

Financial Conduct Authority
12 Endeavour Square
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The International Securities Lending Association
1 George Yard
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25th January 2023

Dear Sir/ Madam

ISLA would like to take this opportunity to respond to [Consultation Paper 22/20](#) on Sustainability Disclosure Requirements and Investment Labels.

ISLA originally responded to the FCA's [Discussion Paper 21/4](#) in January 2022 with regards to Question 12, that looked to explore the role of derivatives, short selling and securities lending in the context of sustainable investing. ISLA was encouraged to see the FCA's endorsement of securities lending and the vital role it plays in contributing to deep and liquid capital markets in this iteration. We also welcomed the statement that the FCA **does not** consider the practice of securities lending to be incompatible with the integration of ESG Considerations and we are supportive of the recommended policy advise that where applicable, firms should clarify their securities lending policy and express how it is coherent with their sustainable investment position.

ISLA would however, like to address the number of concerns raised by respondents in relation to DP 21/4.

1. A concern that by engaging in securities lending an investor would be unable to exercise their voting rights and hence fulfil their stewardship objectives effectively.

ISLA would like to reiterate that the practice of securities lending should never impede an investors ability to vote. Recalling securities for voting is common practice and the right to do so is a standard feature of industry contractual documentation. For example, the International Securities Lending Associations [Global Master Securities Lending Agreement](#), Clause 8.1 – Lenders right to terminate a loan, states a '*Lender shall be entitled to terminate a Loan and to call for the delivery of all or any Equivalent Securities at any time by giving notice on any Business Day*'.

To alleviate this concern ISLA would advocate the following:

- Lenders of securities should have in place a firmwide investment policy regarding stewardship & voting.
- The policy should detail the parameters in place for proxy recalls.

- The policy should incorporate ESG considerations around corporate events.

ISLA would also like to point to the following guidance already issued by policy makers and regulators in the UK:

- Financial Reporting Council states within its [UK Stewardship Code, Principle 12](#) – with regards to exercising rights and responsibilities, that signatories must *‘actively exercise their rights and responsibilities’* as well as declare the *‘approach they have taken to stock lending, recalling lent stock for voting and how they seek to mitigate empty voting’*.
- [Bank of England Money Markets Code](#) – 6.4 *‘If a beneficial owner wishes to exercise voting rights, a clear instruction should be provided to their lending agent in sufficient time for the securities to be recalled in time for voting rights to be exercised. If securities are not returned in time, beneficial owners may ask their lending agent to use reasonable efforts to pass on the voting instruction to the borrower of the securities’*.
- FCA’s Proposals to promote shareholder engagement Final Rules and Implementation of the EU’s Shareholders Rights Directive II, Article 3 - Transparency of Asset Managers states that disclosures must include reporting on *‘the firm’s policy on securities lending and how that policy is applied to support the firm’s engagement activities if applicable, particularly at the time of the general meeting of the investee companies’* to help strengthen the position of shareholders and reduce short termism by promoting active engagement.

ISLA would also like to share the Global Alliance of Securities Lending Associations (GASLA’s) Voting Practices and Shareholder Engagement [Guide](#) to demonstrate the industry’s commitment to develop market practice in this area.

2. A concern that by lending, an investor may facilitate the short selling of securities issued by companies that they consider to have strong sustainability credentials.

ISLA believe that there is often a misconception that ESG considerations can only be incorporated into a long only buy and hold investment strategy however, it is important to note that short selling can also contribute to several positive sustainability outcomes.

- Shorting can be used to hedge a portfolio’s exposure to ESG related risk, including climate risk.
- Short selling can incentivise a change in corporate behaviour.
- Short sellers can expose fraudulent activity including greenwashing.
- Short selling can help aid the flow of capital to sustainable activities.

Naked short selling, which involves selling securities in the market without the appropriate coverage, is banned in the UK under the Short Selling Regulation.

ISLA would like to refer to the United Nations, Principles for Responsible Investment think tank that released a [review](#) on Shorting and Responsible Investment, where they state that *‘shorting can be one way to express the view that an entity, security or asset is mispriced and not adequately incorporating ESG factors or systemic risks into its business activities, governance structures or future scenarios’*.

They also advise that *‘Shorting can be used to hedge a portfolio’s overall exposure to material ESG-related risks’*.

In 2019, under the action plan ‘Financing Sustainable Growth’ the European Regulator, ESMA undertook a [study](#) on undue short term pressure on corporations. This included a section in the report on shareholder activism, short selling and securities lending. The report notes a *‘warning’* from an investor association that claimed, *‘securities lending can place undue short-term pressure on companies when long-term oriented investors lend securities to short sellers that use the securities for short-term purposes.’* The report from the regulator found the following; *‘ESMA has considered the general arguments in relation to the impact of short-selling and securities lending practices and their potential link with short-termism. Nevertheless, ESMA points out that short-selling and securities lending are key for price discovery and market liquidity. Moreover, [ESMA is not aware of concrete evidence pointing to a cause-effect connection between these practices and the existence of undue short-term market pressures.](#)’*

3. A consideration of the identity of counterparties in back-to-back transactions given some lenders may not wish to enter into transactions with parties that do not share their values and standards.

ISLA notes that whilst lending agents that act on behalf of underlying lenders may exercise due diligence when selecting borrowers in the market, it is the underlying lender which must approve and maintain oversight over the borrower.

Transparency to the underlying lender with regards to onward lending is not available due to the legal transfer of title from lender to borrower however, in the UK, the FCA will have visibility of securities lending transactions reported under the Securities Financing Transaction Regulation (SFTR) and also the reporting of net short positions under the Short Selling Regulation (SSR).

ISLA envisages that post the finalisation of policy around sustainability disclosure requirements in the UK, it will be easier for firms to identify a company’s values and standards as part of their requirements to produce responsible investment policies around their activities, and also align to the UK Taxonomy.

4. Consideration of whether constraints on the sustainability profile of firms’ investment portfolios should similarly be reflected in restrictions on the collateral they accept against securities loans.

ISLA would like to advise that in the absence of clear regulatory guidance around the treatment of collateral, there remains a lack of clarity and consistency in the market on the extent to which ESG policies should apply. Given the current lack of regulatory certainty or policy advice, asset managers and institutional investors may be inclined to take a more risk-based approach to align their eligible collateral guidelines with the ESG parameters in respect of their long holdings, which can be problematic.

[ISLA seeks policy guidance for its members from the FCA on whether collateral, as a risk management tool, should integrate the same level of ESG screening as the long portfolio of the fund or, alternatively, whether eligible collateral guidelines should intentionally constitute broader and more liquid parameters, in order to effectively manage risk.](#)

Whilst it is recognised that all fund assets must embed ESG criteria, it should be noted that collateral **does not** form part of the funds' assets. Equally, it is recognised that, irrespective of whether the fund's long portfolio ESG policies are applied to collateral, it will nevertheless be essential to embed sustainability into the acceptability framework for collateral, as a matter of good risk management under emerging prudential requirements such as Basel 3.

By adopting a broader acceptable collateral schedule, lenders are able to effectively diversify their risk. If lenders were to limit acceptable collateral to the parameters of their long holdings, this could have an adverse impact on their ability to manage risk, as collateral would be less diversified, and liquidity in the market could be impacted.

For collateral to continue to serve as an effective risk management tool for the market, the risk analysis for collateral acceptability must consider all relevant risks, which should include sustainability/ESG risks however, collateral guidelines should also be adequately diversified with a key aim of properly mitigating credit risk and also ensure collateral is liquid and can be realised in the event of default, thereby providing the lender with effective protection against counterparty exposure.

For further detail, ISLA would like to share a [discussion paper](#) written in conjunction with counsel to discuss the applicability of ESG to collateral, in the securities lending context.

ISLA welcomes the opportunity to discuss the above in further detail with the FCA.

Yours faithfully

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Director of Regulatory Affairs

About ISLA

The [International Securities Lending Association](#) is a non-profit industry association representing the common interests of securities lending and financing market participants across Europe, the Middle East and Africa. Its geographically diverse membership of over 190 firms includes institutional investors, asset managers, custodial banks, prime brokers and service providers. Working closely with the industry, as well as national, regional, and global regulators and policy makers, ISLA advocates for, amongst other things, the importance of securities lending to the broader financial services industry. It supports both the [Global Master Securities Lending Agreement \(GMSLA\)](#) legal framework as well as the periodical enforceability and security enforcement across global jurisdictions.