POSITION PAPER ON SECURITIES LENDING

What is securities lending?

Securities lending is the loan of shares to a party that needs these shares temporarily. The shares are generally lent by an institutional investor against payment of a lending fee. The legal ownership of the shares is transferred in full by the lender, subject to the obligation on the borrower to return an equal number of the same shares at a certain time. In most cases, the lender is also entitled to demand the earlier return of the securities (*recall*). The beneficial ownership remains with the lender throughout the entire loan period.

Why are shares borrowed?

There are various reasons for borrowing shares and four of them will be referred to here. The first is dividend arbitrage, a strategy that is possible when the lender, i.e. the institutional investor, holds foreign shares and cannot reclaim all the dividend tax in the country in question. Shortly before the dividend date, the shares are then lent to a borrowing party which is able to reclaim this tax (or most of it) and part of the dividend tax paid back to the borrower is subsequently incorporated into the fee for the lender. The attraction of this strategy depends in part on the country in which the share was issued and the period on which the dividend tax can be reclaimed. A second reason is connected with going short on certain shares, which means acting in anticipation of an expected fall in the share price. The short seller sells his shares to a third party in the expectation of being able to buy back similar shares at a lower price. In the meantime, the short seller will have to meet his obligations to deliver and can do so by borrowing shares temporarily and delivering these borrowed shares to a third party. A third reason is the provision of liquidity. The settlement of share transactions generally requires several days, but can take longer in some cases and can be effected more smoothly by the option of borrowing shares temporarily. A fourth reason for borrowing shares is to cover risks relating to derivatives transactions, such as option contracts and equity swaps.

Why do institutional investors lend?

For an institutional investor, securities lending is a relatively simple manner – in addition to dividend and any price gain – of generating extra yield on shares that it will not be selling for the time being anyway, in view of its own investment policy. The extra fee earned from securities lending is viewed by the parties as a welcome supplement to the yield. Under normal circumstances, furthermore, the practice of securities lending contributes to the liquidity of the capital markets, which is also useful to institutional investors.

What is the downside of securities lending?

Lending shares confronts an institutional investor with a number of dilemmas. In the first place, the investor who lends the shares loses the voting rights that attach to the shares and it is possible that either the shares are not voted at all in a general meeting, or that the voting rights are exercised by a borrower in a manner that is not necessarily in the interest of the lender and beneficial owner of the shares and may be at odds with the voting policy of the lending institutional investor. In the second place, as described above, the lent shares can be used for speculation on a fall in the share price (going short). If many market players go short on a share at the same time, they can collectively call down the anticipated fall in price on their own heads by creating a self-fulfilling prophecy. After all, the price will start to fall automatically due to the increased supply of shares and the risk of market manipulation will arise.

Eumedion's Position

- Eumedion can imagine that going short and/or naked short on shares in companies which are of vital importance to financial stability may be restricted or completely forbidden <u>temporarily</u> in <u>exceptional circumstances</u>, in order to avert a possible self-fulfilling prophecy of short selling. It must be emphasized that this should be a temporary measure, because selling short can contribute in general to the liquidity and/or efficiency of the capital market. Institutional investors have their own responsibility to consistently make cost-benefit analyses in order to determine what is in the best interests of the beneficiaries in a certain situation.
- Through its Corporate Governance Manual 2008, Eumedion propagates the application by its members of the *Securities Lending Code 2007* from the International Corporate Governance Network (ICGN). This Code makes institutional investors aware of their own responsibility to prevent abuse of the facility of securities lending through the exercise of voting rights by the borrower in a way that is not in the interests of the lender, who is the beneficial owner.
- Eumedion already adopted the position in 2006 that the lending of shares by institutional investors should be discouraged in event-driven situations affecting the listed company. The risk exists that certain borrowing parties will abuse the voting rights on the borrowed shares. If a certain general meeting may produce an event-driven situation of this kind, Eumedion brings this to the attention of its members and suggests that they consider recalling any lent shares before the record date, so that the institutional investor itself can exercise the voting rights on the relevant shares in the general meeting.