserve Bank of New York set up a temporary sterling:dollar swap facility to allow banks in the UK to obtain US dollar liquidity from the Bank. While banks in the UK had not been encountering problems with dollar funding (continuing to use the usual routes of borrowing from the market and from the Fed (via open market operations or through the discount window)), the swap facility was set up as a precaution in case banks were to encounter difficulties in obtaining funds from these sources. In this case, the Bank would provide same-day dollar liquidity against suitable collateral (or, if that was unavailable, through dollar/sterling foreign exchange swaps).

10. Some UK organisations suspended the lending of securities in the immediate aftermath of the events of September 11 and until the global stock markets regained some degree of normality. But many other large UK-based fund managers decided to continue day-to-day lending business with the exception of certain sector stocks such as oil, banks, insurance companies and defence-related stocks. There was no discernible effect on UK infrastructure although some UK firms had some problems completing US transactions.

11. Mrs Pitt said that regulators and central banks will be sharing thoughts on the lessons to be learned in terms of improving market infrastructure at a G10 meeting later this month. Clearly there are issues regarding the concentration of primary and back-up trading and processing sites in a confined area. Some contingency sites are

not designed or sited to be used on a long-term basis. One difficulty with moving to contingency sites was that firms were unable to contact the contingency sites of other affected firms; some firms relied on mobile phones initially. Common reliance on essential infrastructure such as local telecoms is another issue. The planning and testing of contingency sites for Y2K, which the Bank coordinated in the UK and internationally, appears to have been of significant help.

12. Mr Rippon invited comments from the rest of the committee.

13. Mr Murfin said that since September 11, the FSA had been liasing with market participants and following up allegations that the terrorists had traded on their inside knowledge ahead of the attacks. The FSA have examined OTC transactions in cash and derivatives, focusing primarily on airline and insurance stocks, and oil prices. It has also responded to requests for information from overseas regulators. As yet, nothing suspicious has been found to support the allegations. The FSA will continue to investigate and looked forward to reading the reports from the individual exchanges. The information gathered would then feed into a report due to be presented to the European Council at the end of next week. There had been some calls to the FSA from the market regarding stock shortages but these problems had not been widespread and had been resolved quickly.

14. Mr Davies said that CREST had continued largely unaffected in both a technical and operational sense.

15. Mr Hills noted that a few member banks had called the BBA; this had been more for reassurance rather than for any specific technical problems.

16. Mr Ewen said that one of the problems encountered by BoNY was that of communication: hardware at their main site could not connect to that at their contingency site.

17. Mr Hibbitt noted that one advantage for the US compared to the UK was the back-value facility. In the US, trades can be back-valued (recorded as if they were done on a previous day) so that once everything had settled down, there was no discernible effect. In London, that facility is not available.

18. Mr Reichardt said that there had been a lack of trade confirmation tickets from BoNY which had led to concern over credit exposures. This was particularly so for smaller payments, which went aggregated involved substantial sums. Individual high

value payments had been less affected. He also noted that many financial projects had now been postponed such as the US move to T+1. Mr Gibson agreed, and said that there were likely delays for GSTP and other messaging projects. There were also still outstanding concerns regarding reconciliations.

19. Mr Davies said that a potential weakness in contingency planning was that of telecommunications. Most CREST users for example did not subscribe to both Swift and BT Syntegra networks due to the cost – estimated to be around £100k pa to use an additional network. However this cost is likely to fall when the new providers come on line later this year. He also said that while contingency planning had been considered in London, the scale of the September 11 attacks had meant that this planning needed to be reassessed and that there was now a much higher ante involved in contingency planning. Most companies would need to rethink their plans which currently involved having primary and back-up sites too close together such as in the City and at Canary Wharf.

20. Mr Serocold noted the importance of 'boring' tasks such as archiving. Also, bearer certificates should be recorded and backed up in a separate location. The same applied for client agreements. He said that LIBA would be running some disaster recovery workshops in due course.

21. Mr Gibson wondered whether the Bank would provide some guidance on contingency planning such as some best practise/minimum standard guidelines. This would not necessarily take the form of a publication. There was support for this suggestion from market participant members of the Committee, with Mr Serocold saying that they saw the Bank as the hub/focal point for the market and thus it had a unique position from which to provide guidance. Mrs Pitt said she would pass this, as well as the other feedback on to senior members of the Bank. Mr Rippon encouraged market participants to feed in as many comments as they could provide to the Bank, so that full consideration can be given to all the lessons.

STOCKLENDING – RECENT PRESS ARTICLES AND CURRENT POSITION

22. Mr Rippon noted the recent press articles on stock lending and short selling and asked the Committee where the market now stood and what lessons could be taken from this.

23. Mr Jones suggested that the fund management industry had tended to always be suspicious of the merits of stock lending and hence once the press had picked up on the issue, the impact on the industry had been exacerbated. Mr Chadwick thought stock lending had an image of being "arcane" and "existing in a murky world". Mr Clayton said that The Sun had reported that stock lending was not a regulated activity which was clearly incorrect. He also noted that some insurance companies had called him and said that they thought the FSA had been directing them not to lend stock. The objective now was to try and improve the image of stock lending for the "man in the street".

24. Mr Chadwick said that the HBOS press article had been over-exaggerated and was in fact not to do with HBOS' treasury division but instead related just to Clerical Medical. He thought a statement by the Bank/FSA supporting stock lending would help resolve some of the many misconceptions about stock lending that exist in the wider market.

25. In response Mr Rippon considered what impact a statement by the authorities at the time would have done. On the one hand it may have helped resolve the situation; on the other hand it may simply have exaggerated the concerns. He explained that one factor behind the Bank's approach (ie not to make a statement at the time) was that our bilateral contacts suggested that there was not a general loss of confidence in the stock lending market or any evidence of widespread or significant departures. Mr Hibbitt thought a better approach would be to detail why the market engaged in stock lending: its use for technical and settlement issues and not just for short selling. Mr Rippon mentioned the IOSCU/CPSS publication of July 1999 on securities lending which acknowledged the authorities' recognition of the value of securities lending. Mr Serocold noted the problem of obtaining accurate statistics on the subject in order to support these uses of stock lending.

26. Mr Murfin said that short selling is in normal circumstances a natural and important feature of the market. It provides liquidity and many would argue improves price discovery helping the market to adjust more quickly to new information.

Similarly stock lending plays an essential part in the efficient working of these markets, again improving liquidity and allowing more efficient hedging of derivatives and other risks. These activities are a normal and accepted part of activity in developed financial markets. He said that the FSA were supportive of these normal activities as indicated in Howard Davies' statement on September 25. Much of the reporting of the FSA's views has nevertheless been misleading – e.g. the FSA has not discouraged stock lending in any way. It is for individual stockholders to exercise their own judgement as to whether, to whom and on what terms they will lend.

27. Mr Murfin also noted that short selling raises some policy issues. It can be used as part of an abusive strategy such as where it is used to distort or position the price of a stock at an artificial level. But long purchases could equally be used to distort a market – but people seem to complain less about a rising market than a falling one, and less about aggressive buying than aggressive selling. There is nothing inherently wrong with aggressive trading per se. But where either is used as part of an abusive strategy they could still fall foul of the new market abuse regime.

28. Other policy issues concern the degree of transparency surrounding short selling – it would be possible to have more transparency here say by stock, but this is not straightforward for stocks which trade across multiple platforms. It would also be possible to have tighter requirements for delivery to ensure that short sales have been properly covered. The FSA will be reviewing these issues again (following a review in the early 1990s) to see if changes are appropriate but that is not to say that the FSA believe there is anything wrong with existing market practises, more to see whether there is a need to adapt transparency and other market rules in light of developing practises.

29. Mr Rippon reminded the Committee that the SLRC Stock Borrowing and Lending Code of Guidance existed and had the endorsement of the Bank and the FSA: it can be found at: http://www.bankofengland.co.uk/markets/slrc.htm

30. Mr Hills volunteered to draw up a fact sheet on stock lending to help public understanding. It will be ready for the Committee to consider at the December meeting.

STOCK BORROWING AND LENDING CODE OF GUIDANCE: UK ANNEX

31. Mr Rippon said that the code had been finalised at the end of last year, and that work had begun on a UK annex by a sub-group of the Committee. This work had stalled on the issue of deadlines for elections on dividends and the relationship with London Stock Exchange rules.

32. Ms Banton said that the Bank, LSE, CREST and ISLA had met and some progress had been made. The LSE is considering some changes to its deadlines and as such, a market notice is currently under internal review before being released to the market for a 28-day consultation. The notice will suggest that deadlines be reduced from 6 and 5 days to 4 and 3 days (the exact length depending on the capacity of the member).

33. Mr Rippon said that provided this progress continued, the annex should be completed by the start of next year.

NETTING SUB-GROUP

34. Mr Jones briefed the Committee on the sub-group's earlier meeting. He said that both the US and English GMSLA opinions had been finalised, both now including enforceability of the agreement as a whole and not just close out netting. The US also now covered registered broker-dealers. Luxembourg's opinion was close to completion while in Norway, changes to legislation had not impacted stock lending and hence the opinion remained negative.

35. Italy's recent legislative changes meant that the opinion was improved for transactions that were conducted on-exchange but unchanged for those off-exchange. Unfortunately with transactions largely conducted off-exchange, the legislative changes had little impact on the existing opinion which remained negative.

36. Mr Jones also noted that an additional opinion will be produced for the UK for additional counterparties, that of insurance companies, building societies and pension funds/unit trusts.

37. Distribution of opinions by Freshfields will in due course switch from paper circulation to the posting of them on a secure internet site with access to subscribers only. Those wishing to continue receiving paper versions will be charged for them.

THE HAGUE CONVENTION

38. Mr Rippon provided the Committee with information on the work undertaken through the Hague Convention to reduce legal risks associated with taking securities held through multiple tiers of intermediaries' collateral. The increase in legal agreements and cross border transactions has heightened the market's awareness of this issue.

39. The traditional conflict of laws rule for determining the enforceability of a transfer or pledge of securities is based on the law of the place where the securities are located. This is easy to apply in the case of bearer of directly held securities, but it fits less well with an indirect holding pattern. In this case, the "look through" approach may be adopted – looking at e.g. the place of incorporation of the issuers, the location of the issuer's register or the location of the certificates.

40. The Hague Convention is examining an alternative approach as well – that of looking at the location of the intermediary maintaining the account to which the securities are credited – the place of the relevant intermediary approach (PRIMA). With this approach, even if a portfolio of securities from different countries is involved, the governing law applicable will be from just one jurisdiction, that of where the relevant intermediary is located.

41. Discussions are continuing as to how to locate the relevant intermediary. The principle agreed on for the initial test will be the place designated in the account agreement with the relevant intermediary unless that designation was clearly inconsistent with the actual operation of the account in practise. Work is continuing with a view to finalising the text in December, and the aim is to have a ratified convention later next year.

42. Mr Rippon suggested progress could be reviewed at the December SLRC along with progress on the EU Collateral Directive.

ANY OTHER BUSINESS

43. Mr Serocold asked about the state of play regarding pre-hedging of convertibles (following last month's briefing to the Committee by Kate Wormald of the FSA). Mr Murfin said the FSA were in the process of speaking to market

participants on the distinction between “bought deals” and “public offerings/disclosures”. Mr Murfin said the issue was still open to consultation and that the FSA’s market practitioners group would be meeting on this subject at the end of the month.

DATE OF NEXT MEETING

44. The date of the next meeting will be Tuesday 11 December, at which the Bank will provide a Christmas buffet for members.

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