CSFME

1101 PENNSYLVANIA AVENUE
WASHINGTON, D.C. 20004
+1.202.531.7999
www.csfme.org

March 17, 2022

Ms. Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE, Washington, DC 20549

**Re: File No. S7-18-21: Reporting of Securities Loans**

Dear Ms. Countryman:

The Center for the Study of Financial Market Evolution ("CSFME" or the "Center")[1] writes today to supplement our December 15, 2021[2] and January 7, 2022[3] comments on the Securities and Exchange Commission's ("Commission") November 18, 2021 proposal, "*Reporting of Securities Loans."* (the "Proposal")[4] We have taken the opportunity afforded by the Commission's extension of the Proposal's comment period[5] to expand on our previous input and describe a proof of concept study we intend to undertake demonstrating the value of industry-wide pooled securities lending data. We will also place our suggested alterations to the Proposal in the context of the global efforts to increase securities lending transparency since the Financial Crisis.

**Summary of Recommendations**

We recommend that the Commission consider an alternative disclosure solution that expands the definition of RNSA and avoids the exclusion of a data trust formed by lenders to report their own securities loans. If lenders can form a data trust, regulators as well as lenders' advisors and custodians could improve their risk management systems by using encrypted subsets of data generated by rule 10c-1, as well as their "know your customer," proxy voting, ESG, and related contractual or policy restrictions. Those data have never been compiled in one place before.

Such an expansive alternative would avoid creating the "free-rider" problem we identified in our December 15th comment letter. The missing peer data needed for performance attribution could

[1] Founded in 2006, the Center for the Study of Financial Market Evolution (www.csfme.org) is a nonprofit organization whose mission is to support research that promotes sound regulation of capital markets.
[2] https://www.sec.gov/comments/s7-18-21/s71821-20109658-264014.pdf
[3] https://www.sec.gov/comments/s7-18-21/s71821-20111702-265034.pdf
[4] Reporting of Securities Loans, Rel. No. 34-93613, 86 FR 69802 (proposed November 18, 2021),(codified at 17 CFR 240). ("Proposing Release" or "Proposal").
[5] Reopening of Comment Period for Reporting of Securities Loans, Release No. 34-94315, File No. S7-18-21, 87 FR 11659 (March 2, 2022).

be held securely in the lenders' data trust and used by administrators to restore measurement reports under contract with the existing data vendors. As we described in our January 7th comments, the alternative would likely save at least $100 million of the $375 million projected to be required for lender-financed development.

We indicated in our previous correspondence that, given time for further research, we would study the feasibility of data trusts for managing counterparty risks using mapping algorithms and smart contracts with distributed ledger technologies. Therefore, we respectfully request the Commission to instruct staff to assist forensic accountants from the European Securities and Markets Authority (ESMA) in compiling the resources needed for "proof of concept" testing of the alternative in the form of a voluntary Cross-Border Stock Loan Registry. If the alternative concept is proven, then a scaled-up version would be equally effective as the proposed 10c-1 regime but more efficient and far less costly.

Underlying our recommendations is the conviction that modern investor protection requires the use of holistic datasets. Random data fields may seem relevant, but if incomplete even when compiled, will provide neither useful disclosures to investors nor useful data for lenders and regulators.

**Inadequacies noted in our December 15, 2021 letter**

In our initial comment letter on the Proposal, we endorsed the Commission's goals but pointed out that the proposed disclosure system creates a "free-rider" problem. The potential benefits of the disclosures under rule 10c-1 would seem to flow to all participants in the securities lending markets. However, the choice to impose the reporting duty on lenders alone would burden that investor segment with nearly the entire cost of compliance.

We also pointed out that the data proposed to be collected under rule 10c-1 provides very little value to those lenders. Under the Proposal, the data reported to the RNSA would be insufficient to build peer groups for performance measurement and not granular enough to assist with counterparty credit risk management. Without more value to lenders who bear the costs of compliance, we warned that the 10c-1 rule proposal will not succeed as currently specified.

We indicated that given time for further research, we would study the feasibility of pooling data from lenders to apply mapping techniques and distributed ledger technologies. Our goal would be to derive metrics for optimizing loan recalls to vote proxies, for validating cross-border loans, and for improving counterparty risk management.

**Recommendations from our January 7, 2022 letter**

Our subsequent comment letter laid out a plan for how the proposed reporting regime could be improved. We proposed an alternative or alteration to the reporting system under proposed rule 10c-1 that would provide regulators, investors, and brokers with the same data and in the same time frame as in the Proposal, but with greater benefit to lenders who bear almost all the cost of the regime. We also indicated that the alternative we propose could be achieved at significantly less cost in implementation and ongoing application than the estimates in the Proposal by ameliorating some of the technical, reconciliation, formatting, and programming costs associated with feeding data to the RNSA. Our proposed alternative would also provide lenders who bear the ultimate cost of compliance with rule 10c-1 with a better value proposition in exchange for bearing this burden.

Specifically, we proposed the reporting system be adapted to accommodate a data trust formed by beneficial owners in the securities lending industry. We believe if lenders were permitted to join together to form a data trust they could pool not just the information required by rule 10c-1, but also "know your customer," proxy voting, ESG, and other transaction data for their own benefit. The data trust could in turn provide a single transaction data feed to the RNSA in whatever format and frequency the Commission chooses for the final rule.[6] We also described the benefits of industry-wide pooled data to both regulators and to lenders.

**Discussion**

The reporting regime set forth in the Proposal avoids many of the pitfalls raised by commenters in response to proposed FSB frameworks for data collection and the extensive consultation and adoption processes of the EU's Securities Finance Transaction Regulation ("SFTR").[7] However, the Commission's proposed rule 10c-1 reporting regime still lacks some elements necessary to address risk of contagion through a fire sale of cash collateral reinvestments that was the primary concern of the FSB back in 2015. Though the Dodd-Frank Act's Section 984(b) directs the SEC to make rules for securities lending transaction disclosure to investors and brokers, the section is part of the larger Dodd-Frank legislation which is really a reaction to market leverage. It provides the SEC with tools to respond to the elements of the securities lending industry highlighted by the FSB as having played a role in the financial crisis. The Commission could be remiss in executing the intent of the directions under Dodd-Frank if it does not take full advantage of this opportunity to maximize to its fullest exent its abilities to monitor excess leverage through the data it intends to collect under the Proposal.

[6] See Proposal, Question 54.
[7] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R2365&from=EN

The Dodd-Frank Act specifically requires the SEC to implement rules to make the securities lending industry more transparent, and amends the Exchange Act to give the Securities and Exchange Commission the power to regulate participants in the securities lending markets directly.[8] Through these rulemaking provisions, the SEC has sought "increased transparency, better investor protections and new regulatory tools" that serve to create "a stronger marketplace and financial future for all Americas."[9] The direction from Congress for more transparency is embodied in section 984(b) - "Increased transparency of information available to brokers, dealers, investors, with respect to loan or borrowing of securities." Whereas, the driving force behind the Dodd-Frank Act is the need for market surveillance for excess leverage, contagion - once again punctuated by Gamestop.[10] As the Proposal states, "the data elements are designed to provide regulators with information to understand: whether market participants are building up risk; the strategies that broker-dealers use to source securities that are lent to their customers; and the loans that broker-dealers provide to their customers with fail to deliver positions."[11]

It may be useful to recap the arc of policy considerations leading the Commission to this point. In November 2015, the FSB published the consultation paper, "Standards and Processes for Global Securities Financing Data Collection and Aggregation,"[12] (the "2015 Consultation") building on policy recommendations to address financial stability risks in securities finance transaction (SFTs), in particular, recommendations to improve transparency of securities financing markets. CSFME has followed these developments closely, providing feedback to the FSB[13], and even creating a university-level curriculum around the move toward greater global SFT transparency.[14] The FSB followed up with the 2018 publication of "Securities Financing Transactions Reporting Guidelines"[15] with greater specification of the kinds and types of SFT

[8] Pub. L. 111-203, 984(b), 124 Stat. 1376 (2010). Section 984(a) of the Dodd-Frank Act ("DFA"), now Section
10(c)(1) of the Exchange Act, makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange … to effect, accept or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[9] Mary Jo White, Public Statement, Statement on the Anniversary of the Dodd-Frank Act (June 2015), http://www.sec.gov/news/statement/statement-on-the-anniversary-of-the-dodd-frank-act.html.

[10] See, Section 929X(a): "Rules regarding reform of short sales." See also, "Short Position and Short Activity Reporting by Institutional Investment Managers, Rel. No. 34-9313, 87 FR 14950, March 16, 2022.

[11] Proposal at p. 69804.

[12] FSB, Standards and Processes for Global Securities Financing Data Collection and Aggregation, 2015 ("2015 Consultation")
https://www.fsb.org/2015/11/standards-and-processes-for-global-securities-financing-data-collection-and-aggregation-3/

[13] CSFME Comment Letter, Feb. 12, 2015.
https://www.fsb.org/wp-content/uploads/CSFME-on-1411DEG.pdf

[14] Comment Letters from Fordham University Students.
https://www.fsb.org/wp-content/uploads/Fordham-Univ-students-on-1411DEG.pdf

[15] https://www.fsb.org/wp-content/uploads/P050318-3.pdf

data desired. While end-to-end traceability of individual transactions was never a priority in either of these releases, capturing position-level data from both ends of each transaction has been the focus since the inception of the SFT data collection initiative. As the FSB said in the 2015 Consultation:

> *"The global data collection could be based on the aggregation of reporting from either one or both parties to a trade (e.g. repos and reverse repos, securities lent and borrowed). Since the standards and processes are developed for the FSB member jurisdictions, a two-side reporting scheme, where both counterparties report the trade, would maximise the data collection coverage."* (emphasis added)[16]

Indeed, the FSB emphasized throughout the 2015 Consultation the absolute importance of trade-level data collection to the ultimate goals of obtaining flow data and position/stock data for meaningful risk analysis.

As we mentioned in our comment letter on the 2015 Consultation, in the context of securities lending, two-sided reporting is also imperative to regulators and policy-makers in assessing, "the threat to market stability from widespread recalls and returns of securities loans, as those terminations can lead to forced redemptions of cash collateral and the untimely sale of pool investments."[17]

We further cautioned that the 2015 Consultation's focus on global aggregates limited to position metrics "will have minimal value, and may well prove to be misleading." While position aggregates in securities lending may help track the level of cash collateralized loans, these metrics alone cannot track the risk of collateral fire sales, one of the main systemic risks that supervisors have linked to securities finance. Rather, we proposed that FSB and national and regional authorities expand the data initiative beyond position aggregates, to include risk mitigation resources as well as termination activity.[18]

> *"To have a true understanding of the risk associated with collateral fire sales, loan recalls and returns must be tracked along with position aggregates. In addition, because lending agents can mitigate these termination risks with rebate incentives, cash buffers and loan substitutions, these mitigation techniques and practices must be considered as well.*[19]

[16] 2015 Consultation, at 2.2.
[17] See note 5, infra. CSFME Comment Letter, Feb. 12, 2015 at p. 3
[18] https://csfme.org/Full_Article/csmfe-submits-comments-on-fsb-data-collection-proposals
[19] Ibid.

Other industry commenters identified areas where the FSB's early framework efforts confused the concept of regulatory reporting with the disclosure of corporate information to the public market. **ICI Global** pointed this out in their 2015 comment letter.[20]

> *"It appears to us that the Consultation confuses the concept of regulatory reporting with the disclosure of corporate information to the public market. As a starting point, we consider corporate disclosures coupled with point-of-sale and periodic reporting by fund managers as important tools through which the information needs of investors are served. Regulatory reports on the other hand serve the needs of supervisors in discharging their obligations; including identifying, monitoring and managing the risks posed by the fund to the wider financial system."*
>
> *"The confusion between regulatory reporting and corporate disclosure presented in the Consultation is particularly unhelpful. It furthermore creates a significant risk of overlap in reporting – whereby duplicate information is reported in regulatory reports and corporate disclosures, resulting in additional cost for all parties involved."*

ESMA's SFTR and the Commission's Proposal took heed of these warnings; however the resulting disclosure regimes diverge in the number of fields collected, the extent to which individual fields are directly disclosed to the public versus which are disclosed in aggregate, and the timing of public disclosure.[21]

> *"The specific approach taken by the SEC is a direct response to the mandate given to the agency under Section 984b of the Dodd-Frank Act. The language of the statute required the Commission to "promulgate rules designed to increase the transparency of information available to brokers, dealers, and investors, with respect to loan or borrowing securities." While SFTR focuses on providing regulators information to monitor the concentration of leverage and potential points of failure, the SEC's proposal follows its mandate to provide better data to the broader audience of investors, market participants, and regulators."*[22]

SFTR is a collection of data for market surveillance purposes first, with some aggregate public disclosure. In contrast, proposed rule 10c-1 is a collection of data for public disclosure first, with an apparent further goal of market surveillance. While the Commission's Proposal has successfully navigated the distinction between data collection for public disclosure versus data

[20] https://www.fsb.org/wp-content/uploads/c_130129ar.pdf
[21] Under Article 7 of SFTR, aggregate position data for the prior week is published each tuesday in a tabular format that allows for downloading and kept on the Trade Repositories' websites for 2 years. https://www.esma.europa.eu/policy-activities/post-trading/sftr-reporting
[22] https://csfme.org/Full_Article/sec-proposes-sweeping-securities-lending-disclosure-rules

collection for market surveillance, there still remains a significant gulf between the data useful to investors versus that which yields superior market surveillance.

By virtue of the expanded authority to regulate securities lending markets[23] the Commission has chosen to define what it means to "loan a security" broadly to include all lenders and related activities. In doing so, the Proposal captures broker-dealer onlending to third-party broker-dealers. By requiring the lender in each subsequent loan (*i.e.*, each on-loan) of the same security to report information to the RNSA, the Proposal avoids certain hurdles encountered under SFTR where some securities finance activities transacted on the books of broker-dealers on behalf of clients escape reporting. This broad scope of the Proposal, *e.g.*, to designate brokers as reporting "lenders," should result in a more complete data capture and a better picture of the securities lending market to the regulator.[24]

**Time for a proof of concept**

All this history is relevant now because it reinforces the need to pool complete datasets, not collect data fields that themselves may seem relevant, but when taken together are incomplete and provide neither useful public disclosure to investors nor useful data for regulators to monitor markets for excess leverage and address contagion during market stresses. As we stated in our previous comment letters, complete transaction data collected, pooled, and encrypted would provide beneficial owners (who bear the ultimate cost of compliance) with a better value proposion. It would also facilitate a more robust and complete dataset for regulators to monitor for excess leverage. We believe the Commission should consider expanding the definition of RNSA to include an industry-wide pool of securities lending data in the form of a data trust.

As we described in our previous comment letters, data trusts combine technology, policy, and law to provide effective ownership and control, data security, access controls, and scalability. By introducing a data trust into the proposed rule 10c-1 regime, the Commission can speed adoption and reduce the costs of implementation and ongoing compliance because a data trust is better suited to collect, standardize, and store data securely.

<u>Standardized Data Format</u>

Setting aside any potential ownership or anti-trust issues, a data trust allows the pooling of data before submission to regulators on an encrypted basis. It also could standardize data formats, easing the implementation and reducing the cost of the rule 10c-1 reporting regime. A direct

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[23] See note note 8, *supra*.
[24] A few 10c-1 commenters suggested that the scope of disclosed transactions be limited to those booked under standard securities lending agreements. However, such an exemption would miss securities borrowed to settle the short sales of hedge funds and other "retail" accounts.

lesson could be taken from the implementation of SFTR about the value of standarizing data formats for regulatory collection.

> *"Speaking to SFT, ISLA's Adrian Dale indicates that had there been a market standard data representation of securities lending prior to that regulation, SFTR's implementation would have been significantly faster, it would not have required years of consultations and clarifications, and would not have demanded as much development effort by market participants. At the same time, it would have offered regulators a clean view of the relevant SFT markets."*
>
> *"ISLA recommends that the support of a market-derived data set should be considered, both to facilitate transparency proposals and to assist the market in its future development. The Association has been working with its members, and with the International Swaps and Derivatives Association (ISDA) and the International Capital Markets Association (ICMA), to create a consensus-derived market data standard, the Common Domain Model (CDM), which has been widely discussed elsewhere in SFT. Dale indicates that ISLA has made itself available to the SEC to discuss any of these points, including development and wider application of the CDM."*[25]

Data Security

A data trust model also fosters data security. Commenters have raised the issue of data security throughout the process of mandating disclosures for securities lending transactions. For example, **ICI Global** raised the issue in response to the FSB's 2015 Consultation:

> *"[T]he Consultation only addresses regulators' own data security measures in passing, noting that "assigned confidentiality flags…will prevent any disclosure of the data not intended to be disseminated." The FSB should take a much stronger position in this regard. Some of the data that the FSB expects national or regional authorities to collect may be sensitive and potentially commercially actionable. As a threshold matter, the FSB should recommend that every national or regional authority to have appropriate systems and procedures in place to ensure the confidentiality and security of such information before requesting it from market participants.* ***Appropriate systems and procedures, in this regard, go far beyond assigned confidentiality flags****." (emphasis added).*[26]

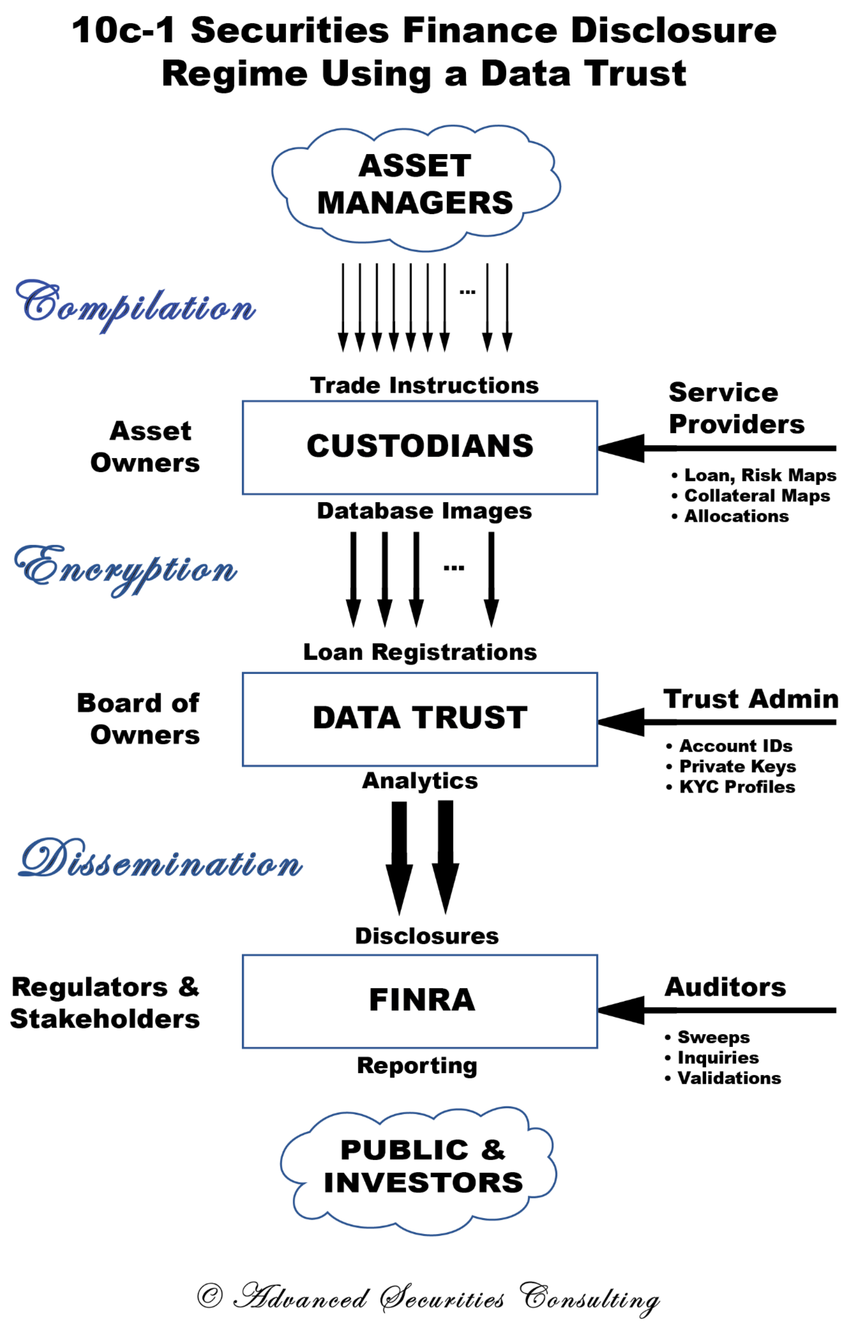
In fact, the **Managed Fund Association** raised the issue of data security at the RNSA in its comment letter on the Proposal.

[25] Currie, Bob, "10c-1 reporting: SEC reopens consultation," Securities Finance Times, https://www.securitiesfinancetimes.com/specialistfeatures/specialistfeature.php?specialist_id=533&navigationaction=features&page=&newssection=features
[26] https://www.fsb.org/wp-content/uploads/ICI-Global-on-1411DEG.pdf

> *"While MFA applauds the Commission's efforts to ensure that FINRA has policies and procedures in place to protect the confidentiality of information that is submitted to it, MFA believes that the Commission should require more prescriptive measures. For example, under Rule 613 of Regulation NMS (consolidated audit trail), each self-regulatory organization and RNSA subject to that rule is required to have system security features that ensure the security and confidentiality of information that address confidentiality, restrictions on use and access, information barriers, information security systems, user confirmation and access audits, among other things. Given the confidential and proprietary nature of some of the information that an RNSA will be collecting, MFA believes it is imperative that the Commission ultimately ensure that FINRA adopt more prescriptive confidentiality and information security in connection with any final rule."*[27]

We agree that the data to be collected under the Proposal would be acutely sensitive and commercially actionable and should be subject to the most stringent security and access protocols. Data trusts are intended specifically for data stewardship and access control and could be designed in such a way to either report to a RNSA or operate as a RNSA itself, if the Commission allows. As illustrated below, the introduction of a data trust either as an RNSA or as a single submitter to FINRA acting as an RNSA would not disrupt the goals of the Proposal, but could reduce or eliminate many of the technical challenges and reduce the costs associated with collecting and submitting the data specified by rule 10c-1.

[27] https://www.sec.gov/comments/s7-18-21/s71821-20111683-265021.pdf


10c-1 Securities Finance Disclosure
Regime Using a Data Trust
ASSET MANAGERS
Compilation
Trade Instructions
Asset Owners
CUSTODIANS
Service Providers
• Loan, Risk Maps
• Collateral Maps
• Allocations
Database Images
Encryption
Loan Registrations
Board of Owners
DATA TRUST
Trust Admin
• Account IDs
• Private Keys
• KYC Profiles
Analytics
Dissemination
Disclosures
Regulators & Stakeholders
FINRA
Auditors
• Sweeps
• Inquiries
• Validations
Reporting
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**Our Test Case and Goals**

Obviously, we do not expect the Commission to be swayed by our recommendations alone. As we described in our earlier comment letter, we are embarking on a proof of concept to create an industry-wide securities lending database of a limited set of cross-border transactions.
In doing so, we indend to create reference metrics for managers of banks, broker-dealers, regulated funds, and investment advisors to use in advancing the ESG strategies of their clients.

We expect loan data to be provided on a confidential basis by beneficial owners, as they have before.[28] Certain fields and blocks will be encrypted to assure confidentiality, as they would in a data trust, but the raw data will remain under the control of the principals. Selective encryption by an independent service provider will result in hosting the digital ledger ("golden record") on a neutral venue ( *i.e.*, a data trust) to be shared with brokers and banks for validation of their activity sources.

The creation of a cross border compliance database will become useful to U.S.-E.U. lenders in view of the German Federal Supreme Court's recent decision that certain "cum-ex trades" are illegal, compounded by the risk of intrusive tax audits as promised by the Ministry of Finance.[29]
We believe legitimate cross-border lenders will support a voluntary compliance platform, just as travelers accept the burden of visa stamps, not only to get ahead of a rising flood of foreign tax audits, but also to equip their service providers and regulators with tools for dynamic margining in support of a vastly improved risk management process in an T+1 settlement regime.
Additional disclosures are also possible, in that the same transaction data flows needed by the monitoring functions in smart contracts could also be streamed for real-time reporting of securities loans, a challenge that was recently put forward by the New York Stock Exchange in a meeting of the House Financial Services Committee.

> *"[a] system that anonymously published the material terms for each stock loan would provide the necessary data to understand shifts in short-selling activity while protecting the intellectual property of individual market participants."*[30]

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[28] *Borrowed Proxy Abuse: Real or Not?* CSFME and RMA, 2010.
https://www.sec.gov/comments/s7-14-10/s71410-174.pdf
[29] CSFME, "Germany Throws the Book at Tax Criminals,"
https://csfme.org/Full_Article/germany-throws-the-book-at-tax-criminals
[30] New York Stock Exchange Chief Operating Officer Michael Blaugrund. May 6, 2021 Congressional testimony, See "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide," Part II: Hearing Before the H. Comm. on Fin. Serv., 117th Cong. (2021).
https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-blaugrundm-20210317.pdf

As an organizing principle, we believe that disclosure of encrypted metrics into a "need-to-know" append-only, timestamped ledger hosted on a neutral venue will attract wide support from both retail and institutional investors, especially those who are demanding the ability to monitor the propriety of their loans end-to-end, *i.e.* as a credit from source to use. (Those lender preferences have been well-publicized since GameStop.) End-to-end transparency would also broaden their brokers' and agent banks' ability to monitor the market's real-time leverage and understand changes to their clients' counterparty risk profiles.

**Conclusion**

Through the proof of concept, we hope to demonstrate, through the lens of cross-border securities loans, to the Commission and the securities lending industry the value of pooled securities lending data and the value of the data trust model. In doing so, we believe that we can demonstrate the value of pooling securities lending data into a data trust on a larger scale for purposes of improving and reducing the initial and ongoing costs of the proposed 10c-1 reporting regime. We also hope to prove that a more equitable value proposition for those most burdened by the disclosure regime is possible. We look forward to discussing how our recommendations can help the Commission meet its responsibilities under Section 984(b) to develop effective new disclosure regulations.

Sincerely,

David S. Schwartz

Enclosures (2)

**About CSFME**

CSFME is an independent, nonprofit organization whose mission is to improve transparency, reduce risks, support research, and promote sound regulation of financial markets. It does so by conducting data-driven analysis, providing investor education and outreach, and supporting regulatory reviews in otherwise opaque markets.

The Center serves individual and institutional investors, banks, brokers, other financial market participants, academic institutions, and government regulatory agencies. Since its founding, CSFME has focused its research on securities lending, repo, and securities finance activities and has a long history of working with securities lending data.

Our principals have more than 45 years of directly relevant experience in evaluating securities finance transactions and securities lending programs. Prior to forming the Center, CSFME's founder created the first securities loan pricing and benchmarking systems and pioneered many of the securities lending metrics used today.

Since the 2008 financial crisis, CSFME has closely monitored efforts to bring securities lending out of the stigma of "shadow banking." Recommendations have been made to global standard setting bodies, including the Financial Stability Board (February 12, 2015 attached) and Basel Committee on Banking Supervision, as well as government data-gathering agencies, such as the U.S. Office of Financial Research. Regulators have responded with new disclosure regulations, most notably the Securities Finance Transaction Regulation ("SFTR")[31] of the European Securities Markets Authority.

The Center has provided extensive feedback on the various regulatory frameworks proposed as well as substantive comments on details of models and pilots for data collection.[32] We have provided written commentary and met with the Commission's staff to provide input on earlier work on implementing aspects of Section 984(b) of the Dodd-Frank Act,[33] including an August 6, 2021 letter to Chairman Gensler wherein we advised the Commission of our plans to research many of the aspects of our suggestions above.[34]

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[31] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R2365&from=EN

[32] https://www.fsb.org/wp-content/uploads/CSFME-on-1411DEG.pdf

[33] https://www.sec.gov/comments/df-title-ix/lending-borrowing/lendingborrowing-22.pdf. See also, https://www.sec.gov/comments/df-title-ix/lending-borrowing/lendingborrowing-16.pdf,

[34] Blount, Edmon W. Letter to Chairman Gary Gensler, "Re: Section 984(b) of the Dodd-Frank Act, Loan or Borrowing of Securities," August 6, 2021 (unpublished).

CSFME
Center for the Study of
Financial Market Evolution

February 12, 2015

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002 Basel, Switzerland
FSB@bis.org

Re: "Additional data for financial stability purposes," per the FSB Consultative Document: Standards and Processes for Global Securities Financing Data Collection and Aggregation (November 13, 2014)

Dear Sirs and Mesdames:

We are writing to urge the inclusion of a limited set of underlying activity metrics for securities lending in the global securities financing data initiative ("Initiative"). As described, the Initiative is intended to outline the design of a monitoring system to help market supervisors infer changes in systemic risk that are said to be created by securities lenders, repo traders and margin lenders. However, we believe that global aggregates which are limited to position metrics will have minimal value, and may well prove to be misleading.

Position aggregates in securities lending may help track the level of cash collateralized loans. But position aggregates alone cannot track the risk of collateral fire sales, one of the main systemic risks that supervisors have linked to securities finance. Fire sales result when borrowers return or lenders recall a significant proportion of their positions. Aggregates may show the position changes, but cannot help to anticipate changes in the underlying dynamics affecting the risk of fire sales.

It seems clear to us that, if the risk of collateral fire sales is to be fairly calibrated, loan recalls and returns must be tracked along with position aggregates. Still, lending agents can mitigate these termination risks with rebate incentives, cash buffers and loan substitutions, as described below. Therefore, to achieve their policy objectives, we believe that Financial Stability Board and national and regional authorities must expand the data initiative beyond position aggregates, to include risk mitigation resources as well as termination activity. Aircraft pilots cannot monitor risks based solely on altitude; neither can market supervisors.

About the Center

The mandate of the Center for the Study of Financial Market Evolution ("CSFME"), which was founded in 2007 as a not-for-profit research firm, is to assist academics and supervisors in evaluating market practices and structures. The CSFME's first

1101 Pennsylvania Avenue, NW • Suite 600 • Washington, DC 20004
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major project was a study of alleged proxy vote manipulation by hedge funds through the U.S. securities lending markets. A major finding of the 2010 report was that incomplete data had misled researchers into assuming that activity spikes on proxy record dates were due to hedge fund borrows, when the spikes were actually lender recalls and agents' loan substitutions.[1] Our recommendations to expand the Initiative are based partly on the lessons of this study, and partly on the experiences of the CSFME's founder in creating the first securities loan pricing and benchmarking systems.[2]

FSB Policy Goals

The Initiative is based upon the FSB Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, published on August 29, 2013 ("Policy Framework"). We understand the goals of the Initiative, as mandated in the Policy Framework, to be the creation of supervisory metrics to:

1. "subject cash collateral reinvestment to regulatory limits on liquidity and leverage risks."
2. "restrict, or put a floor on the cost of, securities borrowing against assets subject to procyclical variation in valuations/volatility, to reduce the potential for the excessive leverage to build-up and for large swings in system leverage when the financial system is under stress."
3. "reduce financial stability risks arising from client uncertainty about the extent to which assets have been re-hypothecated and the treatment in case of bankruptcy, and to limit re-hypothecation of client assets (without an offsetting indebtedness) to financial intermediaries subject to adequate regulation of liquidity risk."
4. "reduce (i) the risk of financial contagion and (ii) opacity."
5. "improve collateral valuation practices."

Discussion

Our recommendation to collect termination and mitigation metrics is intended to address Policy Goal #4, specifically the risk of financial contagion.

The Policy Framework defines financed positions as "amount of security lent." The Initiative proposes an expanded data definition, but the data element tables in the consultation document are still designed to capture only aggregate positions. With position values, supervisors would (at best) only be capable of interpreting changes to market *leverage*. Even if this view can be achieved, we question the utility of leverage alone as a risk metric for an activity as dynamic as global securities finance.

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[1] The CSFME empty voting white paper is available on the SEC's website, at: https://www.sec.gov/comments/s7-14-10/s71410-202.pdf.

[2] As CEO of ASTEC Consulting, Ed Blount created a securities lending database of 90,000 global issues, which he sold to SunGard Data Systems in 2007.

Supervisors should also consider the possibility that activity spikes, capital withdrawals and similar sources of position turmoil in the underlying transaction markets can intensify *liquidity* risk and, in turn, heighten systemic exposure to fire sales in collateral pools. To monitor this risk, the data tables should be expanded to include aggregates for loan terminations such as recalls, returns and collateral redemptions. Loan originations might also be included to monitor linked financing activity from agency substitutions of recalled loans and on-lending activity.

Finally, and most significantly, we strongly recommend that the Initiative include data elements that can help to monitor the role of financial intermediaries who act as systemic risk mitigators. Market stability can be supported if agent banks, prime brokers and central counterparties retain the capability and willingness to absorb or deflect the stresses caused by loan terminations on the collateral of securities lenders and financed positions of margin customers.

<u>Loan Terminations</u>

It is the rapid and uncontrolled unwinding of securities finance positions, not the accumulation of those positions, that intensifies systemic risk. Market supervisors have spoken time and again of the threat to market stability from widespread recalls and returns of securities loans, as those terminations can lead to forced redemptions of cash collateral and the untimely sale of pool investments. [3]

Despite the risk of unwinding, the consultation for the Initiative makes no reference to data that can be used to calibrate the potential for sudden termination of posi-

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[3] In "Unwinding of Securities Lending Transactions" (Section 3 of the 2009 Senior Supervisors Report on *Risk Management Lessons from the Global Banking Crisis of 2008*), there are several instances of the adverse effects of loan terminations cited, with <u>emphasis</u> added:

> A number of U.S. cash collateral reinvestment funds experienced … pressures as some borrowers <u>redeemed cash collateral</u> and some lenders curtailed lending or <u>withdrew (or attempted to withdraw) cash collateral</u>. (p.10)

> Major credit disruptions … triggered an <u>unwinding</u> of securities lending transactions. Securities lenders retreated across the major markets, reducing exposures by <u>recalling securities on loan</u>, severely curtailing new loans, and reducing the tenors of new transactions. (p.11)

> The liquidity stress was greatest in the United States, owing to its larger emphasis on cash collateralized transactions… Agent lenders faced a huge <u>demand to return securities</u> to the beneficial owners <u>and cash collateral</u> to borrowers, along with a high number of margin calls. The funds thus experienced shortages of cash associated … with the <u>return of securities</u> from deleveraging hedge funds ... (pp. 11-12)

> Operationally, the pullback by the beneficial owners contributed substantially to the spike in "fails" (the failure of trades to settle) in September 2008. The number of beneficial owners (including many foreign central banks) <u>calling their securities back</u> for fear of dealing with any broker-dealers reduced the supply of Treasury securities available to make settlement. (p.12)

tions. Indeed, the terms "recall," "returns," and "redemptions" do not even appear in the consultation document.

Ultimately, the absence of termination metrics will make it difficult, if not impossible to understand changes in the stability of financed positions. Consider a situation in which 10,000 positions are terminated in a particular month, while 15,000 are added. As proposed, the data framework will report only the net gain of 5,000 positions. If, in a subsequent month, a reported gain of 5,000 positions is the result of far greater activity, e.g., 100,000 terminations vs 105,000 originations, the inherent potential for market disturbance will be missed under the currently proposed framework. Even more significantly, it will also be impossible to monitor the degree to which financing intermediaries have sufficient resources to mitigate the risk of uncontrolled terminations, as discussed below.

Rebate Incentives

We question whether it will be possible to monitor, much less form a quantitative basis for policy decisions that restrict the true cost of securities finance, as cited in Policy Goal #2 above, through reference to aggregate fee and rebate metrics alone. Pricing in securities finance is highly sensitive to availability and demand for the security being financed, as well as collateral quality, counterparty relationships, trade size, position stability, market volatility, yield curves, spread dynamics, and a host of other factors. All of these will be overlooked in aggregates and the cost of carry, a major influence on position finance, will be distorted by a simple average.

Nevertheless, certain pricing metrics can be useful for monitoring the ways in which agent banks manage their cash pools and prime brokers control their cage operations. For example, agent banks can use rebates to maintain the stability of their cash collateral pools. In 4Q2008, during a period of falling short-term rates, agent banks raised rebate rates as an incentive to borrowers considering the removal of their cash collateral after the Lehman failure. This is one way in which agent banks protected the stability of their reinvestment pools during the temporary period of stress caused by the liquidity crisis.

If pricing metrics are included for new and terminated loans, it may be possible to monitor the direction of incentives as a complementary data point for related trend analytics. Aggregate pricing will have little value for such purposes.

Intermediaries as Risk Mitigators

In addition to rebate incentives, both agent banks and prime brokers have procedures and systems for reducing the degree to which the termination of financed positions will lead to in buy-ins and forced sales. Agent banks in receipt of a customer recall notice will often substitute shares available from other customers to avoid closing out the loaned position. In this way, the agent banks avoid passing the recall along to the borrowing prime broker. Similarly, those prime brokers who have received a recall notice can tap other sources of supply, either internal or external, then return those shares to avoid forcing a buy-in on a customer's short position.

In the case of returned loans, agents who maintain uninvested cash or a cash-equivalent buffer in their collateral pools can meet redemption demands from borrowers without selling collateral. As a rule, cash managers for securities lending programs maintain a significant part, often 10% to 20%, in the "core liquidity" of their collateral reinvestment portfolios. Like mutual fund managers, cash managers for securities lenders vary the proportion in response to changing market conditions and counterparty behavior, thereby influencing the lenders' yield in order to manage the redemption risks.[4]

In addition to the risk mitigation capacity of banks and brokers, the proposed inclusion of central counterparties to the securities finance markets may offer the possibility of further buffering and substitution capabilities. Indeed, it may also be possible to enhance the industry's ability to mitigate systemic risk if CCPs are able to provide capital efficiencies to intermediaries through their operations.

The consultation document for the Initiative does not include metrics for calibrating the degree to which banks, brokers or central counterparties can ameliorate the effects of sudden terminations of financed positions. At a minimum, it would seem necessary to consider the relative size of cash buffers, as well as available and lendable, but unloaned securities positions, as compared with relative termination activity and newly originated and existing on-loan positions. However, to be accurate, cash buffering should be tracked on a portfolio basis for agents who manage more than one collateral pool, and the substitution metrics should be tracked at least on an asset class or sector basis, if not an issue-by-issue basis, to avoid distortion.

With the inclusion of flow data aggregates, particularly recalled and returned loan termination metrics, it should be possible for national and regional authorities to monitor the degree to which intermediaries are providing an effective systemic risk mediation service. Furthermore, global aggregates with greater granularity will allow authorities to derive more accurate comparisons when evaluating the risk profiles of regulated market participants, especially those with extensive cross-border counterparties, holdings and transaction activity.

[4] "According to JP Morgan," as cited in a BlackRock white paper, "current cash cushions across the industry average 4% for equity, 9% for bond and 12% for hybrid or balanced mutual funds, which invest globally in a combination of equities, bonds and cash and cash equivalents." Available at https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf

Submission of Supplemental Comments

Private entities and trade groups have already collected many of the data flow elements in previous analytic exercises. Notably, in the 2010 study of empty voting, cited above, the CSFME created and relied on a five-year, U.S. securities finance activity database of more than one billion loan transaction records. However, to our knowledge, the loan substitution, cash buffering and other risk mitigation activities of securities finance intermediaries have never been analyzed. It is entirely possible that intermediaries themselves do not track or retain the appropriate metrics in their systems, since they may never have had the need to justify their contributions to systemic risk mitigation.

Consequently, we plan to consult with securities finance intermediaries and present a more detailed description of their activities and reporting capabilities, then submit a supplemental response to the Initiative consultation within 60 days of this initial commentary. We also plan to consult with academic research teams in order to assess the possibility of providing interim metrics for consideration by the FSB's Data Experts Group. We hope to provide the results of the academic assessment at the same time frame as our supplemental submission of comments.

Thank you for the opportunity to participate in the Initiative consultation. If our current comments and intended supplements appear to be useful to FSB staff, we welcome inquiries and suggestions in order to further refine our research goals and methods.

Respectfully yours,

Edmon W. Blount
Executive Director