

1. Best Execution Principles

1.1 Introduction

MiFID/MiFIR applies a best execution requirement to firms when executing orders for their clients.

The purpose of this document is to summarise high level principles that agent lending firms should consider when formulating and applying a best execution policy to securities lending activity. This paper should be read in conjunction with the following ISLA publications which provide guidance to lenders in relation to implementing securities lending programme and which are freely available at www.ISLA.co.uk:

- Establishing an Agent Lender Program: a guide for Institutional Investors and Asset Managers (published August 2014)
- Securities Lending Check List for Lenders (published May 2011)

To participate in securities lending activity, a lender (also referred to as “client” in this document) may instruct a firm to act in an agency capacity and undertake securities financing transactions (SFTs) on lender’s behalf within certain lending and collateral parameters (lending parameters) which are usually detailed in an agreement¹ entered into between a lender and a firm.

1.2 Execution Factors and Lending Parameters

The overarching best execution obligation under MiFID requires firms to take all reasonable steps to obtain the best possible result on a consistent basis rather than in respect of each individual transaction, taking into account a range of execution factors such as the parameters described in this document, when executing client orders or placing orders with (or transmitting orders to) other entities to execute SFTs on behalf of a lending client. With respect to SFTs, we provide examples of such factors and lending parameters, which impact the ability of the firm to obtain the best possible outcome for a client. The relative prioritisation of these will vary in each situation and for each client. Such factors may include (but are not restricted to):

- Value of loan;
- Term of transaction;
- Relative stability of the portfolio/asset;
- Transaction and custody charges;

¹ This may be a stand-alone non-standard document or may be as part of a broader agreement such as a custody agreement or investment management agreement

- Client credit quality and netting status;
- Collateral criteria
- Jurisdiction of client and/or borrower;
- Lending parameters which may include limits on markets, securities, counterparties and duration.

Firms should ensure that the client is aware of the different factors and any potential impact they may have on performance

2. Scope

2.1 Client Category

As with the broader application of the MiFID rules, firms are required to categorise clients as follows:

- (i) eligible counterparty; or
- (ii) professional client; or
- (iii) retail client, the greatest regulatory protection is extended to retail clients with more limited rules applying in relation to dealings with professional clients and eligible counterparties.

Article 24 of MiFID states that best execution is not owed to eligible counterparties, unless they specifically request it or opt for professional client status. In most cases clients for SFT activity are categorised as professional clients or retail clients and best execution obligation will apply.

2.2 Transactions

For the purpose of this document SFTs are defined as the temporary transfer of securities in return for a fee. This included stock lending transactions as well as repo transactions which are generally (but not always) transacted under a Global Master Securities Lending Agreement or a Global Master Repo Agreement.

SFTs, whether bilaterally agreed OTC transactions or transactions entered through order management systems are recognised under MiFID/MiFIR as non-price forming transactions. However this does not exclude them for best execution considerations, albeit the approach may be different.

Specific Instructions:

The nature of certain SFT arrangements is driven directly from a client's decision and instruction, and as such these arrangements are out of scope for best execution.

Arrangements such as exclusives² (including those conducted via an auction process) may also be out of scope on the same basis. Where a firm has an opportunity to offer such an arrangement, the selection of clients to whom the firm offers the opportunity should be subject to best execution principles.

Where an agent lender has an opportunity to offer such an arrangement, the selection of lending clients to whom the agent lender offers the opportunity should be subject to an overarching duty of fairness and transparency.

Investments of Cash Collateral:

If the client defines cash as acceptable collateral, the cash may need to be re-invested for the holding period, (unless a client specifically instructs the firm differently) and this may be achieved using a cash re-investment program whereby the firm invests the cash in outright purchases of money market-like instruments. It should be noted that any cash re-investment program is not covered by this document but firms need to consider the broader application of best execution in relation to this activity. However, firms that re-invest cash collateral on behalf of clients via reverse repo should apply these principles, as these transactions are subject to the same criteria as the initial SFT (i.e. they are non-price forming and subject to the same considerations).

3. Implementation

Where best execution is deemed to apply, firms should prepare a best execution policy that details all reasonable steps the firm takes to ensure the best possible result for each client.

This policy should be published and made available to clients.

Firms should make available to clients an explanation of how they ensure that each client within an SFT programme is treated fairly. This should include an explanation of the circumstances under which exceptions to the allocation process are made. An example of an acceptable exception might be in a situation where a borrower requests access to a specific client portfolio for credit or capital management purposes.

² Exclusives are arrangements agreed by the client to make their portfolio available to borrow to a specific firm at a pre-defined price. This price may be calculated on a lent value basis or portfolio valuation.

It should be made clear to the client where any performance indicators provided are indicative of future performance and not guaranteed.

Firms may offer underlying clients a level of indemnification against counterparty default as part of the commercial agreement between the parties, (the level of protection may differ considerably between firms). Whilst the commercial agreement is not subject to best execution, the provision of indemnification may be a consideration when transacting on behalf of a client because of internal restrictions such as capital constraints. Firms should ensure that the client is fully aware of the potential impact the provision of indemnification may have on performance.

Other potential conflicts of interest should be identified by the firm and described to the client as part of the implementation process as well as any controls in place to monitor these potential situations.

4. On-going Conduct and Regular Review

It should be noted that securities lending is a demand driven activity and firms do not generally seek competitive quotes on a transaction by transaction basis, rather they react to a market request to borrow an asset.

Firms should ensure that they are able to implement and monitor client requirements and, wherever possible, lending parameters should be implemented by system restrictions.

Firms should undertake regular analysis and review of activity across all clients to ensure that best execution is achieved with consideration for each client's parameters.

This review may include (but is not restricted to):

- Information about any allocation process including any exceptions
- Any identified conflicts of interest
- Peer to peer performance comparisons (either internally or externally)

Such analysis should be reviewed by a senior management group or committee with representation that has an independent oversight of the firm's securities finance activity, on a regular basis.

5. Client information

Firms should ensure they conduct periodic reviews of the SFT activity with each client.

Reviews may include factors but are not restricted to the following:

- Analysis of performance;
- Analysis of client parameters and any impact on risk or performance this may have had during the reporting period;
- Summary of any transactions which are not aligned with client's instructions/parameters through the reporting period (and that would have been reported on occurrence during that period).