Securities lending standard

June 2020

Introduction

Securities lending is a mature, well-regulated practice that can be a source of revenue for institutional investors. Investors temporarily lend their securities to borrowers in return for a fee. As security for the loan the 'lender' receives pre-agreed collateral, typically with an additional margin, in the form of other securities or cash before transferring the title of the securities to the borrower. A legal agreement protects the lender's entitlement to all the economic benefits of the lent securities (such as dividends) and, in the unlikely event of the borrower defaulting, the collateral is used to fund the replacement of the securities borrowed.

Nest's standard on securities lending

Nest has taken a two-pronged approach to securities lending: it allows securities lending to take place in its pooled fund mandates where its fund managers have decided to pursue it but has opted not to lend securities in its segregated mandates. This approach is based on a number of factors that seek to balance financial, risk and responsible investment considerations, as guided by **Nest's investment beliefs** and **Responsible investment objectives**.

Core to Nest's securities lending approach are robust fund manager selection, engagement and monitoring standards to ensure alignment with our members' long-term interests, managing risks and behaving as responsible market participants. This is a new Standard, so we will be working with our existing pooled fund mandates to ensure understanding of Nest's position and provide support to develop their approach.

Roles and responsibilities

Internal Control

The Chief Investment Officer will maintain appropriate internal processes to verify the competency of external investment managers to use securities lending as part of our investment mandate.

These processes will include at a minimum:

- provision of necessary resources and controls to ensure appropriate and efficient implementation and reporting
- appropriate contracts to manage the extent to and manner in which securities lending may be used

Third-party fund managers

Third-party fund managers may use securities lending in a manner consistent with Nest members' best interests, regulations, industry codes and standards, trustee delegations, and the investment objectives of the overall fund.

Nest's approach

Nest's approach to securities lending varies in accordance with the type of mandate. Nest only permits securities lending to take place in its pooled funds.

Segregated mandates

Nest does not permit fund managers of segregated mandates run on Nest's behalf to carry out securities lending activities.

Pooled fund mandates

Nest uses pooled funds that may engage in securities lending. Given the nature of pooled funds, Nest does not directly control the securities lending arrangements but places importance on carrying out appropriate due diligence and monitoring to ensure key risks are mitigated. Nest expects managers to:

- comply with applicable regulatory and reporting requirements such as the Securities Financing Transaction Regulation (SFTR) and any other regulatory requirements in relation to the relevant securities lending transactions
- adhere to the side letter agreement entered into with Nest and any other relevant documentation such as policy documents or prospectuses
- consider Nest's voting and engagement standards

Controlling risks associated with securities lending

Securities lending, although subject to increased regulation and transparency requirements, still carries with it risks that can be significant if not properly managed. In most cases it is expected that fund managers will have policies in place to manage these risks and Nest will rely on the effective execution of fund managers' policies to fulfil Nest's standards.

Counterparty risk

Nest expects its fund managers to minimise counterparty risk by expecting that they:

- lend to high-quality borrowers
- carry out extensive credit checks and regularly monitor the creditworthiness of borrowers
- diversify their borrowing base to avoid concentration risk
- disclose to Nest a list of its borrowers in their reporting and upon request

Collateral risk

There is a risk that the value of the collateral falls below the replacement cost of the loan. If the borrower defaults on the loan the lender can suffer loss due to the shortfall. Nest expects fund managers to minimise collateral risk by ensuring that:

- the type of collateral offered is acceptable in terms of value and liquidity, with consideration given to country risk, asset class and type such as cash, non-cash, open-end or term loan
- collateral is marked to market daily

Operational risk

There is a risk that securities sold by the fund manager are returned late and that the lender's agent fails to claim a dividend or other entitlement. Nest expects fund managers to mitigate such risks by:

- ensuring that risks and liabilities are fully understood by any lending agents involved in the securities lending programme
- reconciliations, reporting, verification and management oversight

Responsible investment

Nest takes its role as a responsible investor seriously and expects its pooled fund managers to adhere with its standards in relation to proxy voting and engagement. Moreover, securities lending activities should not obstruct Nest's ability to discharge its duty as a responsible investor.

Voting and engagement

Investors have an opportunity to act as good stewards of the companies in which they invest by voting at shareholder meetings. When shares are lent out, the voting rights are transferred to the borrower. As such, Nest expects that pooled fund managers put in place processes and policies to ensure that:

- lent-out shares can be recalled promptly in the event of a significant vote
- securities lending can be restricted ahead of an important vote
- not all shares of a company are lent out, so as to remain on a company's share register in order to retain engagement access

While Nest acknowledges that it is not always possible to control recalling or restricting securities lending in pooled funds, Nest shares with its fund managers a portfolio subset of Nest's watchlist for voting and engagement and has regular interactions with fund managers to discuss important company votes ahead of voting season and engagement activity.

Empty voting

Empty voting is a practice whereby stock is borrowed to influence the outcome of a vote at a company's shareholder meeting. Nest does not support empty voting, in line with the Bank of England's **Money Market Code**, which states that borrowing shares for the sole purpose of voting 'can distort outcomes for all investors if temporary holders of shares use borrowing to influence voting and is therefore deemed unethical. Accumulating stock via borrowing for this purpose can disrupt the liquidity of the market in the underlying securities and so is against the Code's over-riding principles of promoting market integrity and effective market functioning'.

While it is challenging to fully control this in practice, Nest encourages its pooled fund managers to:

- clearly set out in their contracts with borrowers that empty voting is not permitted
- include previous empty voting as an indicator of borrower suitability in due diligence and monitoring

Short selling

Short selling is the sale of a security that the seller has borrowed; if a security's price falls then the short seller profits. Nest acknowledges that the compatibility of short selling with responsible investment is subject to debate, with arguments on one hand that it can be a legitimate tool that adds liquidity and price discovery to capital markets, and on the other hand that it can lead to volatility, negatively impact share prices and is not compatible with long-term investor ownership.

As such, Nest expects pooled fund managers to:

- put in place policies and procedures to ensure that they do not knowingly facilitate any form of manipulative market activity or abusive short selling
- include previous abusive short selling as an indicator of borrower suitability in due diligence and monitoring

Future procurement

As part of Nest's procurement approach, where we use pooled funds, we will require prospective fund managers to produce a policy on securities lending. If fund managers undertake securities lending in the fund we are procuring, we will expect the policy to include the management of responsible investment considerations and other risks as set out above. The side letter agreement will also include a requirement to adhere to the provisions set out in this securities lending standard.

Where we select to use segregated accounts, we will instruct fund managers not to lend securities on our behalf.

Monitoring

Nest's investment team will review the implementation of its fund managers' securities lending policies annually. The review will take place as part of Nest's overall annual review with its fund managers and will consider the suitability, transparency and cost-effectiveness of their approaches. As part of this, fund managers will be expected to:

- provide an annual attestation of compliance with Nest's securities lending standard
- update Nest should there be any changes to their approach
- provide a list of borrowers for Nest to carry out a suitability review

Nest will also share information across its fund managers to promote a closer alignment of policies and discuss any possible changes that should occur in line with best practice.

This Standard will be reviewed by Nest's investment committee on a triennial basis, or sooner in the event of significant change.

Version Control

Version	Change	Date implemented
1	Document created	July 2020

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