



Securities Lending Update

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NORTHERN TRUST

QUESTIONS FROM EAST SUSSEX

DOES STOCK LENDING PRESENT ANY BARRIER TO THE FUND'S ABILITY TO APPLY FOR THE UK STEWARDSHIP CODE?

No. Principle 6 requires Institutional investors should have a clear policy on voting and disclosure of voting activity. The guidance, noted below, does not prohibit lending as long as the fund has an approach to lending and recalling stock. Additionally, the application of the code "is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies." Therefore, a potential solution for the Fund is to not lend UK equities or instruct recalls over proxy record dates.

"Institutional investors should seek to vote all shares held. They should not automatically support the board.

If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution. In both instances, it is good practice to inform the company in advance of their intention and the reasons why.

Institutional investors should disclose publicly voting records.

Institutional investors should disclose the use made, if any, of proxy voting or other voting advisory services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services

(Source: [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf))"

DOES STOCK LENDING IMPACT ON THE FUND ABILITY TO VOTE AND ENGAGEMENT WITH MANAGERS?)

Whilst the ability to vote a proxy passes from the Beneficial Owner to the Borrower due to the transfer of title of the lent security, it does not impact the Fund's ability to vote and engage with managers. Northern Trust recognises the existence of a potential trade-off between lending revenues and the ability to vote proxies or participate in corporate events. Northern Trust, as a lending agent, is experienced in ensuring its clients are able to vote their stock whilst participating in the securities lending programme. There are a number of solutions we can provide to help achieve this, including the following:

- Buffer management – restricting a portion of lendable stocks or markets to allow for representative voting (e.g. a 1% buffer)
- "Contentious" vote recall – on a best efforts basis and upon client instruction, Northern Trust will recall stock for those instances where a client deems the vote contentious
- Total restriction – clients can advise which stocks they must vote in full - these stocks are restricted from the lending programme in their entirety.

- Value to vote – clients can set a limit of opportunity cost forgone from voting

Our clients tend to combine more than one of the above approaches to ensure suitable restrictions are in place. All of the above options allow for voting on securities not lent out or a portion held back for voting purposes. If the client wishes to vote on all securities they own whether in custody or out on loan, Northern Trust can reallocate or recall all securities from borrowers prior to record date to achieve this, on the basis of timely client instructions. Please note even with this instruction there is always a risk that not all stock out on loan is returned in time to vote but on a best efforts basis we will endeavor to meet the client's request.

Additionally, another potential solution for the client is that we are willing to engage with proxy service firms to integrate voting notification and requirements, and are always open to developing new securities lending approaches with clients. Through our global relationship with Broadridge Financial Solutions, a leading provider of investor communications, Northern Trust is developing an automated proxy monitoring and recall service for clients who wish to participate in securities lending and to vote proxies. This option may have a fee, in addition to the overall fee split, to support given the increased operational work associated with the solution and would be on a best efforts basis due to our reliance on timely notification of the proxy event and timely return of securities by a borrower.

We would work with the client to understand each of the above options and provide a revenue estimate for such options and their impact.

Finally, we would note that the Global Master Securities Lending Agreement (GMSLA) states that the borrower warrants they are not borrowing with the express intent to vote. Additionally, we believe that borrower agreements with their underlying clients generally have a similar clause, so this understanding is passed down the chain of ownership. Further supporting our current legal agreements, we are working with our borrowers to understand their stance on the UK Money Markets Code, which is endorsed by the Money Markets Committee of the Bank of England. This Code makes it clear that "It is accepted good practice in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM or EGM (please see Chapter 4 of the attached document)." Thus far in our discussions with our borrowers, the responses have been positive that our UK borrowers have either signed up to the Code or are operating within the code guidance and are considering signing up to the Code.

IS STOCK LENDING CONSISTENT WITH THE FUND'S COMMITMENT TO RESPONSIBLE INVESTMENT AND BEING AN ENGAGED INVESTOR?

Securities Lending is a well-established investment activity. It is supported by Principle 6 of the Stewardship Code as well as by the Bank of England. Through Northern Trust's programme, the Fund has options to implement its voting requirements.

IS THERE ANY POSSIBILITY FOR LENT STOCKS TO BE USED FOR AGGRESSIVE AND ABUSIVE SHORT SELLING?

Whilst short selling is one reason borrowers borrow securities, there are numerous other reasons such as hedging activity, arbitrage trading, corporate events and fails management. With specific regard to short selling, there are various strategies involved including funds that have a market neutral strategy, a

long/short strategy, a dedicated short bias strategy, various arbitrage strategies, event driven strategies and macro driven strategies to name a few. As a borrower is not required to disclose their trading strategy at the point of trade, it is difficult to determine with certainty if lent stock from a Beneficial Owner is used for short selling.

Further, there are numerous academic studies that support short selling. The study of modern short selling began with Edward Miller in 1977 in his study published in *The Journal of Finance* titled, "Risk, Uncertainty, and Divergence of Opinion" who found that constraints against a group of investors, namely short sellers, leads to an inefficient market and more positive biases on stock prices. According to Boehmer and Wu in 2012 in their study published in *The Review of Financial Studies* titled, "Short Selling and the Price Discovery Process", short selling leads to better price discovery, as prices are closer to the correct fair market value when short sellers are more active. They also found no evidence that short sellers destabilise or manipulatively trade. Regulators generally agree with the view that short selling is beneficial to investors, including the International Organisation of Securities Regulators (IOSCO) who in a 2008 media release stated,

"short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market liquidity, facilitating hedging and other risk management activities and, importantly, limiting upward market manipulations"

We would be happy to provide additional examples of academic and/or regulator studies if necessary.

QUESTIONS FROM HAMPSHIRE

I WONDERED WHETHER JESSICA WOULD COMMENT ON THE FEE AGREEMENT IN COMPARISON TO THE MARKET?

In our view, the fee split proposal of 85/15 is favourable in comparison to the market.

IN ADDITION IS THERE ANYTHING IN THAT IF THE FEE WE PAY IS TOO LOW, MAY NORTHERN TRUST BE OF THE OPINION THAT THERE IS LESS VALUE IN LENDING OUR STOCKS, THAN IF WE PAID A HIGHER FEE?

Northern Trust, as securities lending agent, apportions securities lending opportunities among clients in the Global Securities Lending Programme through an automated loan allocation system. In apportioning loan opportunities, the loan allocation system takes into consideration objective factors such as the relative size of clients' holdings, prior loan activity, existing loan allocations and security availability. The loan allocation system is intended to provide impartial allocation of loan opportunities among our clients and to comply with relevant US and UK laws and regulations. Internally, the governance and methodology of the loan allocation system are subject to periodic review and monitoring by the appropriate Northern Trust committees and may be subject to periodic IT and corporate audit or compliance reviews. Externally, Northern Trust's applicable regulators (such as the US Federal Reserve, US Department of Labor and UK Prudential Regulatory Authority) have authority to review at their discretion Northern Trust's Global Securities Lending Programme, including the loan allocation system.

The clients' fee split is not a factor in the allocation system.

IF WE PAID A HIGHER FEE COULD WE POSSIBLY HAVE MORE STOCK OUT ON LOAN, AND AS A RESULT GAIN A GREATER RETURN FROM STOCK LENDING?

No, see above.

QUESTION FROM NORTHAMPTONSHIRE

CAN AN INVESTMENT MANAGER RECALL STOCK DIRECTLY FROM A CUSTODIAN OR DOES THE CLIENT NEED, IN THIS CASE LINK THE OPERATOR, TO DO THIS ON THEIR BEHALF?

Northern Trust would consider a process where the investment manager instructs us directly for recalls; however, we would like to understand the manager's expected recall activity. If the Fund is considering giving this level of authority to an investment manager, we would urge the Fund to consider limiting the authority to proxy voting only. Additionally, we will also accept an authorised instruction from the Operator, Link, so long as the Fund has given Link that authorisation.

Additionally, whilst the ability to vote a proxy passes from the Beneficial Owner to the Borrower due to the transfer of title of the lent security, it does not impact the Fund's ability to vote and engage with managers. Northern Trust recognises the existence of a potential trade-off between lending revenues and the ability to vote proxies or participate in corporate events. Northern Trust, as a lending agent, is experienced in ensuring its clients are able to vote their stock whilst participating in the securities lending programme. There are a number of solutions we can provide to help achieve this, including the following:

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Finally, another potential solution for the client is that we are willing to engage with proxy service firms to integrate voting notification and requirements, and are always open to developing new securities lending approaches with clients. Through our global relationship with Broadridge Financial Solutions, a leading provider of investor communications, Northern Trust is developing an automated proxy monitoring and recall service for clients who wish to participate in securities lending and to vote proxies. This option may have a fee, in addition to the overall fee split, to support given the increased operational work associated with the solution and would be on a best efforts basis due to our reliance on timely notification of the proxy event and timely return of securities by a borrower.



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Evaluations are based on the asset allocation, actual historical spread and on-loan figures provided to Northern Trust. Consequently, as changes in these factors occur and as trading patterns of the portfolio managers' shift, actual earnings generated in Securities Lending may be impacted.

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