ASIC CLASS ORDER [CO 11/272]

EXPLANATORY STATEMENT

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (***ASIC***) makes ASIC Class Order [CO 11/272] under subsection 673(1) of the *Corporations Act 2001* (the ***Act***).

Subsection 673(1) of the Act provides that ASIC may exempt a person from a provision of Chapter 6C or may declare that Chapter 6C applies to a person as if specified provisions were omitted, modified or varied as specified in the declaration.

1. Background

ASIC Class Order [CO 11/272] is directed to better disclosure of substantial holdings arising from securities lending and prime broking activities. In 2009, ASIC sought feedback on specific relief proposals and the application of the substantial holding provisions to securities lending and prime broking in Consultation Paper 107 *Securities lending and substantial holding disclosure* (***CP 107***). ASIC obtained further industry feedback following this consultation. The class order contains the measures we have implemented following consideration of the issues raised during consultation and the purpose of the substantial holding provisions.

The substantial holding provisions require disclosure by persons that have a substantial holding in a listed entity. A person will have a substantial holding in a listed entity if they, together with their associates, have a relevant interest in 5% or more of a listed entity. A substantial holder must disclose their holding within two business days of the holder becoming aware of the information (or the next business day during a takeover bid) and subsequently when there has been a change of 1% or more in their holding. The disclosure must be given to the listed entity and to each market operator of the financial market on which the entity is listed.

The obligation to notify substantial holdings also applies to parties that lend or borrow securities on usual terms and applies to a prime broker/custodian with a right to borrow its client's securities.

"Securities lending" is the term used to describe a market transaction where securities are transferred from the owner (the ***lender***) to another party (the ***borrower***). The borrower is obliged to return the securities or equivalent securities to the lender either on demand or at the end of the loan term. A securities lending transaction on standard terms will usually result in both parties having a relevant interest in the securities under section 608 of the Act. Securities lending usually occurs between professional investors (such as institutions) in the market and usually involves securities held by custodians. It can, but does not always, occur ahead of, or as part of, short selling

activity. Securities lending can also be undertaken to cover potential failed trades, dividend-driven transactions or other transactions relating to corporate actions, including voting.

"Prime broking" is a commercial term for a package of services offered by an investment bank, typically comprising custodial services, execution, securities lending and financing. These services are normally offered to institutional and professional investors.

As part of this package of services, a prime broker may have the right to borrow its client's securities under a securities lending arrangement. Such a right will be non-exclusive, where the client remains free to deal in particular securities (though the client may need to ensure its account is otherwise sufficiently funded and may need to satisfy certain procedural requirements).

This will usually result in the prime broker having a relevant interest in the client's securities. The prime broker must take this interest into account in its substantial holding calculations at the time of entry into the prime broking arrangement and not subsequently when it borrows the securities. Disclosure at the time of actual borrowing would be more relevant to control over and voting of the securities.

2. Purpose of the class order

The purpose of this class order is directed to achieving better disclosure of substantial holdings arising from securities lending and prime broking activities.

Disclosure of substantial holdings, including for interests arising from securities lending and prime broking, is important for maintaining an efficient, competitive and informed market. Without full disclosure of substantial holdings, there is a risk that the market will be misled as to the ownership and control of listed entities. It is also important that the disclosures allow the market to understand the nature of the substantial holding being disclosed.

As a result of this class order, it will be easier for substantial holders to comply and should result in better disclosures to the market. Along with this class order, we have issued Regulatory Guide [ ] *Substantial holding disclosure: securities lending and prime broking* to provide guidance to the securities lending industry on how to comply with the substantial holding provisions.

3. Operation of the class order

Lender retains relevant interest because of right to recall securities (paragraph 4 of the class order)

The class order notionally modifies the operation of subsection 608(8) of the Act as it applies to a lender's relevant interest arising from its right to recall for the purposes of the substantial holding provisions.

A lender of securities under a standard securities lending arrangement has a relevant interest in securities which it lends by virtue of its right to recall the lent securities (or equivalent securities).

When a borrower on-lends the securities to a third party, provided the borrower retains a relevant interest in the securities, the lender will continue to have a relevant interest in the securities under subsection 608(8) of the Act. In this way, a number of securities lending transactions will result in a chain of people having a relevant interest in the same securities, meaning that each party in the chain must calculate their own holdings to determine if they have a substantial holding.

This chain requires that a subsequent borrower retain a relevant interest. The borrower will cease to have a relevant interest in the lent securities if it disposes of them in circumstances where it does not retain any rights (e.g. where the borrower sells on the relevant financial market). The lender will also cease to have a relevant interest in the securities in these circumstances, even though the lender has the right to require the borrower to deliver equivalent securities under its securities lending agreement. This is because the lender's relevant interest arises under subsection 608(8) of the Act and that provision depends on the counterparty having a relevant interest in the securities.

However, the original borrower and lender may not be aware of a subsequent disposal and the trigger to substantial holding disclosure only occurs on becoming aware of the change in relevant interest. We indicated in CP 107 that it is prudent and good policy for lenders to assume that the borrower (and any subsequent borrower) maintains its relevant interest.

To remove any doubt, we have notionally modified the Act to provide certainty to original lenders and, where the securities are on-lent, borrowers by deeming they retain their respective relevant interests in securities they have lent and on-lent. This will also ensure that the lender's right of recall is recognised consistently, irrespective of the subsequent actions of the borrower.

The notionally modified provision applies to any lenders under a securities lending arrangement, including a prime broker or custodian exercising its right to borrow and on-lend its client's securities.

Unexercised borrowing right of itself does not give rise to relevant interest (paragraph 5 of the class order)

The class order also notionally modifies the Act so that a prime broker or a custodian operating a securities lending program in the ordinary course of its business who has a right to borrow its client's securities that would otherwise give rise to a relevant interest in those securities must defer taking that relevant interest into account for the purposes of the substantial holding provisions unless and until it exercises its right to borrow the securities; at which time it must take the relevant interest in the borrowed securities into account for the purposes of the substantial holding provisions.

This notionally modified provision recognises that a relevant interest may eventually arise from such a borrowing right but that the timing of disclosure for the purposes of

the substantial holding provisions is deferred to when the disclosure would be more meaningful; that is, when the borrowing right is exercised.

This deferral of timing of disclosure for the purposes of the substantial holding provisions only applies where:

(a) the client must not be restricted in how it can deal with the securities in respect of which the borrowing right is given (some standard restrictions are permitted in accordance with usual industry practice); and

(b) the prime broker's or custodian's borrowing right is acquired as part of a bona fide arrangement entered into in the ordinary course of carrying on its prime broking or custodial business.

Securities lending/borrowing fees need not be disclosed (paragraph 6(a) of the class order)

The class order also notionally modifies the information requirements under subsection 671B(3) of the Act so that the consideration paid under a securities lending arrangement does not need to be included in any substantial holding notice.

"Consideration" in the context of securities lending is generally understood to be the margin or fee charged on the relevant transaction. ASIC is of the view that the quantum of this margin or fee does not provide useful information towards the objective of the substantial holding provisions.

Attaching securities lending agreements (paragraph 6(b) of the class order)

The class order also notionally modifies the information requirements under subsection 671B(4) of the Act so that a standard form securities lending agreement and prime broking agreement does not need to be attached to a substantial holding notice. The substantial holder must include the prescribed key summary information and a statement that, if requested, they will give a copy of the agreement to ASIC or the listed entity.

These agreements are lengthy, complex agreements which are not easily disclosed through the announcements platform of a financial market operator. Further, only certain information within those agreements is relevant to substantial holdings. The notionally modified provisions will ease the compliance burden and ensure better disclosures of relevant information.

No effect on takeover provisions

The concept of "relevant interest" is defined in Chapter 6 (takeovers) though it also operates for the purposes of Parts 6C.1 (substantial holdings) and 6C.2 (tracing beneficial ownership) of the Act. While this class order notionally modifies the operation of when a relevant interest arises in certain circumstances, those notional modifications only have effect for the purposes of the substantial holding provisions in Part 6C.1 of the Act.

4. Consultation

In 2009, ASIC consulted with industry on securities lending and substantial holding disclosure through CP 107. ASIC also obtained further feedback in July, August and December 2010. The purpose of CP 107 was to provide a strong compliance message to the market of ASIC's expectations, consult on limited disclosure relief and to seek general feedback on the workability of the guidance. The consultation paper was relevant to substantial holdings of listed bodies where some or all of the substantial holding arose from their participation in securities lending and/or prime broking transactions.

ASIC received 14 submissions (four of which were made confidentially) from industry associations, professional bodies and market participants.

A consistent theme in the feedback received is that the nature of the securities lending industry presents challenges for achieving full compliance with the substantial holding provisions in Part 6C.1 of the Act. Feedback included that disclosure requirements result in an unnecessary regulatory burden, multiple reporting is onerous and confusing for the market, securities lending is not relevant to control and prime brokers (and others with borrowing rights) must disclose a large amount of irrelevant information.

Having considered all the submissions, ASIC maintain the view that disclosure of substantial holdings howsoever arising is important for an informed market in quoted securities. However, disclosure of substantial holdings needs to take place in a way that provides useful and accessible information to the market.