

# **SECURITIES LENDING and INVESTOR PROTECTION CONCERNS**

Cash Collateral Reinvestment; Borrower Default;  
Lending Agent Compensation and Fee Splits; Proxy Voting

## **U.S. SECURITIES AND EXCHANGE COMMISSION**

Roundtable on Securities Lending and Short Sales

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**Statement by Ed Blount**  
**Center for the Study of Financial Market Evolution**

I am the Executive Director of the Center for the Study of Financial Market Evolution (CSFME), which is a nonprofit research organization based in Washington, D.C. with production facilities in Oerlikon (Zurich), Switzerland. The CSFME was founded to gather, compile, and scrub proprietary data files for use by academic researchers, by engaging sources that would not otherwise be available to market analysts.

The first and still-largest project for the CSFME is the [study of borrowed proxies](#), an evaluation of the validity of allegations that activist hedge funds and their prime brokers have abused their privileges as securities borrowers. On a quarterly basis, the CSFME also evaluates trends in collateral management by the cash managers for securities lenders, using data compiled by the Risk Management Association.

We created the CSFME in 2006 to help provide transparency in securities lending and other “opaque market sectors”, as they have been described, without imposing burdensome regulations on participants; without intruding on confidential relationships; and without revealing trade secrets or proprietary strategies. This is an extraordinarily difficult process, but one which results in the discovery of uniquely valuable insights into the ways of fast-evolving market sectors.

Perhaps surprisingly, there is often substantial macroscopic information to describe certain aspects of, or periods in time for these opaque sectors. For example, the Bank for International Settlements (BIS) and the International Organization of Securities Regulators jointly produced an exceptional 1999 study of the practices of the global securities lending market. Consultants, attorneys, accountants, practitioners, trade groups, reporters and academics have since written about current lending practices in the trade and academic journals. There is even a fair amount of data available to describe current securities lending activities, produced not just by the Risk Management Association but also by private vendors.

The most valuable and timely descriptions of lending market activity are contained within the transactor source files, that is, the transaction processing and accounting systems of the market participants themselves. However, academics have never been able to gain access to a sufficiently large number of source files to create a representative sample of the securities lending markets. Nor have they been able to acquire even a single dataset without having to accept crippling constraints that effectively preclude access for subsequent researchers to update their work.

The CSFME was founded to produce research datasets that overcome these barriers through the use of advanced processing and confidentiality-protection systems. The remainder of this paper is dedicated to a discussion of our current and planned research projects, to the extent of their relevance to this Roundtable.

## Relevant Research Findings

We have attached two preliminary analyses of recent trends in risk management and loan volatility within the securities lending market for consideration by the Commission. These analyses are only preliminary in that independent, academic researchers have not yet been assigned to validate their findings. However, we believe the underlying datasets and results are representative of market activities.

### *Trends in Cash Collateral Management by Securities Lenders*

In the first analysis, attached as "Securities Lending Market Dynamics 2Q09", we used the latest data from the Risk Management Association to analyze the substantial turbulence that the securities lending market experienced during the recent credit crisis.

Loan volumes jumped dramatically in 2Q08, rising 91% over the previous quarter, before falling 60% by 1Q09 (page 1, figures 1-3). Industry participants attribute this decline to falling asset valuation, borrower deleveraging, and a movement away from General Collateral (non-specified securities) lending. However, these dynamics created something of a perfect storm for cash pool managers during the credit crisis, which may well have hit securities lenders' collateral pools more severely than it did many other cash management funds. To illustrate, rapid increases in recalls and returns by borrowers required high levels of pool liquidity just as the credit crisis froze the markets for many short-term assets.

In such a circumstance, lending agents were faced with a difficult choice: endanger illiquid reserves or pay unusually high rebate rates to motivate borrowers to maintain their cash balances in place. Armed with superior residual yields, agents elected to pay rebate rates to borrowers above the federal funds rate in 4Q08 (page 3, figure 4), a practice that actually drove intrinsic values down into negative regions (page 3, figure 5). Meanwhile, agents sold off their more liquid assets to meet pool redemptions. That also increased the proportional share of the "Other Corporates" category of assets in their cash pools (page 3, figure 6).

Throughout the credit crisis, median pool maturities were reported as within typical ranges (page 4, figure 7 and 8) while credit quality standards were reported to improve (page 4, figure 9). However, some cash pool managers seem to have increased the final maturities of their portfolios to pick up additional yield (page 4, figure 7), implying that a wide range of tactics was used to manage the pool stresses.

Most recently, the securities lending market has shown signs of stabilizing, even though rising stock prices, which boosted equity loan balances 37% in 2Q09 (page 2, figures 1-2), would have added pressure on the short portfolios of securities borrowers. And while the additional borrowers' collateral would have alleviated some of the stress on agents' cash pool managers, the Fed's new TSLF program seems to have absorbed some of the demand for fixed income loans (page 2, figure 3), and that placed further pressure on agents' cash pool balances.

Average reported securities lending earnings remained substantially higher than historical norms throughout the credit crisis (page 3, figure 5). For example, loan agents worked to protect higher net yields by cutting rebates in the most recent quarter. That allowed lenders to earn three times their normal rates while permitting a shift back to more customary investments, durations, and allocations to higher quality instruments in their cash pools.<sup>1</sup>

### *Allegations of Borrowed Proxy Abuse*

CSFME's first and largest research initiative is to analyze whether securities lending facilitates widespread abuse of corporate governance and proxy voting processes. Academic studies have found instances in which securities were alleged to have been borrowed specifically to acquire voting rights. The evidence for this allegation is based on a finding that loan balances for two market participants were statistically higher on record dates in 1998-99, and that votes were often acquired at no cost in the securities lending market. (When a security is loaned, the lender maintains total economic exposure to the security while the borrower receives the associated voting rights.) Because data on securities lending activity was not readily available, however, these studies were based on anecdotal or limited datasets, raising questions about the extension of their findings outside of the cases used in the studies and to more recent timeframes of market activity.

As described below, CSFME's mandate is to test the allegations of borrowed proxy abuse with substantially more data for more recent periods. Towards that end, we conducted the attached analysis with the first dataset received. Although this data was comparable in scope to the academics' dataset, we were unable to replicate the results of their studies. Instead, we found that:

- Securities lending is a very spiky industry (i.e., loan balances spike frequently for individual securities), but that only a small number of these spikes occur on proxy record dates (page 2, finding 1);
- Loan balances on record dates were not statistically significantly higher than normal (page 2, finding 2); and

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<sup>1</sup> A few qualifications to the analysis above are necessary. We thank the Risk Management Association (RMA) for collecting and compiling the underlying data and making it available to the public on a quarterly basis. However, RMA's sample size varies over time, implying that quarter-to-quarter comparisons are not perfectly consistent. Furthermore, we do not know if the reported results are skewed by differences in accounting techniques, including asset valuation practices and the treatment of illiquid assets. That said, RMA's lending results represent more lending activity than is currently available from any other source and we believe therefore that the analysis above provides useful insight to regulators and market leaders.

- There does not appear to be a clear relationship between securities lending and proxy voting, since some record dates have loan spikes while most do not and the majority of loan spikes occur away from record dates (page 3, finding 2).

It should be noted, however, that this analysis suffers from the same key limitation as previous studies - it is based on a rather limited dataset. Accordingly, we have continued to collect, compile, and validate lending activity records, so that we now have over 600 million records of securities lending transactions during 2005-2008, and expect by the end of the year to have over 90% of all U.S. securities lending activity during the past 4 years. We will use this data to further refine our analysis, to include investigating:

- How intrinsically volatile, or “spiky”, is the securities lending market? Do most securities experience loan spikes, or are spikes driven by specific dynamics?
- What, if anything, is the relationship between loan spikes and proxy record dates? Are loan balances higher on record dates at statistically significant levels?
- How does the practice of substituting loans among and across lenders affect the analysis of securities lending and proxy votes? Can findings be robust if only based on one agent's data?

### **Liability-driven Systemic Risks in Securities Lending**

Beyond the projects described above, the CSFME is evaluating additional research into the nature of risk within the securities lending markets, particularly with respect to the larger capital markets. For example, the similarity of investment strategies followed by pool cash managers can create the risk of a powerful feedback loop, which can affect asset prices in both a positive and negative direction. As a positive force, the prices of relatively illiquid assets can be supported (almost) indefinitely when cash managers collectively direct their resources into sectors such as asset-backed securities and special investment vehicles. By contrast, when those resources are removed, especially at critical refunding periods, asset prices can plunge to the extent that those sectors may remain illiquid for extended periods. Market participants have given a great deal of attention to this phenomenon over recent months.

As significant as the risks may be on the asset side, we believe that not enough focus has been given to the liability side of the lender balance sheet. Some lenders have criticized their agents for investing their cash collateral into, or withdrawing it from unexpectedly-illiquid asset sectors. Yet, many of those agents have been remarkably resourceful at managing the liabilities to borrowers and, thus, preserving the liquid-

ity of their cash pools so as to avoid the need to sell assets. If there had been a “run on the bank”, it is possible that investors far afield of the securities lending markets would have felt the consequences.

Despite the success with which agent lenders have managed their resources, we believe that the Commission should consider the creation of a supervisory risk assessment system to monitor the concentration, liquidity and volatility of the lenders’ cash collateral pools from both a liability and asset perspective. The information needed to populate such a systemic risk monitor is available, but its organization would be a daunting task, whether undertaken by the private or public sector.

### **A Brief History of Modern Securities Lending**

From the 1920s, Citibank, JPMorgan, Irving Trust and the other large American-depository-receipt-issuing banks would pre-release the ADR as a substitute for a specific foreign security to a broker, in advance of the broker's counterparty delivering the underlying foreign shares to its overseas sub-custodian. This was usually done as an accommodation to the customer. For instance, Citibank provided its pre-release service for no additional charge beyond the standard issuance fee, so long as the broker provided sufficient collateral.

In effect, Citibank gave away the securities lending service in order to generate fees from the ADR business. That's a big change from today, where securities lending is a standalone profit center at most service providers. However, other aspects of securities lending have remained consistent since the 1970s. For example, using the techniques of the ADR business, Bankers Trust and other custodian banks loaned domestic securities to brokers who were failing-to-deliver at the clearinghouse.

Standalone profits are still the primary mover for securities lending, although it's no longer an operational consideration as much as it is a short-sale coverage requirement. In the 1970's, the banks earned enough from the new securities lending service to offset losses in the custodial service that had followed the immobilization of physical securities certificates at DTC. The lending service also generated revenues that customers could use to offset their safekeeping fees. In the 1980s, cash collateral reinvestment became a critical element in the business model, so that supplementary revenue from securities lending today remains just as important to custodial banks and their customers, as well as to the new breed of third-party lending agents.

Like many new financial services, securities lending has experienced its share of disruptions. Most prominent were the \$250 million loss by Chase Manhattan Bank in 1982 as a result of the Drysdale Securities collapse and the \$50 million loss by Harris Bank due to failed cash collateral reinvestments in 1994. However, each loss has led to procedural corrections by the industry. To a large extent, today's securities lending business remains functionally true to its roots three decades ago. However,

from a capital markets, as well as risk management perspective, the similarities end with functionality.

The growth in complexity of the capital markets has increased the connectivity of securities lending to virtually every sector, participant, conduit and underpinning of modern investment management. Those linkages have enormous implications for regulators and risk managers. For that reason, changes that affect securities lenders and their intermediaries must be weighed in light of the impact they will have on all sectors of the capital markets.

### **Mandate of the Center for Study of Financial Market Evolution**

As stated above, CSFME's mandate is to gather, compile, and scrub proprietary data files for use by regulators and academic researchers, by engaging sources that would not otherwise be available to market analysts. Transparency and reporting standards frequently lag behind financial market innovation during periods of rapid market evolution. Accordingly, academics or market regulators often lack the robust market data necessary to fully analyze market dynamics or develop sound policy that avoid unintended consequences. Researchers occasionally attempt to overcome these data shortfalls by collecting and analyzing small proprietary datasets, but these datasets are usually granted only under tight nondisclosure agreements that make them unavailable to independent, subsequent researchers for testing and validation. CSFME's goal is to overcome these challenges by compiling and storing industry-wide datasets of proprietary information, conducting the compilation, quality control, and validation steps necessary to ensure dataset robustness, then making the datasets available for academic research, all while maintaining the strictest data protection and confidentiality standards.

However, the inherent challenges of compiling data from disparate sources, such as maintaining definitional consistency and integrating data in diverse formats, should not be underestimated. Financial institutions have different accounting systems that record historical activity within proprietary file structures. Even if one can overcome the structural dissimilarities among these proprietary accounting and transaction processing systems, there will still be firm-specific differences in data definitions, timelines, exclusions, asset identifiers, as well as the need for varying allowances with respect to additions, omissions, conversions, corrections and adjustments.

Even after compiling such a large dataset, however, more detailed lending activity records may be necessary to fully analyze market dynamics around some cases. For example, lenders who recall securities prior to record date to exercise their voting rights may inadvertently generate new loans for other lenders, especially within pooled agency lending programs, and may not therefore eliminate the potential for proxy manipulation. Our intent is to identify any additional data requirements after

the first round of empirical analysis, then reengage the financial industry with both preliminary findings, open issues, and, if necessary additional data requests.

### **Personal Introduction**

My experience with the securities lending business dates back more than 30 years. In 1977, I was hired by Bankers Trust Company to set up a securities lending service at 16 Wall Street for the bank's global custody customers. To accomplish this, I adapted the operational techniques I had learned over the previous three years as the business head of Citibank's American Depositary Receipt (ADR) department. The success of that embedded lending service was quickly affirmed by the substantial degree to which its profits offset the ongoing losses of the securities custody services.

As a result of founding my own Wall Street systems consulting firm in 1980, I remained for three decades an active designer of systems in support of securities lending, clearing, settlement, and custody services; cash management services; foreign remittance services, and related financial services. After co-authoring and editing in 1982 the first securities processing textbook for the American Bankers Association (see [bio](#)), I have been involved in the development of those processing systems as they evolved from Fortran- and Cobol-based mainframe applications hosted on a handful of IBM 370s, to a worldwide network of web-enabled applications running on thousands of vastly more powerful, widely-distributed computer networks.

While building my consulting firm, I also worked with financial trade groups and professional associations on a *pro bono* basis. For example, since 1981 I have been a contributing editor of the ABA's *Banking Journal* and I have consulted with the Risk Management Association of bank lending officers since 1995. I have also consulted with the National Association of State Auditors, Controllers and Treasurers; the Investment Company Institute; and the Mutual Fund Directors' Forum. I have published dozens of contemporaneous articles on the evolution of financial services.

In the early 1990s, when third-party securities lending became popular, I designed and developed the first performance measurement service for securities lenders and their compliance officers. By 2005, my firm was selling online subscriptions to a more advanced, daily securities-loan pricing service for institutional investors and their financial intermediaries. That system, called Lending Pit, had also been integrated into a broader performance measurement and risk management analytic suite by the time that I sold the business to Sungard Data Systems in October 2007. I took over full time management of the nonprofit CSFME shortly after that.

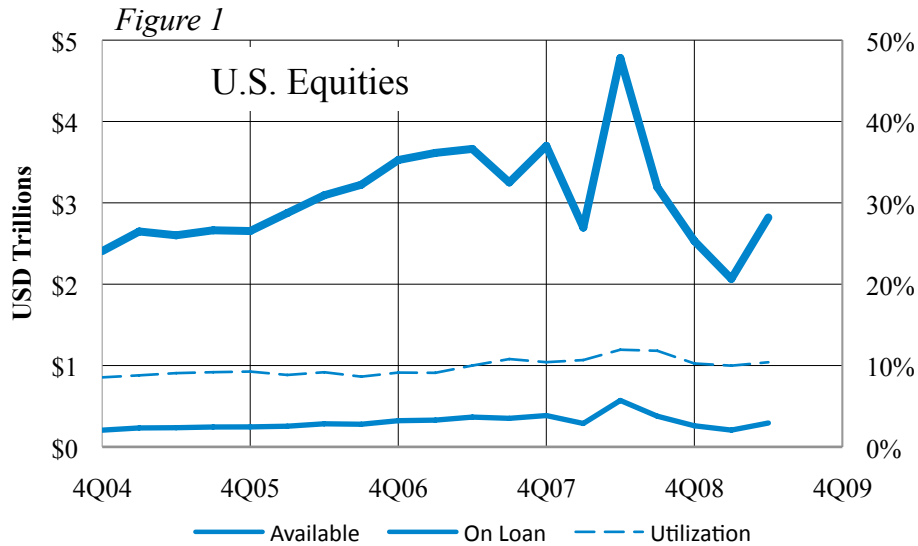


# Securities Lending Market Dynamics 2Q09

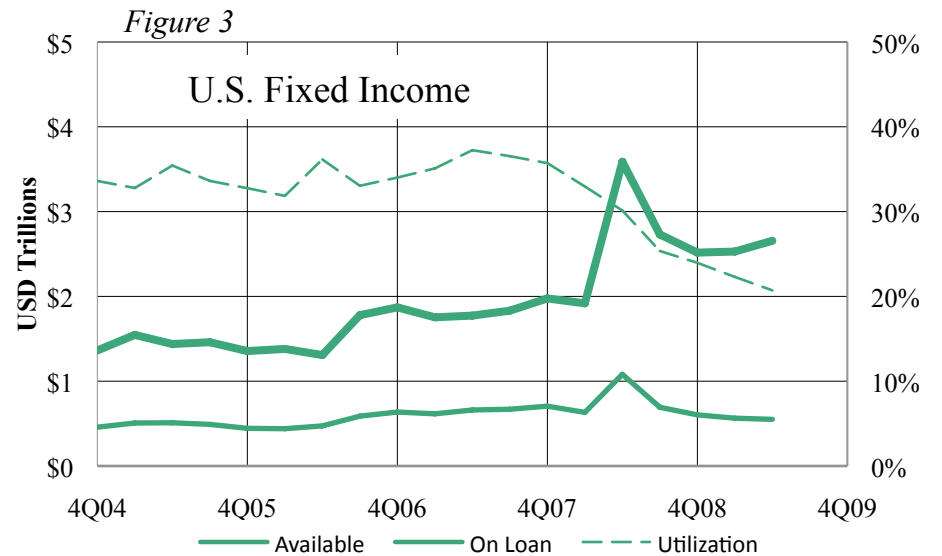
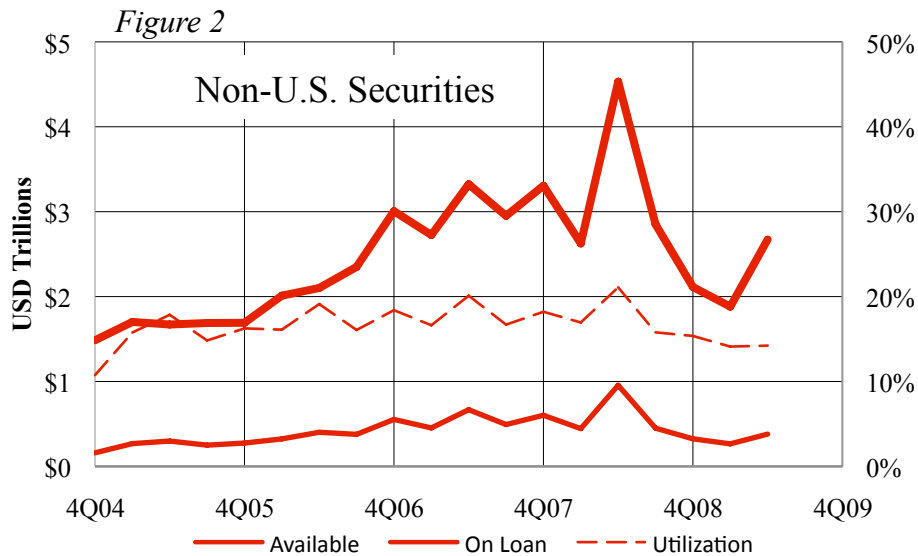
Prepared for the Securities and Exchange Commission by the  
Center for the Study of Financial Market Evolution

Data sourced by the  
Risk Management Association and member banks

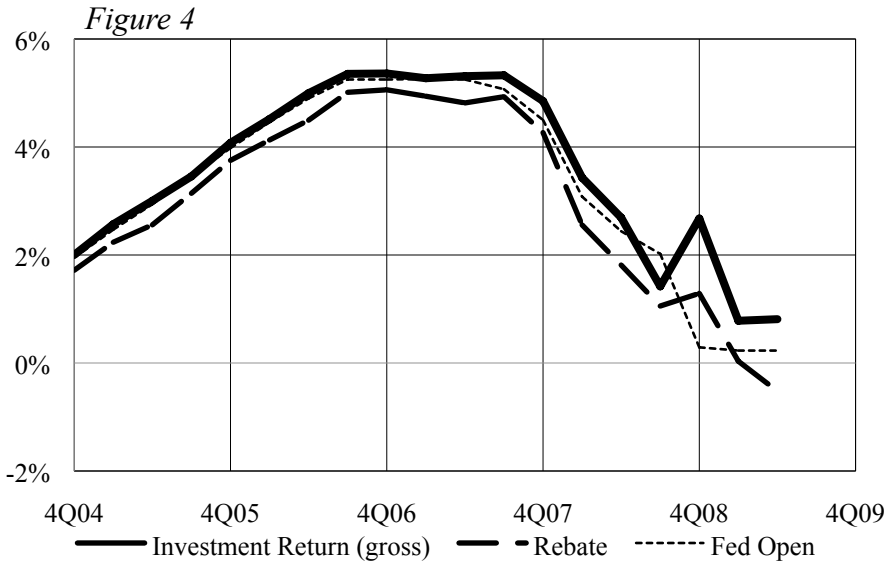
# Rising stock prices boosted loan balances in 2Q09...



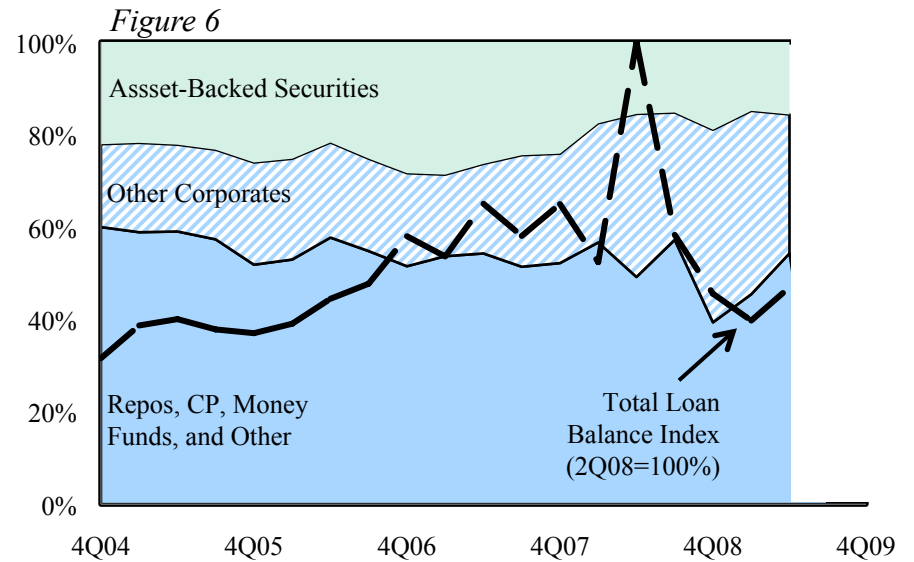
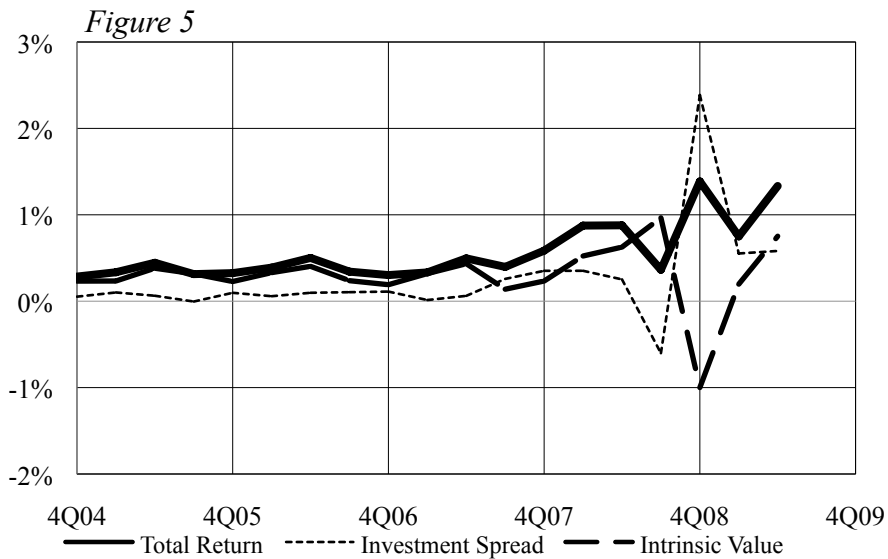
**... but the Fed's TSLF program absorbed non-equity loans, indirectly stressing agents' cash pools.**



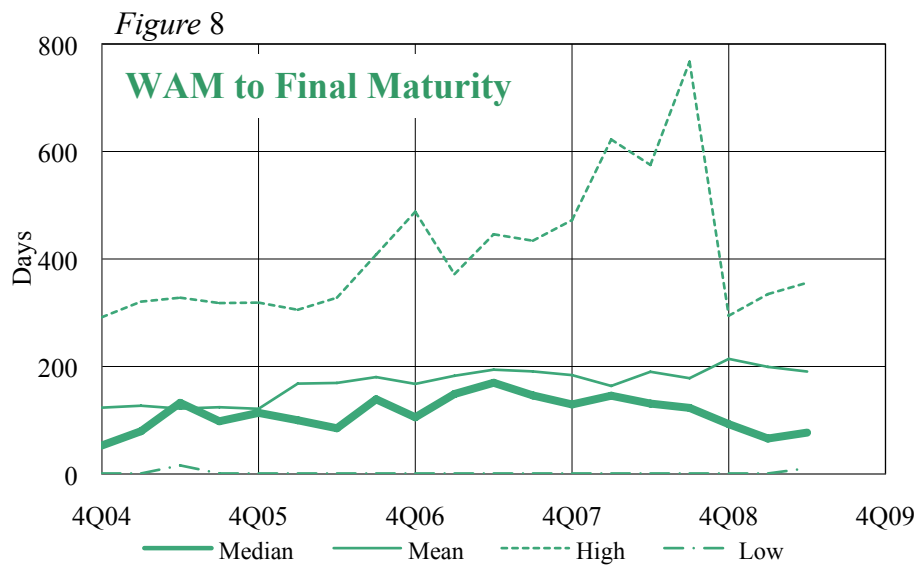
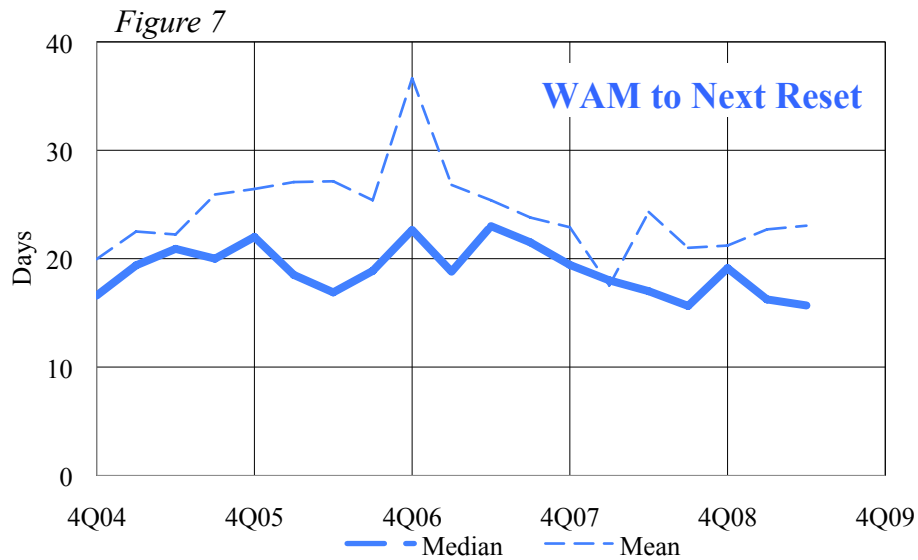
# In reaction, loan agents cut rebates while protecting higher yields ...



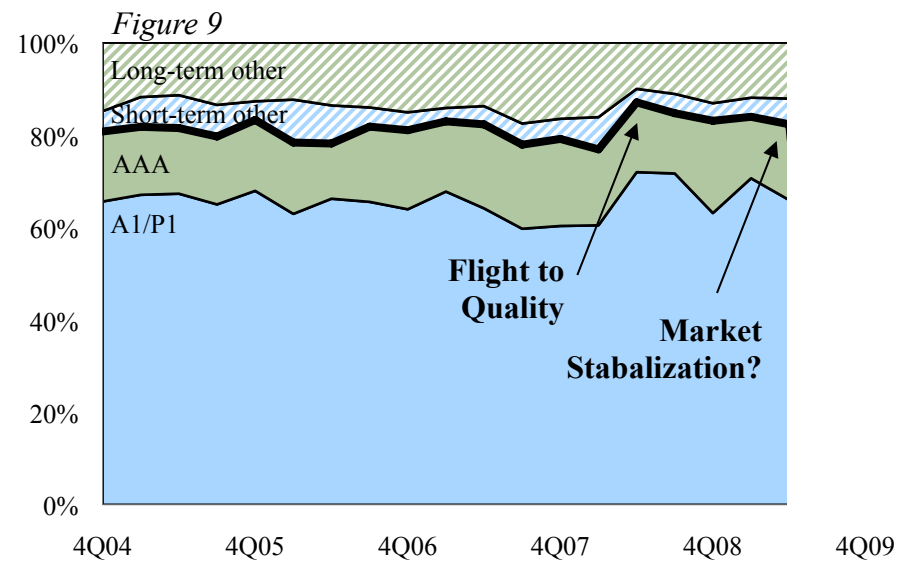
... allowing lenders to earn 3X normal rates while shifting back to typical investments, ...



# ... maintaining durations on cash pools, ...



# ... and holding on to high quality instruments.



# Does Securities Lending Interfere with Corporate Governance?

Analytics by the  
Center for the Study of Financial Market Evolution

Data sourced by the  
Risk Management Association, member banks  
and Broadridge Financial Services, Inc.

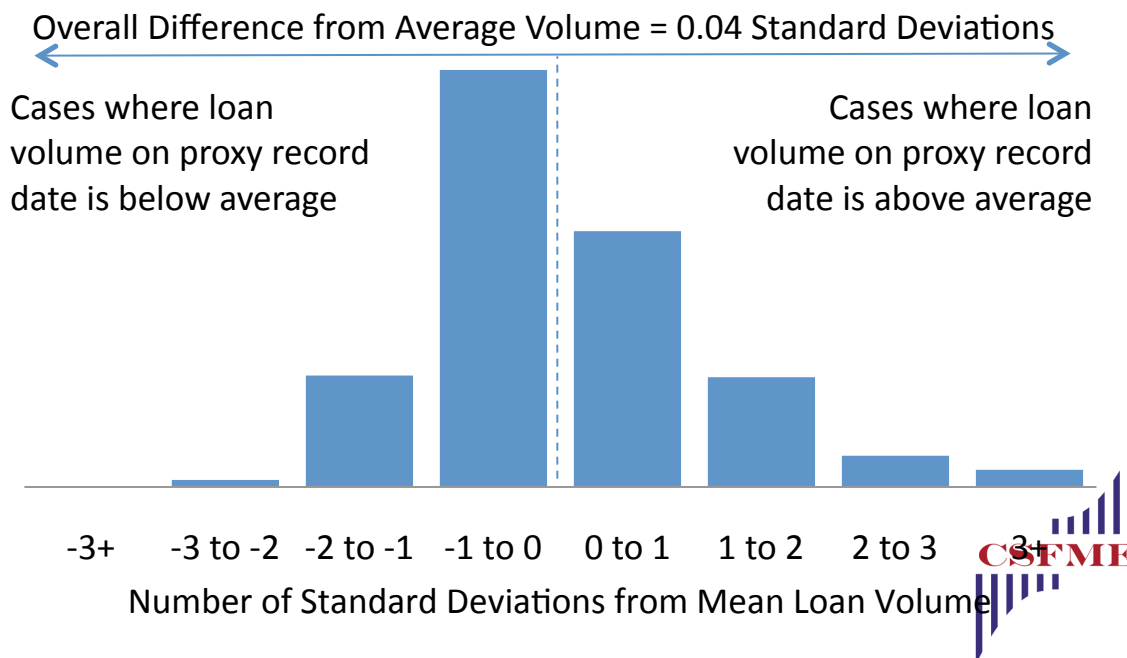


# Loan balances spike often, but rarely on record dates

**Preliminary Finding 1 – Loans spike for many securities, but rarely on proxy record dates.**

	# Securities	% of Total
Total	5,512	100%
with Proxy Record Dates	2,011	36%
with Loan Spikes*	1,334	24%
with Loan Spikes on Proxy Dates	60	1%

**Preliminary Finding 2 – Overall, loan volume on proxy record dates is neither significantly higher nor lower than average.**



# There is no clear pattern of lending around record dates

**Preliminary Finding 3 –  
No clear relationship between loan  
volume and proxy record dates is  
readily apparent. Some spikes fall on  
proxy record dates and others do  
not.**

