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Protecting the retail investor

The European Securities and Markets Authority evaluates the risks facing retail investors that enter into securities financing transactions

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FCA updates guidance on regulatory reporting for short sales and SFTs

The Financial Conduct Authority (FCA) will extend the transition period for implementation of short sales reporting under UK MIFIR and will introduce temporary amnesties for firms that fail to complete reporting fields for securities finance trades and a number of other indicators.

The UK financial regulator introduced temporary measures in January 2022 relating to reporting of the short sales indicator under UK RTS 22, regulatory technical standards governing trade reporting to competent authorities which is part of post-Brexit UK law via the European Union (Withdrawal) Act.

Through this arrangement, UK RTS 22 is the UK enactment of a supplement to the Markets in Financial Instruments Regulation (MiFIR) governing trade reporting to financial regulators, provisions spelt out in the Commission Delegated Regulation (EU) 2017/590 of 28 July 2016.

Through its temporary measures, the FCA has indicated that it will not take action against firms that have failed to populate the short selling indicator field in the relevant transaction reports and it will be extending this moratorium that has been in place since January 2022.

It has also introduced temporary measures indicating that it will not take action against firms that fail to complete other reporting fields: specifically the securities financing transaction indicator, the OTC post-trade indicator, the commodity derivative indicator and the waiver indicator (respectively fields 65, 63, 64 and 61 under UK RTS 22).

In accordance with this provision, the FCA will disable relevant reporting validation rules (specifically CON–610 and CON-640) to prevent submitted trade reports from being rejected in cases where these fields have not been completed accurately.

The FCA will be integrating this new schema into the Market Data Processor (MDP) system — through which reporting entities can submit trade reporting data to the financial regulator — in due course.

The regulator indicates that this will happen prior to implementation of a wider body of changes detailed in the FCA policy statement PS 23/4, which focuses on improving secondary markets for equities transactions.

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BNY Mellon appoints Udeshi

BNY Mellon has appointed Nehal Udeshi as head of the firm’s securities finance business, based in New York. AccessFintech appoints Daur and more

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AMC Repo Clearing launches triparty solution

AMC Repo Clearing, the Mumbai-based clearing house, has established a triparty repo facility supporting repo financing against corporate bonds delivered as collateral.

The company is approved by the Reserve Bank of India to serve as a triparty repo agent and supported its first trades through the service on Friday at an event hosted by Securities and Exchange Board of India (SEBI), the Indian securities markets regulator.

Incorporated in April 2021, ARCL provides clearing and settlement for repo trades executed on repo market platforms at the National Stock Exchange and Bombay Stock Exchange.

Eight entities participated in repo transactions on the first day of the service, with total daily traded value reaching US$55 million (Rs 4800 million) according to the clearing house.

These participating entities were Aditya Birla Sun Life Mutual Fund, Axis Bank, East India Securities, HDFC Mutual Fund, Kotak Mutual Fund, State Bank of India, SBI Mutual Fund and Trust Financial.

AMC Repo is structured as a limited purpose (LP) clearing corporation and has been established with support from buy-side firms seeking an avenue to finance their corporate debt holdings and to improve liquidity in India's corporate debt markets.

AMC Repo indicates that the service operates a settlement guarantee fund, principally by contributions from corporate bond issuers, thereby removing the need for bilateral counterparty exposure limits.

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ESMA withdraws third-country recognition from UAE CCPs

The European Securities and Markets Authority (ESMA) has withdrawn third-country recognition from three UAE-based central counterparties.

This follows the decision by the European Commission to place the United Arab Emirates on its list of high-risk countries regarding its compliance with anti-money laundering standards.

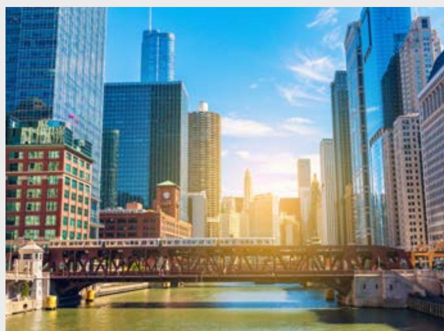
As a result, the Dubai Commodities Clearing Corporation, Dubai Clear LLC and Nasdaq Dubai Ltd are no longer included in ESMA's list of recognised third-country central counterparties.

To be recognised by ESMA, a third-country CCP must meet all cumulative conditions specified under Article 25(2) of the European Market Infrastructure Regulation (EMIR), including the requirement that it does not appear in the AML blacklist drawn up in accordance with the AML Directive.

The European Commission has highlighted "strategic deficiencies" in the UAE's anti-money laundering and counter financing of terrorism (AML/CFT) regime and added the jurisdiction to its list of high-risk countries on 16 March 2023.

ESMA has given the three CCPs three months to adapt to its judgement, dictating that these clearing houses will no longer be authorised to provide clearing services to clearing members or trading venues established in the EU from 25 October.

This reduces the number of CCPs from non-EU countries that are recognised to provide services in the EU to 23.



RMA to merge with the Bank Administration Institute

The Risk Management Association (RMA) and the Bank of Administration Institute (BAI) have put forward a letter of intent to merge the two organisations.

According to the two organisations, the merger will unite their services and expertise, preserve their common mission and consistent values, and build on the loyalty of their members and customers.

The merger is expected to become effective in December 2023.

BAI is a Chicago-based non-profit organisation that provides research, training and thought leadership events for the financial services industry.

The strategic combination aims to make a "meaningful difference" to how the industry is supported at a time when financial institutions encounter expanding challenges and opportunities.

On the completion of the merger, BAI's current CEO Debbie Bianucci will become CEO of the new association.

Nancy Foster, who announced her retirement as RMA's CEO earlier this year, will transition to an advisory role in 2024.

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Credit Suisse fined £87 million for Archegos failings

The Prudential Regulation Authority has imposed a fine of £87 million on Swiss bank Credit Suisse for risk management failures relating to its dealings with Archegos Capital Management, the limited partnership family office managed by Bill Hwang that collapsed in March 2021.

The UK regulator indicates that this is the highest penalty that it has applied and the only time that a PRA enforcement investigation has confirmed breaches of four PRA fundamental rules.

These financial penalties have been imposed on Credit Suisse International (CSI) and Credit Suisse Securities (Europe) Ltd (CSSEL) following a coordinated global resolution that involved judgements by the Swiss Financial Supervisory Authority (FINMA) and the US Federal Reserve Board.

Credit Suisse was acquired by UBS Group on 12 March 2023.

The Federal Reserve Board had previously applied fines of US$268.5 million on Credit Suisse entities in the US that had been found to be in breach relating to their engagement with Archegos.

The PRA identified failings at CSI and CSSEL that it ruled to be symptomatic of an unsound risk culture that failed to balance risk considerations against commercial reward. These Credit Suisse entities had failed to address risks arising from Archegos' investment portfolio and, in providing prime services to Archegos, they had failed to respond effectively when limit breaches were exceeded.

The PRA ruled that the firms had also failed to learn lessons from past experiences and to address concerns that the regulator had raised previously.

In its ruling, the PRA indicates that Credit Suisse breached rules 2, 3, 5 and 6 of the PRA Rulebook.

Specifically, the firms had failed to promote a culture within the investment bank which balanced risk considerations effectively against commercial reward.

The regulator found that the Credit Suisse entities had neglected to put an effective risk mitigation strategy in place for Archegos's

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portfolio and failed to escalate the issue and take appropriate action as this risk exposure increased. It noted that risk oversight was inadequate in the UK for equity total return swap positions that CS entered into with Archegos that were booked remotely into the UK firms via other CS entities.

The PRA also ruled that the firms had failed to assess and respond to the risks presented by their exposures relating to Archegos' portfolio. When Archegos defaulted in March 2021, these Credit Suisse entities suffered US$5.1 billion in losses from their combined exposures to the Archegos portfolio.

More broadly, CSI and CSSEL had failed to install an effective governance framework that effectively monitored or discussed the risks presented by Archegos's portfolio.

SFT has provided a more detailed review of Credit Suisse's dealings with Archegos and the risks that it faced through Archegos's default in SFT Issue 284 and Issue 289.

Commenting on the PRA's ruling, Sam Woods, PRA deputy governor for prudential regulation and chief executive officer, says: "Credit Suisse's failures to manage risks effectively were extremely serious, and created a major threat to the safety and soundness of the firm.

"The seriousness and widespread nature of those failures has led to today's fine, which is the largest ever imposed by the PRA."

South Street Securities to acquire GX2 Systems

South Street Securities Holdings is to acquire financial market software engineering company GX2 Systems (GX2).

As part of the mandate, South Street Securities will acquire all of GX2's equity assets as well as its wholly-owned broker-dealer arm GX2 Spread Markets.

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implementation of US Treasury (UST) securities liquidity and related analytical solutions. It also houses ExMode, a hosted execution platform.

The firm, which is to be acquired in Q4 2023, also provides algorithmic, agency brokerage and principal execution liquidity solutions, along with direct exchange connectivity, real-time pricing of cash and futures markets, and post-trade reporting services.

GX2 CEO David Jaberg will join the South Street executive committee after the transaction closes.

GX2 will continue to operate from its current Chicago office and from South Street's New York headquarters. GX2 was previously majority-owned by Chicago-based firm Geneva Trading.

Commenting on the acquisition, Jim Tabacchi, CEO of South Street, says: "The acquisition of GX2 will allow South Street to be better positioned to serve our clients with cutting-edge algorithmic, agency brokerage and principal market-making liquidity solutions in US Treasuries."

Jaberg adds: "The entire GX2 team is excited to use our expertise to enhance South Street's offerings and expand our reach within the financial industry."

Deutsche Börse Group to acquire remaining shares of FundsDLT

Global market infrastructure provider Deutsche Börse Group has confirmed it will acquire the remaining shares of FundsDLT.

The acquisition, made by Deutsche Börse's DB1 Ventures, will complement and strengthen the fund processing and distribution offerings of Deutsche Börse's post-trade infrastructure provider Clearstream.

The integration will drive existing live blockchain-based end-to-end fund transactions, backed by Clearstream's fund processing platform Vestima.

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In March 2020, and via its post-trade infrastructure provider Clearstream, Deutsche Börse Group joined forces with the Luxembourg Stock Exchange, Credit Suisse Asset Management and Natixis Investment Managers to invest in and further develop FundsDLT as the first platform to carry out fund subscription on blockchain infrastructure.

FundsDLT has now successfully demonstrated the advantages of a blockchain-based distribution model for investment funds in several locations across Europe and Asia, says Deutsche Börse.

The acquisition of FundsDLT's remaining shares is expected to be completed in the fourth quarter 2023 or the first quarter 2024, subject to regulatory approval.

Philippe Seyll, CEO of Clearstream Fund Centre, says: "The acquisition of FundsDLT is a critical and natural step in our digital strategy. It demonstrates our position at the forefront of innovation and will redefine the overall distribution chain of the fund business.

"It enriches distribution capabilities, and is streamlining operations and bringing asset managers closer to retail clients through blockchain. We will see measurable benefits for market participants, including faster time to market and cheaper access to funds."

Olivier Portenseigne, CEO of FundsDLT, comments: "Becoming part of the Deutsche Börse Group is an exciting step for FundsDLT and is timely to accelerate our growth. Clearstream has a long history of driving innovation and shares our vision, values and our commitment to this new generation of market infrastructure.

"Our goal is to enable fund distributors and asset managers, thanks to blockchain and fund tokenisation, to simplify their business and operating model and roll out the technology foundation to enable their clients to connect to fund products anywhere, in an easier and in a more cost-effective manner."

Clearstream picks Regnology's Rcloud for cloud-enabled regulatory reporting

Deutsche Börse's Clearstream Banking AG has selected Regnology's Rcloud technology for cloud-enabled regulatory reporting.

The platform, powered by Google Cloud Platform (GCP), was launched in November 2022 and delivers report submission and reporting data software.

It also offers deployment and infrastructure-as-code services, run and change management automation and self-service via the Regnology Cloud portal.

Regnology's partnership with Google Cloud, which matches 100 per cent of its electricity consumption with renewable energy purchases, also ensures that sustainability is built into the platform.

Regnology services more than 35,000 financial institutions, 70 regulators and tax authorities that rely on its solutions to process their regulatory reporting data.

Regnology was formed in 2021 when BearingPoint RegTech, a former business unit of BearingPoint Group, merged with Vizor Software, a regulatory and supervisory technology firm.

Volker Riebesell, chief technology officer at Clearstream Banking AG, says: "With our hybrid, multi-cloud strategy, Deutsche Börse Group sets new standards for cloud innovation across the financial services industry.

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Protecting the retail investor

The European Securities and Markets Authority highlights the risks facing retail investors that enter into securities financing transactions, a trading constituency that is creating a "significant source" of revenue to firms providing investment services. Carmella Haswell explores these risks with insight from market participants

The European Securities and Markets Authority (ESMA) has released a public statement highlighting the risks of securities lending in regards to retail client financial instruments, and how MiFID II rules apply in this area to protect investors.

While securities finance transactions (SFTs) may bring extra returns on financial instruments, ESMA says, SFTs are also a "risky and complex practice" that can present counterparty and collateral shortfall risk, proving difficult to understand for the average retail client.

Given its concerns around these perceived risks for retail customers, the Authority has released a public statement highlighting the dangers of securities lending in regards to retail client financial instruments and how the second Markets in Financial Instruments Directive (MiFID II) rules apply in this area to protect investors.

In its statement, ESMA highlights that the investor lending out financial instruments will incur a loss if the external borrower is unable to return the borrowed financial instrument, the value of the collateral is

insufficient to cover the loss of the financial instrument lent out, or if the investment firm is unable to compensate for the loss.

MiFID II is an EU regulatory framework designed to regulate financial markets and improve protections for investors. MiFID II therefore imposes strict requirements regulating the use of client financial instruments. The regulation enforces rules on securities lending in the areas of client consent, provision of collateral and information disclosure.

Speaking to SFT, an ESMA spokesperson says: "Securities lending is a risky practice for retail clients and it affects their ownership rights on the securities lent out. The objective of the statement was not to 'democratise' the use of securities lending with retail assets but to flag relevant risks and identify some practices to ensure compliance with legislation and fair treatment of clients."

Preventing risk via MiFID II

The securities lending industry is moving into the spotlight as appetite from private investors continue to grow, according to Alex Panaite Fornari, general counsel at Sharegain. Panaite Fornari notes an increased regulatory focus in key areas including customer protection, client asset segregation and revenue share. These are world-wide trends, she adds.

"The growth of this sector and, in particular, the role of the retail client aggregators or brokers, raises some important questions for our markets," explains Farrah Mahmood, director of regulatory affairs at the International Securities Lending Association (ISLA). She adds it is imperative to ensure that the underlying retail investor fully understands the risks involved in any such arrangement.

ISLA supports ESMA's statement regarding the risks arising from securities lending activity for retail clients, and encourages ESMA's focus to strengthen investor protection in tandem with the "increasingly more complex investment options" becoming available to this segment of the market.

While London-based consulting firm Aon agrees that securities lending and other SFTs are a — as ESMA puts it — "risky and complex" practice, Tom Daniels, practice lead for Aon's securities lending oversight service, says that SFTs do not have to be 'risky' transactions, despite complex transaction nuances.

He continues: "Many agents accommodate beneficial owner customisation in their direct lending programmes, some down to the transaction level, thereby allowing for fine tuning of the risk-reward ratio that is in line with the lender's risk tolerance and revenue objectives."

Based on the lendable assets' demand value, Daniels indicates that a certain base level of collateral and parameter flexibility may be required and can be optimised with expert guidance. He adds that there are operational safeguards and legal risk of loss provisions that can further mitigate client risk exposures.

To help protect retail investors, Daniels suggests that since retail lending programmes "do not typically provide the investor the level of customisation, disclosure or oversight that may be available in direct lending programmes", firms could benefit most by engaging in lower risk transactions that focus on the intrinsic demand of the lendable assets. Daniels explains that this has less reliance on collateral risk, whether that be cash collateral reinvestment return or potentially less liquid non-cash collateral.

In light of these perceived risks, ESMA indicates that the bar for investor protection is higher when a firm engages in lending activity using retail client financial instruments.

In its technical advice to the European Commission on aspects relating to retail investor protection (ESMA35-42-1227 – April 2022), ESMA identified securities lending, in relation to client financial instruments, "as a practice increasing the risks incurred by retail clients and deserving further analysis in order to ensure the rigorous application of MiFID II investor protection requirements in this area", according to the regulator's spokesperson.

To safeguard client assets, MiFID II presents a requirement for firms to make adequate arrangements to safeguard the ownership rights of clients and to "prevent the use of a client's financial instruments on own account except with the client's express consent", as dictated in Article 16(8).

To prevent loss occurring to the investor who is lending out the financial instruments, firms involved in these transactions should adopt specific arrangements to ensure that the borrower of client financial instruments provides appropriate collateral, as stated by Article 5 of the MiFID II Delegated Directive. The firm must also monitor the "continued

appropriateness” of such collateral and take steps to maintain the balance with the value of the client financial instruments.

Allocation of additional revenue

ESMA indicates that firms should always act honestly, fairly and professionally in accordance with their clients’ best interests, as pinpointed by Article 24 (1) of MiFID II.

Written consent is a large component of the MiFID II Delegated Directive on investor protection. Article 5 of the regulation states that firms entering into SFTs which involve use of client financial instruments should obtain written consent from clients regarding how these client assets will be used on specified terms.

For written agreements and provision of information, firms are required to provide adequate information to the client on an ex-ante and ex-post basis, also providing transparency through “clear, full and accurate information” in terms of the obligations and responsibilities held by the firm with respect to the use of those financial instruments — this includes the risks involved.

Where SFTs involving client financial instruments will generate a return for the client, the terms must be included within the written client agreement. When a firm is securing a client’s consent, ESMA explicitly states that this written agreement should not be sought as part of agreeing to the firm’s general terms and conditions, a practice that the Authority has identified at some firms.

Developing this point, ESMA has questioned whether retail investors are receiving the full benefit of revenues generated from securities lending of retail client financial instruments in all cases.

The Authority found that some firms are retaining a share of revenues arising from this activity — sometimes justifying this activity by stating that retail clients are benefiting because it enables lower trading commissions to be charged to clients, ESMA reports.

In ESMA’s view, however, a firm using retail client financial instruments to generate additional revenues for the firm “may not be acting fairly and professionally in accordance with the best interests of its retail clients”, as required under MiFID II.

The Authority states that additional revenues from securities lending should directly accrue net of a normal compensation for the firm’s services to the retail client whose financial instruments are being lent out — for example, direct and indirect operational costs and a fair and proportionate fee.

The prospect of any indirect ‘benefit’, such as lower trading commissions, may not justify exposing a retail client to the risks of securities lending, according to ESMA. Furthermore, such an indirect ‘benefit’, if any, would not necessarily and proportionately accrue to all retail clients exposed to the risks arising from the lending of their securities, but to retail clients exhibiting more active trading behaviour, the Association adds.

On this point, Daniels says: “Firms engaging in retail client SFTs argue the practice benefits their clients by lowering other fees. While this may be true, those accommodations may not necessarily accrue to clients in accordance with the demand value of their securities. In other words, one client may reap larger revenue benefits or cost savings due to the value of their larger AuM but low demand securities relative to another client that has less AuM but higher demand securities.”

He argues: “It may be controversial whether the revenues should directly accrue to the applicable retail client versus proportionally to clients overall. Regardless, we think there needs to be more disclosure and standardisation of fees and the nature of charges for quicker take up.”

ISLA supports the broad premise that the bulk of all lending revenues should accrue to the underlying consumer in all areas of the market. ESMA acknowledges in its statement that intermediaries in the value chain should be duly compensated for their services. In this regard, ISLA’s Mahmood notes that the cost of a firm's services may differ for a number of reasons including the service level offering, return generation and risk management.

Mahmood endorses transparency in the disclosure of costs arising from securities lending intermediaries, adding that regular reviews of these securities lending arrangements is a must. She adds: “To provide maximum protection to end investors, there must be choice; this will help to support a commercially viable securities lending market for retail aggregators and allow them to maintain their ability to earn revenue for the benefit of their end investors.”

A good starting point

In May 2023, the European Commission adopted a Retail Investment Strategy to empower retail investors to engage and invest for their

long-term interests since, according to Mahmood, retail participation in the EU had been traditionally low when compared to other jurisdictions. This strategy also forms part of the 2020 Capital Markets Union Action plan.

The Retail Investment package includes amending rules for MiFID II, the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive and the Alternative Investment Fund Managers Directive (AIFMD). The package also amends the Insurance Distribution Directive (IDD) and Insurance and Reinsurance Directive (Solvency II).

Discussing how well MiFID II regulation protects the retail investor in the case of securities lending, Mahmood comments: “Securities lending requirements for retail investors will likely be adapted as part of this package of measures, to ensure the safety of consumers.”

ISLA says it will be working closely with regulators in Europe and the UK to ensure “sufficient levels of investor protection” through legislation and market guidance. The Association views similarities in the existing rules around UCITS and see this as a good starting point as ISLA begins to address similar issues.

The international association is also considering creating a securities lending guide for retail investors to educate and inform them of the practicalities and benefits to the wider capital markets of engaging in stock lending, as well as providing an additional return on their investment and to boost long-term savings.

In an effort to protect the retail investor, Sharegain provides a Securities Lending as a Service solution that aims to democratise the practice of securities lending. This is designed to give lenders the flexibility to meet different regulatory and structural requirements globally, and the varied needs of their own underlying clients.

For Sharegain’s Panaite Fornari, adaptability to ongoing regulatory change is important in protecting the retail investor, while having an agile partner can reduce the legwork significantly. “We believe that ESMA’s statement, and the proactive approach taken by other regulators across the world, will have a positive impact on our industry and will lead to even wider adoption by private investors,” she says.

“While MiFID II certainly contemplates many beneficial, base-line requirements, barring independent oversight, it does leave open the opportunity for potential abuses to retail investors like above market fees and application of expenses,” Daniels adds. “Without the client seeking consultative guidance, there may be no transparency for the client to understand if they are reaping adequate return for a given level of risk.”

The Aon representative says that there needs to be more disclosure and standardisation of programme parameters, as well as the nature and application of fees to further the democratisation of securities lending. A form of independent review or oversight would help alleviate avenues for firm self-dealing and retail investor abuses. He adds: “A review of retail investor programmes would help provide further confidence to safely grow this space.”

Panaite Fornari suggests that education is key to allowing securities lending to grow safely within this space. “While the industry has made positive steps toward educating the wider market, there are still several misconceptions among private investors about what securities lending entails, how lending programmes work and what rights they have,” she explains.

“We’re working with our clients to demystify securities lending for private investors,” Panaite Fornari adds. “Even simple changes in terminology, such as distinguishing securities lending from securitised lending, can have a significant impact. Further collaboration between all industry stakeholders is required to continue these efforts, establish best practices and deliver solutions that are transparent and absolutely trustworthy.”

In conclusion, ESMA’s spokesperson says: “Securities lending appears to be used as a significant source of revenue by some firms engaging in this practice when providing investment services to their clients. ESMA is therefore issuing the statement to clarify its expectations arising from the application of MiFID II requirements to treat clients fairly and professionally in accordance with their best interest.

“This includes the expectation that revenues directly accrue to the retail clients, who ultimately bear the risk of this practice, net of a normal compensation for the firm’s services; furthermore any such compensation should be clearly included in information on costs and charges provided to the client.”

ESMA and National Competent Authorities will continue to monitor whether firms’ behaviours are in line with these expectations.

Fiscal authorities target tax abusive transactions

In a two-part article, tax experts speak to Bob Currie about how tax reforms are impacting securities financing markets and how tax authorities are acting to eliminate the risk of tax abusive schemes

Tax authorities are stepping up their efforts across a number of European jurisdictions to eliminate dividend tax reclamation fraud and to seek recovery of funds lost through cum-ex and cum-cum trading.

In June, the UK Financial Conduct Authority (FCA) brought its largest-ever cum-ex-related enforcement action, imposing a £17.2 million fine on the now-closed ED&F Man Capital Markets for aiding clients to claim illicit tax rebates from Danish tax authorities between 2012 and 2015.

Niall Hearty of London-based law firm Rahman Ravelli explains that, according to the FCA, ED&F Man Capital Markets helped clients — that were mostly US pension funds — to reclaim £20 million in tax on dividends from shares that they never owned or paid taxes on. “This is the latest big money development in the share-selling practice known as cum-ex, but few observers would bet on it being the last,” comments Hearty.

Securities Finance Times provided a comparative review of measures being taken by tax authorities and policymakers to combat dividend tax reclamation malpractice in SFT Issue 299, published on 29 March 2022.

Meera Khosla, chair of ISLA’s Tax Steering Group, explains that since the European Securities Market Authority (ESMA) and the European Banking Authority (EBA) launched investigations into such schemes — and directed member states to implement appropriate legislative and supervisory responses to such schemes within their respective legal frameworks — a plethora of legislation has been introduced with the objective of targeting tax abusive transactions that have the aim of avoiding withholding taxes.

“This requires participants to implement robust tax governance frameworks aimed at identifying, mitigating and reporting potential tax abuses,” says Khosla. “Abusive cum-ex and cum-cum schemes have clearly got the attention of regulators and banks are expected to have adequate controls in place to manage such risks.”

ISLA’s director of regulatory affairs Farrah Mahmood indicates that there have also been significant operational changes to the European settlement infrastructure including, but not limited to, the launch of the European Central Bank’s TARGET2-Securities centralised settlement platform, changes to the way market claims are processed and, most recently, the publication of European Commission’s proposal for a Directive on Faster and Safer Relief of Excess Withholding Taxes. This directive aims to simplify and digitalise withholding tax relief processes, but may also be seen as a response to the constant stream of media and European Parliament attention around cum-cum and cum-ex fraud schemes.

Targeting dividend tax reclamation fraud

On 15 February 2023, the French tax authorities published two public rulings relating to the withholding tax (WHT) treatment of manufactured dividends paid by French banks to non-residents. According to international law firm Clifford Chance, these changes substantially widen the legal scope of French dividend withholding tax rules, broadening their reach to dividend-equivalent payments made under temporary acquisitions of French equities and delta-one derivatives transactions with an underlying in French equities.

Dividend income paid to a non-resident is typically subject to WHT at a rate equivalent to the French corporate tax rate of 25 per cent. However, dividends paid to non-residents in jurisdictions which do not have a double taxation treaty with France are subject to the higher withholding tax rate of 75 per cent.

From 1 July 2019, the French tax authorities introduced a specific “anti-abuse rule” against dividend arbitrage trades relating to stock lending arrangements when the temporary transfer of securities is for a holding period of less than 45 days.

Under these rules, non-residents may apply for a refund of WHT paid on dividend payments providing that the transaction was not conducted, as “its principal purpose and effect”, to obtain a tax advantage or to avoid payment of French WHT.

Prior to the introduction of this anti-abuse law, payment of dividend-equivalent payments, or ‘manufactured dividends’, to a non-resident beneficial owner did not trigger an obligation to pay withholding tax on the proceeds.

However, in the first of these public rulings, the French tax authorities sought to extend WHT application to dividend-equivalent payments. It rules that WHT will now be applicable not only to a situation where a bank pays actual dividends linked to ownership of French equities, but also when the bank passes on dividend-

equivalent payments to a non-resident (i.e. in cases where the actual dividend has not been paid directly to the bank).

In a second ruling, the French tax authorities also broadened the scope of the anti-abuse rule to derivatives transactions where the underlying is a French equity. In doing so, the anti-abuse rule now also captures dividend tax reclamation fraud propagated through "synthetic" derivatives-based positions.

"Seemingly in conflict with this position, the French tax authorities state that temporary acquisitions of French equities will be subject to WHT when employed for hedging short-sales positions or even when the acquiring entity wishes to build its inventory"

Critics have raised concerns about uncertainties and inconsistencies in how sections of these tax rules are currently written. With regard to temporary transfers of French equities involving non-residents, for example, the French tax authorities have stated that the transaction will not be subject to WHT provided that the transaction does not involve any benefit for the bank or a related party.

However, seemingly in conflict with this position, it subsequently states that temporary acquisitions of French equities will be subject to WHT when employed for hedging short-sales positions or even when the acquiring entity wishes to build its inventory. This is the case, say the authorities, even when the lender or seller of French equities does not seek a tax benefit.

Clifford Chance partners Alexandre Lagarrigue, Eric Davoudet and Alexios Theologitis observe that these tax rulings, and particularly the generality of their terms, raise important questions regarding their scope and their legal grounds. They conclude that these proposed changes may require additional tax compliance and monitoring to ensure that WHT reporting, and other associated tax obligations, are made when required.

ISLA wrote to the French Ministry of Finance earlier this year emphasising that policy changes that discourage or curtail securities lending activity could have serious implications for financial trading activities, market making, hedging and other financial risk management activities.

In the absence of a liquid securities lending market, participants may be forced to buy back securities in the stock market to close short positions, causing short-term volatility and market disruption, thereby inhibiting price formation. Additionally, if market makers find it difficult to borrow stock, this may cause bid-offer spreads to widen and the risk of settlement failure to increase, resulting in higher trading costs and potential fines under the settlement discipline regime of the Central Securities Depositories Regulation (CSDR).

Tackling dividend tax reclamation fraud in Austria

In Austria, the Ministry of Finance also introduced a series of tax reforms in 2022 and 2023 designed to prevent tax abusive transactions that have the aim of avoiding withholding taxes. While supporting the commitment of the authorities to eliminate this malpractice, market participants and trade associations have raised concerns that these changes (particularly the November 2022 changes, see below) have, in some cases, resulted in inconsistent tax rules, problems of interpretation or they have contributed to a reduction in lendable supply in securities lending markets.

Prior to the November 2022 changes, withholding tax treatment of dividend payments to non-residents was guided principally by tax information issued by the Austrian Ministry of Finance in 2014 (the BMF Information 2014). Under this framework, dividend attribution in the Austrian market from a tax perspective arose to the person or entity who held the settled position as at close of business on the day before ex-date (Ex -1).

In terms of its impact for securities lending intermediaries, agent lenders — when instructed — typically arranged for the stock to be recalled prior to the Ex-1 date to ensure that the non-resident lender would be entitled to a withholding tax refund if applicable.

Alternatively, agents applied a restriction on the return of that stock from the borrower around the key dividend dates and the borrower would instead agree to pay a manufactured dividend to the lender. This manufactured dividend was set at a level which compensated the lender for the loss of right to reclaim WHT.

BMF Information 2022

In July 2022, the Austrian Supreme Administrative Court published a decision that determined that the person who is the beneficial owner at the time of the resolution of a dividend (i.e., AGM date), is entitled to a refund of withholding tax (see Box below).

Austrian Supreme Court decision of July 2022

In July 2022, the Austrian Supreme Administrative Court published a decision that determined that the person who is the beneficial owner of shares on AGM date is entitled to a refund of withholding tax.

The case related to a claim by a company based in the United Arab Emirates (UAE) which had bought Austrian shares cum-dividend, with the trade settling after Ex-1 and the record date. The company received a dividend compensation payment and argued that it was entitled to a refund of WHT as the cum-dividend owner. However, the Federal Fiscal Court rejected this claim and upheld the requirement of the BMF's Information 2014 with regards to who was entitled to the WHT refund, specifically that it is the holder of the settled shares on Ex-1 that is entitled to a WHT refund.

As a result of the Supreme Court decision, the BMF issued a statement in November 2022 (the "BMF Information 2022") confirming that the share dividend is attributable to the person who is the beneficial owner of the shares on the AGM date.

To fulfil this condition, trades conducted in the run up to the AGM must be settled and registered in the purchaser's securities account by close of business on the business day before the AGM (AGM-1). If settlement has not been completed by this deadline, the seller will be deemed to be the beneficial owner and therefore eligible for the dividend payment.

Significantly, the changes introduced through the BMF Information 2022 also applied retrospectively, being applicable to dividend payments already made prior to the publication of the Supreme Court's decision.

Reduction in loan supply

Following the enactment of these changes under the BMF Information 2022, ISLA identified a negative impact on liquidity in securities lending markets in Austria, manifested most obviously in a contraction in lendable supply. According to the Association, this had prompted agent lenders to recall Austrian equities that were previously on loan and to limit new lending activity in Austrian shares.

Drawing on market data provided to ISLA by S&P Market Intelligence, ISLA indicates that this has resulted in a 47 per cent YoY contraction in the lendable supply of Austrian securities, with lendable value falling from US$19.958 billion on 31 December 2021 to US$10.522 billion on 31 December 2022.

On consulting with agent lenders, ISLA identifies several reasons why some agents have reduced or suspended lending activity in the Austrian market. The first is linked to operational considerations. Agent lender systems are typically set up to monitor the record date for dividend entitlement, in line with market practice globally, and may not be currently equipped in Austria to track the AGM date for WHT purposes (although they may be tracking AGM dates for reasons not directly linked to their tax operations, for example to enable proxy voting or to support clients' ESG strategies). Banks indicated that updating tax and corporate actions systems to align with the new tax procedures would involve significant cost and operational overhead, especially where the AGM date in Austria is a variable date and can potentially fall up to 30 days before the record date for dividend payments.

Third, ISLA finds that the retrospective application of the rule changes in BMF Information 2022 also prompted some agent lenders to discontinue lending. "Investors who had prudently instructed that cum dividend stock on loan was returned prior to the

Ex-1 date, are now having their withholding tax reclaims challenged when they had a legitimate expectation at the time that they would be entitled to a withholding tax refund, based on the BMF Information 2014," ISLA explains in a letter sent to BMF, dated 21 February 2023.

On this point, ISLA emphasises that the securities lending market functions optimally through lenders and borrowers having a clear understanding of their rights and obligations under the loan agreement.

Austrian Tax Amendment Act 2023

Subsequently, the Austrian government published legislation relating to WHT treatment of dividend income. In a change to the BMF Information 2022, the Draft Bill specifies that dividend entitlement paid on shares will be attributed to the owner of the share on close of business on record date for dividends paid after 30 June 2023.

"The securities lending market functions optimally through lenders and borrowers having a clear understanding of their rights and obligations under the loan agreement"

To be eligible to reclaim WHT on its dividend income, the shareholder must also meet two further criteria: it must bear adequate economic risk of the shares; and it must have held the shares for at least a 45-day minimum holding period prior to and following record date. These two additional criteria will be waived in cases where the transaction does not lead to a tax advantage.

"Adequate economic risk" requires the shareholder to bear the risk that the share price may decrease by at least 70 per cent.

Responding to these changes, ISLA has welcomed the change from AGM-1 date to settled position on record date as the date for calculating dividend entitlement. These changes become applicable from 30 June 2023 and, unlike the BMF Information 2022, do not apply retrospectively.

However, ISLA indicates that borrowers in securities lending transactions will not typically be in a position to satisfy the economic ownership criteria since they do not take price risk on the shares — except in instances of default — since the securities remain on the lender's balance sheet throughout the loan term.

The Association has also highlighted the need for further clarification around the 45-day minimum holding requirement — for example, whether this applies per group level entity or for each single account, and whether this should be accounted on a last-in-first-out (LIFO) or first-in-first-out (FIFO) basis.

Kholsa notes that these two points have become less important with the introduction of the caveat specifying that these requirements fall away where there is no tax advantage. "The problem now for the industry is understanding what the Austrian tax authority will deem to be a tax advantage," she says.

More broadly, ISLA understands that the additional requirements are based on anti cum-cum rules stipulated in the German Income Tax Act. "[We] would like to note that the German Rules are prescriptive and are strictly limited in their scope to German residents and certain non-German resident taxpayers who benefit from a WHT rate of less than 15 per cent under a double tax treaty," says ISLA in its consultation response.

The Association adds that, in Germany, market participants have identified a sharp decline in lendable supply before and after the record date owing to the 45-day German minimum holding period and the operational challenges of applying the FIFO accounting methodology to evaluate this consideration in the German market.

SFT will consider other ongoing tax developments in Europe — including the European Commission's proposal for a Financial Transaction Tax and ongoing dialogue in the UK relating to UK Stamp Tax — in the second part of this article in SFT Issue 334.

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US equities: the hero of H1 2023

US equities have been the powerhouse for near-record securities lending revenues during the first half of 2023. S&P Global Market Intelligence's Matthew Chessum explains why, amid considerable economic uncertainty, US lending markets have remained highly robust

The first half of 2023 recorded the second-highest half year securities lending revenues to date, raising US$7.020 billion, US$5.394 billion of which was generated through equities lending. During the first six months of the year — as during the past 18 months in particular — lending of US equities has been an important contributor to these overall revenue numbers, accounting for 48 per cent of H1 equity revenues.

The US economy has experienced a very eventful 18 months. It has experienced everything from banking collapses, artificial intelligence mania, a narrow equity rally — which has started to broaden out — a potential US debt ceiling cliff edge and a predicted, but never materialising, recession. Despite all of this uncertainty, securities lending markets in the US have remained remarkably robust.

Uncertainty can sometimes be a double-edged sword for the securities lending markets as confidence and conviction remains key to ensuring that the conditions remain optimal for trade execution. If these precise conditions do not exist, then investors tend to sit on the sidelines awaiting market signals that strengthen conviction and momentum. Luckily, for both lenders and borrowers, market conditions were ripe for a bumper H1, especially in the US.

Over the six-month period, the lending of US equities generated an impressive US$2.592 billion, driven by US$1.298 billion in Q1 and US$1.294 billion in Q2. This represents an increase of 28 per cent YoY, rising from US$2.029 billion generated in H1 2022. Examining these trends on a month-by-month basis, there were three stand out months for US equities during H1. January revenues of US$421.8 million represent a year-on-year increase of 84 per cent. February revenues were up 64 per cent YoY to US$456.9 million; and the US$481.9 million raised during April represented a 44 per cent increase YoY (fig 1).

Over the six-month period, June was the only month that did not exceed the previous year's revenues, with revenue contracting 16 per cent YoY to US$393.0 million. The average increase in revenues over the period was an impressive 35 per cent YoY.

Vibrant specials market

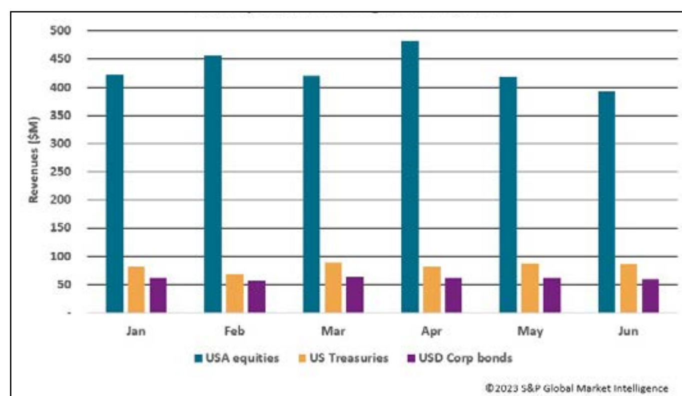
The momentum provided by the numerous market events that took place throughout H1 helped to cultivate an exceptionally healthy specials market in the US. At S&P Global Market intelligence, the specials market refers to loans of a security at a fee greater than 500bps.

US equity specials generated US$2.049 billion in revenues over the first six months of the year. To put this in context, this represents a 44 per cent increase on the US$1.4 billion generated in H1 2022 and also an improvement on the US$1.290 billion raised in H1 2021 and US$1.185 billion in H1 2020. Over the course of H1, April was the strongest month for US equities specials revenue, returning just under US$393 million. During this month, 77 per cent of all US equity revenues were generated by specials trading.

Over the six-month period, an average of 78 per cent of all monthly

revenues was generated by specials, accounting for 3.2 per cent of all balances. As long as any recall risk is managed effectively, this market has been very good at producing exceptionally strong risk-adjusted returns for lenders.

Fig 1: Monthly securities lending revenues for US assets for H1 2023



During H1, all of the 10 highest-generating equities across all regions were US-listed assets. AMC outpaced all of the other names, generating in excess of the US$450 million alone. Significantly, AMC generated more than the next four highest revenue generating names combined (Beyond Meat, BYND, at US$126.63 million; Lucid Group, LCID, at US$116.71 million; Upstart Holdings, UPST, at US$93.38 million; and Gamestop Corp, GME, at US$76.96 million) over the H1 period.

US equities have dominated the top revenue earning tables for many quarters. As markets continue to climb in the region and valuations reach levels not seen for many months, it is likely that this will continue going forward. The strength of the stock market, coupled with higher valuations, is also likely to provide fertile ground for the re-emergence of initial public offerings (IPOs) and an increase in corporate activity heading into Q3 and Q4. This is likely to drive up volumes in the securities lending markets as investors look to source liquidity and exploit any pricing differentials that may be generated from a change in corporate structures.

Fixed income markets

Across the fixed income markets, both USD-denominated corporate debt and US treasuries also experienced a fruitful H1. Over the six-month period, the lending of US treasuries generated US$493.6 million, representing an enormous 202 per cent increase YoY.

Revenues surpassed US$80 million during every month in H1 apart from February, which generated US$67.5 million. US treasuries experienced strong demand over H1 due to persistent interest rate hikes by the Fed and the uncertainty experienced by the ongoing discussions regarding the US debt ceiling. Over the period, T-Bills expiring towards the X-date traded special — the date at which the US treasury would potentially run out of money to pay its bills — helping to boost revenues. Short-dated treasuries remained popular, dominating the highest revenue-generating government bond tables over both Q1 and Q2.

In the corporate bond markets, lending of USD-denominated investment grade and non-investment grade corporate bonds soared. Revenues reached US$363.7 million over H1, which represented an increase of 123 per cent YoY. Q1 saw revenues grow by 146 per cent YoY to US$180.8 million and revenues rose during Q2 by 104 per cent to US$182.9 million.

Despite the increase in revenues, average fees were lower during every month of H1, standing at an average of 47bps over the six-month period. Balances significantly increased YoY, however, which helped to push revenues higher, resulting in an average YoY increase of 197 per cent per month during H1. Corporate bonds continued to be affected by changes in treasury yields, a lack of market liquidity, and some specials activity linked to refinancing and company news.

The latest World Flash report, produced by S&P Global Market Intelligence, suggests that the leading indicators that remain consistent with an expansionary narrative are starting to lose momentum. This is the case, despite resilient US economic data and a disinflationary trend within the US economy. US hiking cycles appear to have further to go as persistent inflation and resilience in labour markets are likely to compel the Fed to continue to tighten policy until it is convinced that inflation is back on target.

The report also concludes that recent disinflationary readings on US consumer data and producer prices are likely to be insufficient to sway policymakers from making two more 25bps hikes during 2023. While consensus surrounding a soft landing for the US economy does appear to be gathering steam, this is not a forgone conclusion. Further uncertainty is likely to offer additional opportunities for both borrowers and lenders in the US. Securities lending revenues remain resilient and strong, however, and currently point towards all-time highs as we head into H2.

Major industry moves at BNY Mellon, SWIAT and Credit Benchmark

AccessFintech, a provider of data and network collaboration, has appointed Christopher Daur as global head of buy-side sales and relationships.

Based in New York, Daur will lead the global buy-side strategy, product and sales with a focus on driving engagement and client success.

He joins AccessFintech after an 18-year-long tenure with Goldman Sachs, where he was most recently managing director and head of client coverage group for the Americas.

In his previous role, he focused on post-trade challenges, strategy and solutions for the firm’s clients.

Earlier in his career, Daur spent nearly 15 years running numerous functions and asset classes across global markets operations. Before Goldman, he spent five years working at J.P. Morgan in multiple operations roles, and also worked in the Africa External Affairs Office of the World Bank.

The hire follows the growth of the firm’s Synergy Network, which has expanded to more than 100 buy-side institutions. Synergy generates real-time insights through its collaborative data network, enabling fail prevention and optimised inventory usages, the firm says.

Commenting on the appointment, AccessFintech CEO Roy Saadon says: “The opportunity to serve the buy-side's strategic initiatives, especially in these turbulent times, is an area of focus for AccessFintech.”

BNY Mellon appoints Udeshi

BNY Mellon has appointed Nehal Udeshi as head of the firm’s securities finance business, based in New York.

Udeshi joins the US bank from a 17-year tenure at Goldman Sachs, where she took on a range of roles in New York and London. She was most recently co-head of global cross asset financing within the global markets and banking division.

Among her roles at Goldman Sachs, Udeshi was part of the structuring and marketing group for global liquidity products and was also involved in structured funding for money markets.

Commenting on the announcement, Laide Majiyagbe, head of the markets’ financing and liquidity business, says: “Nehal joins the organisation at a pivotal time. We are confident that her deep experience and commitment to client service will strengthen BNY Mellon’s position and shape our future.”

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SWIAT has appointed Timo Reinschmidt as chief commercial officer and co-chief executive officer.

Reinschmidt brings 20 years of banking management experience to the German blockchain fintech, including his most recent position as managing director for Germany, Austria and Switzerland at Standard Chartered Bank.

He previously worked as managing director at RBS Global Banking and Markets and before that held roles at the Bank of America and KPMG.

Reinschmidt joins SWIAT as the firm finalises its joint venture with Dekabank, Landesbank Baden-Württemberg (LBBW), SC Ventures, Standard Chartered's innovation, fintech investment and ventures arm, and financial software specialist Comyno.

Commenting on his appointment, Reinschmidt says: "I am convinced that SWIAT will quickly establish itself as an open and cooperative international transaction platform for blockchain-based financial services and I am looking forward to working with an extremely competent and motivated team."

Michael Carty has stepped down from his role as CEO of Euroclear UK & International, a role he began in 2020.

Chris Elms, currently deputy CEO of Euroclear UK & Ireland, became the company's interim CEO on 5 August.

Carty has been appointed as CEO of LME Clear, the clearing house for the London Metal Exchange. He will begin the role in October.

Carty has served at Euroclear for more than 16 years. He has held several leadership positions, including CEO of Euroclear Sweden, where he led the team in obtaining its CSDR licence.

The company has credited Carty with "developing a compelling vision and strategy designed to transform Euroclear UK & International into a resilient, modern, digital UK financial market infrastructure".

An internal and external search has been launched to appoint a permanent successor to the role of CEO.

Credit risk data and analytics firm Credit Benchmark has appointed Michael Crumpler as CEO. He replaces Donal Smith, current CEO and co-founder, who will retain his position as executive chairman.

In the role, Crumpler will be responsible for expanding the firm's global client footprint, maintaining its status and developing existing analytics and product functions.

Crumpler has close to 20 years of experience in the financial services industry, and has been a part of Credit Benchmark since 2016. He joined the firm as a managing director and global head of contributor relationships, before becoming chief operating officer and head of risk in 2021.

He has held senior roles at Goldman Sachs and Barclays Investment Bank, and currently serves as president of the board of directors at the Capital Markets Credit Analysts Society.

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