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# BUILDING PIPES

HQLA$^X$ is now backed by some of the biggest names on Wall Street. COO Nick Short explains why connectivity is the key to its success


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# ISLA lays out 2021 road map, prices may vary

The International Securities Lending Association (ISLA) has laid out an ambitious action plan for 2021 including a focus on developing environmental, social and governance (ESG) best practices, the further development of the common domain model (CDM) and the digital clause library for the global master securities lending agreement (GMSLA), among several other projects.

However, the membership fee hike for 2021 to fund these initiatives has raised concerns that smaller market participants, including buy-side members that are most in need of support, may be excluded.

ISLA contacted members in November 2020 to outline its aspirations for the year ahead and explain how the increasing demands on its resources had coincided with the loss of revenue from its primary European industry event.

As a result, the association told members, it was necessary to increase its membership fees across the board "in order to support the day-to-day running of the association".

The not-for-profit association uses a tiered approach to fees for its 176-strong member base that places the majority of the financial burden on the larger agent lenders, broker dealers and principal borrowers. This scales down to the lowest rung which is reserved for buy-side members.

ISLA's 15 buy-side members were charged £750 for an annual membership in 2020. For 2021 fees are £1,500. Comparatively, tier-one members were charged £20,000 for the year.

When asked about the increase, ISLA told SFT that, as of this year, new beneficial owners joining the association will benefit from a 50 per cent discount for their first year of membership, meaning they will be charged £750.

The new first-year discount is understood to be available indefinitely, subject to review by the subcommittee.

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# Inside this issue











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## ISLA lays out 2021 road map, prices may vary

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Membership costs for vendors and law firms, typically categorised as associate members, are also understood to have increased by several thousand pounds each.

Additionally, fees for access to ISLA's legal opinions, which were updated last year, increased to £20,000 for tier-one members and £15,000 for members and associates.

Previously, membership fees only increased by a few hundred pounds at a time, which last occurred in 2018.

Responding to industry concerns around the higher-than-normal fee increase, ISLA CEO Andrew Dyson notes that the scale of the challenge posed by the digital agenda and CDM projects are more far-reaching than in previous years and the payoff will be slower but more meaningful. He adds that the eventual cost savings from the improved market efficiency that the modernisation initiatives will bring could more than offset ISLA's fees.

Dyson acknowledges that the annual fee increase is more than that seen in previous years but says that ISLA's agenda is driven by members, while the fees are decided by a subcommittee of the board, which includes members from banks, broker-dealers and beneficial owners from a diverse geographical area.

However, market observers warn that a persistent lack of buy-side voices in working groups, roundtable discussions and on panels throughout the industry will lead to a situation where the needs of beneficial owners are interpreted by agents and vendors and then dictated back to their clients without a meaningful dialogue.

As new, global trends such as ESG continue to develop, market participants are emphasising the need for trade bodies and other entities to foster a broad-church approach when developing universally viable solutions.

The securities lending industry has always struggled with gaining active engagement from beneficial owners who often see their lending programmes as second-order activities that may only be reviewed closely a few times a year when analysing their agent's performance against the market average.

As modern technology makes opening a lending programme more appealing to smaller pension funds and asset managers than would previously be viable, it is important not to risk putting off those newcomers with even modest barriers to entry, a source who did not wish to be named tells SFT.

Meanwhile, Dyson says: "I would encourage any buy-side member thinking of joining us to do it for a year and let us prove our value", adding that as a member, firms have a chance to proactively shape the industry through its working groups in key growth areas.

He affirms that the value proposition for buy-side members is still significant even with the increase, especially this year given that a large amount of the work planned, such as around ESG, will directly benefit beneficial owners more than any other market constituent.

According to Dyson, the increase also reflects the fact that ISLA was unable to draw revenues from its flagship industry event in 2020. He has also not budgeted to receive earnings from a physical event this year either, given the ongoing challenges of the COVID-19 pandemic.

Dyson emphasises that revenues from events

are not integral to ISLA's financial stability and all profits are reinvested into the association.

As well as new initiatives, Dyson explains that on-going issues such as monitoring the Securities Financing Transactions Regulation, along with other incoming EU regulations and the new post-Brexit market environment, will all require resources to effectively navigate and add value to members.

## SFTR phase four goes live

The fourth and final phase of the EU's Securities Financing Transactions Regulation (SFTR) is now live, bringing non-financial counterparties (NFCs) within the orbit of the reporting framework.

UK NFCs are no longer required to report under SFTR as the UK scrapped phase four of the regulation when on-shoring its version of the rules framework prior to the completion of the Brexit transition period.

SFTR represents the securities finance industry's first dual-sided reporting regime, including legal entity identifies and unique transactions identifiers that account for just two of the 155 data fields that must be sent to an approved trade repository on a T+1 basis.

Phase one and two related to sell-side firms, central counterparties and central securities depositories that began reporting in July 2020, while phase three brought in investment funds, pension funds and (re-) insurance undertakings, which joined in October 2020.

With the fourth phase of SFTR phase now in play, the industry can fully turn its attention to solving some of the lingering reporting issues from earlier phases.

According to Susana Huete, a senior consultant at Margin Reform, these include data quality, reporting delegation, collateral bulk rejection from trade repositories (TR) and pairing challenges.

Huete adds that the UK's divergence from the EU's SFTR means the main focus for this final phase will be to get the correct reporting depending on jurisdiction, as there will be no inter TR reconciliation between UK and EU.

This means that some firms will need to report to both an EU and UK TR.

## IHS Markit to acquire Cappitech

IHS Markit has acquired compliance technology provider Cappitech to expand its suite of global, multi-asset class transaction regulatory reporting offerings to the financial industry.

Cappitech's cloud-based platform is relied on by more than 200 global banks, brokers, asset managers, hedge funds and corporations.

In 2019, IHS Markit selected Cappitech's platform as a key component of its Securities Financing Transactions Regulation solution, which is now used by some of the largest financial institutions.

Of the deal, IHS Markit says: "Capitalising on the established relationship and existing integration, this latest move will deliver unified solutions to the market and solidify IHS Markit's continued commitment to providing industry-leading regulatory reporting solutions."

The details of the financial terms of the deal and a timeline for its completion were not disclosed. The make-up of the management structure for the combined entity is also not currently available.

## Deutsche Bank conducts first stock loan via QFII scheme

Deutsche Bank has facilitated a margin trading and securities lending transaction under China's expanded Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQII) schemes.

A QFII licence allows international investors to participate in mainland China's stock exchanges. As of November 2020, the abilities of licenced investors expanded to include securities financing and short selling activities.

The new rules have also lowered entry requirements and simplified procedures under the combined quota-free QFII and RQFII.

Deutsche Bank China confirmed it supported a qualified foreign investor as its China onshore custodian bank on the first day of trading under the new rules.

According to Deutsche Bank, it offered a full suite of custody services including account opening, asset custody, cash transfer and regulatory reporting, and helped in completing a smooth transaction on the first trading day of margin trading and securities borrowing under the new rule.

## Denmark charges two UK traders for $1.5bn tax fraud

The Danish State Prosecutor for Serious Economic and International Crime has charged two British nationals with using a cum-ex tax fraud scheme to pocket more than $1.4 billion in dividend tax refunds due to the Danish Treasury.

Dividend arbitrage, commonly known as cum-ex transactions, requires securities to be borrowed over the dividend date and then returned in a trade structure requiring three participants that enables a tax refund to be claimed by two entities on the same asset.

The practice is understood to have been widespread across Europe over a decade ago before laws were tightened but not before tax authorities in Germany, Denmark and elsewhere were deprived of an estimated tens of billions of euro in revenue.

The Danish state prosecutor describes the affair as one of the largest fraud cases in the country's history.

Of the two men charged, one is a British national who is resident in Dubai, and one is a British national still in the UK.

The maximum penalty is usually imprisonment for eight years. But, due to the severity of the case, the size of the amount, the length of the period in which the crimes were committed, and the organised nature of the fraud, the state prosecutor is seeking to apply a special section of the criminal code under which the maximum penalty may be increased to 12 years in particularly serious cases.

The state prosecutor believes that – on behalf of a number of investors and companies – the two men used a "well-designed and organised fraud scheme" to submit more than 3,000 applications to unlawfully receive dividend tax refunds from the Danish treasury.

They are suspected of fraud of a particularly aggravated nature in contravention of section 279, read with section 286(2), of the Danish Criminal Code, for just shy of $1.5 billion and attempted fraud of a particularly aggravated nature for $90 million.

Per Fiig, who is acting state prosecutor at the office of the state prosecutor for Serious Economic and International Crime, believes that this involves a setup of 24 Malaysian companies and 224 US pension plans.

More than 70 companies incorporated in places like the British Virgin Islands, Cayman Islands, the United Arab Emirates and the UK participated in the transactions.

The investigation against other suspects in several other tracks of the dividend reclaim case continues.

"In one of the tracks, we have now raised formal charges against the two British nationals for fraud worth more than $1.4 billion. In this track, there are still a number of other suspects. We still need to complete a few interviews and investigative measures, and we expect to decide whether we will be raising formal charges against the other persons within a few months," says Fiig.

"In addition, we have several other tracks in which we are investigating a number of different networks of people for the remaining part of the fraud totalling more than $1.9 billion," he adds. "It will take a while longer before our investigations show whether there are grounds for raising formal charges."

Due to the size and complexity of the reclaim case, the investigation has been an international collaboration under the European Union Agency for Criminal Justice Cooperation since 2016 including Denmark, the UK, Germany and Belgium; with Denmark heading the team.

Moreover, Europol has been involved, and the US authorities participated as observers. The dividend reclaim case involves fraud worth a total of $2 billion.

## EC approves LSEG acquisition of Refinitiv

European Commission has approved the London Stock Exchange Group's (LSEG) proposed acquisition of data analytics firm Refinitiv, while underscoring mandatory pre-conditions to avoid harming market competition.

Chief among these conditions is that LSEG must divest 99 per cent of its stake in the Borsa Italiana group, which includes MTS, LSEG's trading venue for EGBs. To this end, LSEG inked a preliminary deal with Euronext in October last year to sell the stake.

Although several regulatory hurdles still stand between Euronext and completing its deal, the confirmation by the commission that LSEG must sell to acquire Refinitiv significantly improves Euronext's chances of success.

Euronext already has approval to acquire the G7 stock exchange from the German Federal Cartel Office, its shareholders, and the Italian Council of Ministers. Despite these hurdles, Euronext predicts the deal will be complete in the first half of the year.


## Eurex Repo reports 2020 volume boost

Eurex Repo chalked-up double-digit percentage growth in 2020 trading volumes compared to the year before, despite a significant volume drop-off in December.

Overall, the Deutsche Boerse-owned marketplace for secured funding and financing, saw term-adjusted volumes jump by 10 per cent year-on-year in 2020. GC Pooling volumes increased significantly at the onset of the COVID-19-related turbulence.

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## CFTC-ESMA sign derivatives clearinghouse MOU

The Commodity Futures Trading Commission and the European Securities and Markets Authority are building on their cooperation regarding the exchange of information with registered US derivatives clearinghouses.

The regulators recently signed a new memorandum of understanding to facilitate cross-border supervision of US central counterparties licenced under EMIR.

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## EMIR reporting to TR KDPW triples

KDPW, the Polish central securities depository and trade repository, has reported a spike reports under EMIR.

The increase is driven by the acquisition of new international clients and an increase of derivatives turnover in Europe.

EMIR includes obligation to report all derivatives and defines the trade repository operating framework.

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## Euronext reports Q4 cash market trading volume surge

Euronext reported that its total number of cash market transactions was 56.6 million for December, a 58.3 per cent year-on-year (YoY) increase.

December's total transaction number represented a 24 per cent dropoff from November 2020. Full-year figures reveal the total cash market transaction value to be €2.5 trillion, with an ADV of €9.7 billion, up 20.3 per cent and and 19.3 percent, respectively YoY.

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## Tradeweb sees strong December repo trading

Tradeweb Markets, a global operator of electronic marketplaces, has reported strong growth in its money market trading volumes for December 2020.

Repo average daily volume was $304.5 billion, up 50.4 per cent for December 2020, compared to the same period in 2019. Overall, global repo activity continued to grow, driven in part by the addition of new dealers and participants on Tradeweb's global institutional repo platform.

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## OCC achieves record breaking 2020

Options Clearing Corporation's (OCC) securities lending clearing business closed 2020 on a high, marking a 21.2 per cent increase in activity for December compared to the same period in 2019. The average daily loan value in the final month of the year was $100.8 billion.

The central counterparty activity in new loans also increased by 22.8 percent year-on-year for December, with 126,355 transactions last month

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# Building pipes

*Drew Nicol reports*

*HQLA$^X$ is now backed by some of the biggest names on Wall Street. COO Nick Short lays out why connectivity is the key to success and what's next for the DLT platform provider*

## HQLA$^X$ recently revealed it has secured fresh funding from multiple international banks who will also be directly connecting to the DLT platform in various capacities. What does this mean for your growth?

Beyond the substantial financial backing we've received from BNY Mellon, Goldman Sachs, BNP Paribas Securities Services and Citigroup, as well as our existing strategic partner in Deutsche Boerse, the most important thing is it allows us to continue our focus on collaborating with key industry partners to further enhance the platform functionality and meet the needs of our clients.

Beyond the core securities finance market, we also have a long-standing relationship with R3 who provide the technology — Corda Enterprise — for our distributed ledger technology (DLT) platform.

For our newest partners, BNY Mellon will connect as both a triparty agent and agent lender, Goldman Sachs as principal, BNP Paribas Securities Services as a triparty agent, and Citibank as a custodian.

What's key here is that these big name firms are committing publicly to our platform, which is very important for us. Having BNY Mellon and BNP Paribas as triparty agents goes a long way to enhancing the 'network effect' of our platform by adding the collateral pools they manage. Citibank as a custodian also brings another collateral pool.

Moreover, having BNY Mellon also operating as an agent lender will increase the supply of upgrade transactions on our platform, while Goldman Sachs as a principal should help drive overall volumes.

This is in addition to Clearstream, Euroclear and J.P. Morgan, all of which are all already connected to the HQLA$^X$ platform as triparty agents.

## The adoption of DLT solutions within securities finance has come a long way from conversations of theoretical use cases. Could 2021 be a pivotal year for DLT?

It's clear that infrastructure providers and market participants are taking DLT seriously and this is another example of that.

There are other examples, such as with J.P. Morgan's intraday repo transaction which used an in-house blockchain platform back in December. It all adds further validation that DLT can provide efficiency benefits for not only securities finance and collateral management markets but also the wider financial industry.

## HQLA$^X$ had a busy 2020 and now you've had a positive start to 2021. How are you looking to grow from here?

The platform today supports collateral swaps. Primarily, we enable simultaneous exchange of ownership for baskets of securities without settlement movement between custodians or triparty agents.

In the near term, meaning this year and next, we are looking to connect additional triparty agents and custodians, as well as additional clients.

In terms of products, we are working on specific flows for agency securities lending and others such as one-sided title transfer. Our aim is to address 'specific pain points' for our clients and for the broader benefit of the securities lending and collateral management market.

The reality is that there are many things we could focus on, so we're careful about developing the ideas that will provide the most benefit to our clients. For the solutions that reach the top of the priority list, we run regular client roundtable meetings to help focus everyone on designing the solution, validating it, and to then get the solution up and running on the HQLA$^X$ platform.

## Last year saw demand for high-quality collateral and overall trading volumes spike. How did the COVID-19 pandemic affect your business and your clients?

During the Spring volatility last year we heard from our clients that some of the products we've laid out in our future roadmap, such as pledges, would have helped them navigate the period if they were available.

We've been exploring creative ways to use the HQLA$^X$ platform to help clients satisfy pledge requirements. These could be to offset counterparty credit exposures to a central counterparty or a bilateral counterparty for over-the-counter derivatives, or to help source intraday cash liquidity with a clearing bank or central bank.

> *"During the Spring volatility last year we heard from our clients that some of the products we've laid out in our future roadmap, such as pledges, would have helped them navigate the period if they were available"*

In terms of technical connectivity, we've put considerable effort into defining flows in order to plug into existing infrastructure providers, and we've continued to streamline our technical connectivity to clients to facilitate their onboarding to HQLA$^X$.

For example, we've worked with the Deutsche Boerse Trusted Third Party to deliver a solution to make the Securities Financing Transactions Regulation reporting of HQLA$^X$ collateral swap transactions as easy as possible for our clients.

Another example of innovating on top of our initial product, is that we're working with a leading agency securities lender to enable their bank borrowers and beneficial owners to benefit from exchanging ownership of collateral and principal legs simultaneously via the HQLA$^X$ platform.

For borrowers, this will help avoid the capital costs that exist today because of intraday credit exposures and operational risk caused by the collateral and principal legs moving at different times.

Roughly the past decade has been dedicated to meeting new regulatory requirements. Now there is a sense that houses can pause for a breath and look at their core processes and see which could be automated or made more efficient. Optimising collateral across multiple uses, in particular, is being driven by the regulations such as the Uncleared Margin Rules as well as internally.

## HQLA$^X$ is a European platform, but do you have a vision of entering other regions?

We see a lot of requests from other regions but we are staying focused on Europe to begin with. Our aim is to add real value to our European clients first and foremost but it is a global marketplace and many of our clients operate globally.

# Actionable analytics and tools to optimise margin requirements

*The events of 2020 brought the risk of margin volatility into sharp relief. Ingvar Sigurjonsson Managing director, funding and collateral solutions team, State Street Global Markets reviews what happened and what can be done to mitigate future upheaval*

Large margin calls, sparked by the COVID-19 pandemic in the first half of last year, have sent many market participants into a scramble for cash and collateral. Some were not able to deliver on their obligations, causing counterparties to close out their positions with longer-term consequences.

Continuous optimisation of margin requirements using pre- and post-trade tools can help buy-side investors start from the best position possible in a bout of volatility. These tools can also help you proactively manage the situation as it is happening. Central clearing counterparty (CCP) margins, in particular, are sensitive to volatility; margin requirements can increase quickly and substantially, as recently seen. To further complicate matters, increased marks to market and stressed risk factors can put pressure on risk limits across counterparties and clearing brokers.

Tools that comprehensively cover your trading portfolio across CCPs and clearing brokers can help you make rapid, well-informed decisions. This can include CCP switches, porting across clearing brokers, or unwinding trades to reduce margin obligations, thus helping you stay under risk limits with the least possible disruption to your portfolio's return and strategic objectives.

## Increased demands on treasury functions

More broadly, recent volatility underscores the need to consider collateral, funding and liquidity holistically. In the traditional model, the front office executes a trade that generates a collateral requirement, the back office pledges required collateral, and the treasury function funds it. Without pre-trade tools, the front office will not know whether its trades are generating the lowest possible funding cost. Without collateral optimisation, the back office will not know if it is selecting the most efficient securities to pledge. And, without insight into the process and access to tools of its own, the treasury function cannot manage funding and liquidity as efficiently as possible.

As clearing has become more prevalent among buy-side market participants, the need for cash to meet variation margin requirements has increased demands on funds' treasury functions. This is particularly true for pension funds. Those who used to be able to meet bilateral margin requirements by pledging from their expansive bond portfolios now need to produce cash to fulfill obligations the same day and in the right currency. This challenges treasury functions to set capital aside in either cash or high-quality bonds that can readily be turned into cash to meet margin calls. If not done right, this can be costly for the firm. Buffers that are too large create a drag on performance; buffers that are too small can have serious consequences in times of volatility.

It's in the treasury's best interest to ensure the front and back office have the tools they need to optimise and proactively manage liquidity. To size and manage buffers appropriately, a treasurer needs to be able to predict potential outflows and understand what levers to pull to reduce outflows when needed. Margin forecasting capabilities and post-trade optimisation analytics that quantify opportunities to lower margin are both essential components of a treasurer's liquidity management toolbox.

## Securities finance and collateral management – two sides of the same coin

Expensive cash buffers can be reduced further if securities held by a fund can be put to work to generate needed liquidity. Access to funding markets is thus another crucial part of liquidity management — whether it's to generate cash through repos or transform ineligible collateral into eligible non-cash collateral through trade upgrades. Equally important is the ability to deploy excess cash and high-quality securities in reverse repos or collateral downgrades to enhance a fund's performance. Reliable access to these markets is best achieved by securing multiple avenues to trade. Exploring benefits of diverse sources of liquidity whether through traditional financing/lending markets or evolving peer to peer marketplaces can benefit managers. You want as much of your portfolio to work as possible.
A security holding can be put to work by:

- Pledging the security to satisfy a margin requirement
- Upgrading the security to cash or higher quality, non-cash collateral
- Lending the security out for a fee

Collateral optimisation will routinely suggest the optimal securities from your holdings to meet a margin requirement. The more sophisticated models will also take funding and transformation costs into account, and suggest trade upgrades as appropriate. But securities lending is often left out because it is seen as a separate process from collateral optimisation. This can lead to inefficiencies that negatively affect a fund's performance. A security that the fund holds may have inherent demand in the market, or is trading 'special', which can produce a healthy income or cheap funding for the fund if put on loan. If that security is encumbered as collateral, a manager loses an opportunity to improve the bottom line. A holistic collateral optimisation process should integrate seamlessly with securities finance analytics and incorporate funding costs, transformation costs and lending rates. Collateral optimisation and securities lending both seek to get the most out of a portfolio's holdings: one aims to minimise costs while the other aims to maximise income. They should be considered as two inter-connected components in the enhancement of a fund's net income.

## A holistic approach to collateral, funding and liquidity

In the best of times, a fragmented approach to managing collateral, funding and liquidity will unnecessarily increase a fund's costs. In the worst of times, it can lead to acute funding pressures, asset fire sales or missed margin calls. While interacting across departments in a fast-paced environment may seem daunting, timely and accurate data — along with quantitative tools to parse data into actionable analytics — puts decision-makers in a better position to succeed. The difference between success and failure in this space has become all the more apparent in the recent times of market volatility.

# A new era in collateral management

*Collateral management in the derivatives space has been on a decade long journey that is nearly at its end with the final two phases on UMR on the horizon. AcadiaSoft's head of community development Mark Demo, explores what happened and outlines what's to come*

The next few years will be a game-changer for the non-cleared derivatives industry as collateral management shifts towards an automated, risk-based process. The shift has been years in the making, the culmination of actions by global regulators, industry trade associations, market participants and vendors since events were first set in motion in 2009. Now, firms have access to increasing amounts of data, and many are making significant investments in technology, setting the stage for a rapid shift towards automation after years of slow and steady progress.

## Collateral management – a brief history

The shift began more than a decade ago when the G20 countries convened in Pittsburgh, Pennsylvania and agreed to reform their financial markets in response to the global credit crisis. In the derivatives space, among other things, they agreed to create a central repository for trade reporting, incentivise central clearing and disincentivise bilateral derivatives trading.

However, when local regulators in many of these G20 countries proposed new, conflicting rules, industry trade associations and market participants pushed back. The Basel Committee on Banking Supervision (BCBS) stepped in to create a global rule framework that was to be phased in over a multi-year timeline, which we now know as the Uncleared Margin Rules (UMR).

As firms began working to implement the rules, AcadiaSoft, then a small start-up, had already been piloting our own electronic margin messaging platform called Margin Manager (formerly MarginSphere) between large broker dealers. The first automated margin call was completed between HSBC and Credit Suisse in 2009. As the broker dealer community got a glimpse of what the future held from a margin call volume perspective, it became clear that the existing manual processes had to change.

## Collateral management today

Now, with four phases of UMR successfully implemented and the final phases set to come into scope in September 2021 and September 2022, firms have undergone massive changes to their margin process.

The traditional way that firms carried out their margin process – calculating exposure, calculating a margin call, sending or responding to a margin call via email, manually chasing if no response is received, then manually updating call status in downstream exposure and payment systems – has nearly vanished.

In its place, a much more automated process that seamlessly combines data and client interaction in an integrated electronic workflow between counterparties has emerged. The result is a margin process that requires much less time and human interaction – a margin process that instantly scales to meet both expected and unexpected demand with a much higher degree of accuracy and control. This new automated end-to-end workflow enables firms to focus on the exceptions to the process rather than the standard successful use case.

## Automation will spur innovation

Firms that have automated their collateral management processes can now focus on next level optimisation of operations, systems, approach to risk mitigation and vendor management by combining data from multiple systems to make smarter financial decisions. For example, firms can now more closely evaluate how a CSA factors into the pricing of a swap or the cost of collateral to carry and liquidity across asset classes.

It also spurs additional questions, such as how a firm aligns cash flows and swap obligations to generate capital savings. Regardless of the promise of potential capital savings generated by Settle to Market (STM), full-on margin and collateral automation frees up the firm to better explore:

- Is my firm moving collateral assets quickly enough for same day settlement? If not, how do we get there?
- Should digital assets be a part of my firms' future construct?
- Are we full on with the trade booking process and the final collateral requirement of the trade or does noise or inefficiencies in the process cause change during the initial settlement of the trade and subsequent collateral movements?

However, automation doesn't just free up firms to explore more options. It also facilitates many new and creative opportunities for analytics and reporting. Deep STP analysis of each step in the workflow process can reveal whether a firm is truly maximising the accuracy and timeliness opportunities afforded by electronic capture. At the same time, electronic capture also makes possible peer comparisons (on a blind basis) to enable each firm to understand how it stacks up to competitors. This new insight capability provides firms with targeted intelligence to maximise technology investment budgets for maximum competitive impact.

## The shift towards a risk-based platform

Over the past decade, AcadiaSoft has been nudging collateral management towards a transformation from a day-to-day risk mitigation process to a more continuous, real-time risk-based platform. Until now, the focus has been primarily on preparation, but we are on the brink of a data-driven sea change for collateral management and, ultimately, risk management. We believe this shift will only accelerate as firms have access to more data than ever before and have already made significant investments in automation. AcadiaSoft will help the industry stay ahead of the curve by setting the standard for near perfect data that will be widely available over a common operating model.

As we look ahead to 2021 and the coming decade, data standardisation and centralisation will usher in a new era of operational efficiency and effectiveness across the entire trade life cycle. Now, more than ever before, access to quality, near perfect data will be paramount.

# Trading and technology

*Fran Garritt, the RMA's director of global markets risk and securities lending, interviews Charles Schwab's Eric Lytle and OCC's Matt Wolfe about how institutions can ease the adoption of new platforms and products and achieve a downward sloping cost curve for the securities lending industry*

As head of trading in Charles Schwab's securities lending group, Eric Lytle sees every day how rapid advances in data and technology, new vendor entrants, and products are shaping trading and securities finance. As the Options Clearing Corporation's vice president of securities finance, Matt Wolfe has been involved for many years in the continual improvement and innovation of the world's largest clearinghouse for equity derivatives and securities lending.

## Can you talk about the history of how market participants connect to various platforms, vendors, and central clearing counterparties (CCPs) within securities lending?

***Eric Lytle:*** It's an easy one word answer, 'bespoke'. I run the securities lending trading desk now and before that I managed the 15c3-3 portfolio. Every vendor and market that I wanted to adopt had its own unique connection protocol. It is like rebuilding the wheel every time you start the adoption process. This had and still has several negative effects on each individual firm and the industry: increased development time and cost, and increased complexity for your internal technology teams to monitor and maintain the unique connections. Considering these factors, it creates a mechanical barrier to entry for new vendors, limits pathways to market participants and venues (CCPs), and reduces price discovery options. At the end of the day you have a lack of operational efficiency and increased operating costs. Generally speaking, I would say there has been a lack of industry focus on standardisation.

***Matt Wolfe:*** I agree that there has not been an industry focus on standardisation. I have worked on standardisation efforts with market participants and global CCPs for clearing options and futures. The benefits are clear in those markets. For context, the Options Clearing Corporation (OCC) clears for 16 US options

exchanges and approximately 100 clearing members. As a result of standardisation, the process to introduce a new options exchange is a relatively small project that the options industry has done about once or twice a year over the last few years. That has enabled great innovation and a diversity of market models designed for different strategies to ensure deep liquidity and best execution for investors. We are continually looking for ways to apply that success to the securities lending industry..

## What are the high-level benefits of message standardisation?

***Lytle:*** I try and think about this from every stakeholder's perspective and believe the advantages outweigh the disadvantages. Let's look at this from the perspective of the market participants (the lenders and borrowers) and the vendors (pre-trade data vendors, trade execution platforms, and post-trade platforms and CCPs) and then extend that view out to their constituents (beneficial owners, hedge funds and regulators). Standardised messaging will allow market participants to develop the necessary messages (on loan balances, availability, trading, and post-trade) once and then utilise those same messages multiple times with multiple vendors. This will make the implementation process much quicker and thus less expensive. If this is true then the barrier to entry for new vendors is lower, making for a true win-win scenario for the market participant and the vendor.

My argument goes one step further regarding the benefits to the industry if we are able to lower the barrier to entry for vendors. It is founded on a theory that competition in the industry is good for all stakeholders. Since I can't say it any better, I will steal a quote from the new members exchange: "Competition in the marketplace brings out the best in all the participants and benefits investors. Increasing the diversity of exchanges improves overall market robustness, stability, and innovation, which will ultimately result in improved operational transparency and reduced fixed costs." In other words, competition will benefit all securities lending market stakeholders by driving innovation and transparency in the industry and driving down operating costs. That is something we can all get behind.

## What are some common standard communication protocols that would work best for securities lending?

***Wolfe:*** There are several messaging protocols that can be considered, but three stand out from the rest: FIX, ISO, and CDM.

FIX was developed about 30 years ago to support electronic trading. The first asset class to adopt FIX was the equities market and it has since seen wide-scale adoption in the exchange-traded derivatives markets. It is the de-facto standard to connecting to exchanges and CCPs around the world. FIX is a community led standard and continues to evolve according to the needs of the financial markets. FIX has a flexible tag = value format (e.g., Qty="100") that is easy to understand and flexible to use. There is a robust set of supporting tools for validating, parsing, viewing, and creating FIX messages. The broad adoption for trading equities and the fact that most securities lending market participants already use FIX makes it an obvious choice.

ISO is another widely used messaging standard that could be a good fit for securities lending. ISO is used primarily within the custody, payments, and settlement space — another area closely-related to securities lending. ISO messaging standards are registered with and supported by SWIFT, the global payments network. ISO messages are more structured than FIX messages, with greater specificity on the format of data elements that are required in different messages. Most securities lending participants already use ISO for communicating with depositories and banks, so ISO is another good standard that the industry could rally around.

A third protocol is a relatively new standard called the common domain model (CDM). FIX and ISO have defined record layouts for expressing different events, such as a trade. Those record layouts include mandatory, optional, and conditionally required data elements; the meaning of those elements; and the format of those elements (e.g., text, currency code, integer, etc.). The FIX and ISO standards also have suggested workflows for how interactions should occur — for example, what message the recipient of a request for quote message should respond with. CDM does all these things and goes one step further: It includes embedded logic and code for performing certain actions. This allows both parties to a transaction to perform the same calculations, which helps reduce discrepancies. CDM is supported by the International Swaps and Derivatives Association, and has been adopted by much of the derivatives markets. CDM has not yet been extended to support securities lending, but it certainly could be.

## Why is now the time to talk about message standardisation?

***Lytle:*** This has been such a tumultuous and volatile year for all of us, I can't help but think about how we further risk-proof and grow our industry and grow our respective businesses, all while working from home. My brain tells me, don't fight the tape, the market will not slow down for you nor accommodate the status quo. The Securities Financing Transactions Regulation is here, DTCC and the OCC are developing their CCP offerings for the securities lending industry, and there are a multitude of really interesting new vendors looking to compete in the US market. It really feels to me that the industry is ready for the next big step forward.

In my opinion, EquiLend's Next Generation Trading (NGT), a multi-asset class trading platform accessed through a web-based user interface or via full automation using EquiLend's proprietary messaging protocol, opened the industry's eyes as to what could be accomplished with trade automation. So then the industry's question becomes, what is next and who is next?

In the pre-trade analytics space, we have all become familiar with the big three data providers (Markit-DataExplorer, Astec Analytics-Lending Pit, and DataLend), but we want more. We want option implied borrow rates and swap rates side-by-side in an easy-to-compare fashion, exchange data on short interest, expiry lockup dates, dividend dates, balance and availability day-over-day changes, utilisation, etc.

In the trade execution space, as I mentioned the industry has become familiar with trade automation via NGT, but we want more. We want competition in the execution space and we want to see the analytics on the same screen we use for executions, cost differences based on collateral types and mark parameters, two-sided market with depth of market in real-time, and real industry-wide locates that decrement as new shorts are executed.

In the post-trade space, we have overnight batch processing on main frames but we want more. We want real-time comparison, perhaps utilising distributed ledger and competition in the space that arguably is the last area within securities lending to adopt new technologies to drive efficiency higher and costs lower.

Generally speaking, the industry is ready to do the work necessary to make efficiency a priority, with the intended goal of improving our trade decisions and driving our cost structure lower.

## What are the next steps towards the message standardisation for the SL industry and how is it going?

***Wolfe:*** We worked with the FIX trading community to form a stock loan working group to expand the FIX standard to better support securities lending. With the support of the RMA FinTech and Automation Committee, we have been collaborating with market participants, vendors, and other CCPs to define a set of messages for communicating loans; contracts with marks; and other life cycle events such as rerates, recalls, returns, buy-ins, and corporate actions. These messages will work nicely with the already established reference data and other messages in the FIX standard. FIX is community-led and anyone is welcome to contribute. Collaboration by the entire industry helps ensure that the messages support all our use cases and are developed using the collective wisdom of the industry. Having an industry-backed and developed standard will help ensure wide-scale adoption and help to realise the benefits of lower costs, greater automation, innovation, improved efficiency, and higher quality data.


# Red flags for securities lending and ESG?

*Roy Zimmerhansl, practice lead at Pierpoint Financial, revisits the news that DWS pulled one of its ETF's securities lending programmes as part of its transition to tracking an ESG index and examines whether there are lessons to be learned or warning signposts as ESG continues to increase in importance*

## The environment

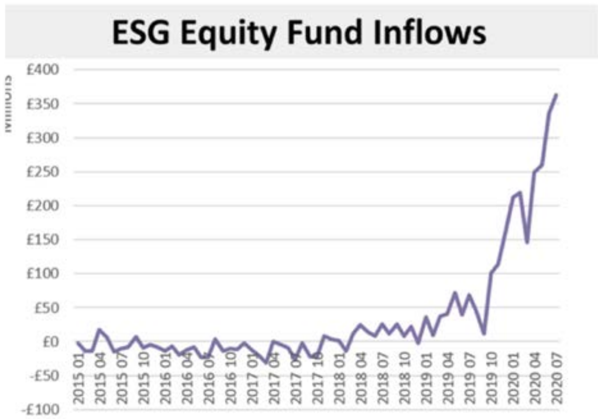
You don't have to look too hard to find data supporting the argument that socially responsible investing is picking up momentum, with the Calastone diagram (see Figure 1) neatly illustrating the rapidly increasing trend. Indeed, I read elsewhere another story by ETF Stream on this news where Simon Klein, global head of passive sales at DWS, advised: "We have seen exceptional flows into environmental, social and governance (ESG) exposures this year and expect that demand to continue into 2021".

## The story

At a headline level, the story reported DWS was 'pulling the plug' on securities lending for one of its exchange-traded funds (ETFs) that tracks ESG indices, citing "the need for restrictive collateral parameters and regular recalls" and referring to "a number of other challenges" which went unnamed, but cumulatively these were identified as eroding potential lending revenue.

So, if the trio of factors - collateral, recalls and unnamed items –

Figure 1: ESG equity fund Inflows  Source: Calastone




undermines the economics of lending while more assets are going into ESG funds, is this a worrying trend for securities lending?

## The fund facts

- The fund has assets under management (AUM) of c. $40 million (according to DWS website as at 23 December 2020)
- The fund tracks MSCI UK IMI Low Carbon SRI Leaders Select on a fully replicating basis (115 stocks)
- The fund was repurposed in early December, with the predecessor index being the FTSE All-Share
- The peak AUM of the fund since launch was in October 2013 at near $350 million

## The fund challenges

When I first saw the current fund AUM, I was surprised that it had even been approved by borrowers given fund approval backlogs that still plague small and some not-so-small beneficial owners waiting for borrower approvals. Then I saw that it was launched in June 2007 and discovered the fund peak size. Given the length of time in existence, it was no longer a surprise. If this were a new launch with that AUM, I think it would be amongst the lowest priority funds.

I had a scan of the MSCI UK IMI Low Carbon SRI Leaders Select index constituents with the ‘top ten’ shown (see Figure 2). Based on weightings, you really need to get to the 18th largest stock before you get a sniff of a stock that is not ‘super-GC’ (very high supply, very low demand). That stock is Ocado, which still has an element of borrower interest, but not anywhere near the interest of two to three years ago. In any case, the holding of the fund in Ocado is likely under $500,000.

My Verdict: this fund has little intrinsic lending value even absent any non-standard lending criteria.

## The wider challenges

The biggest issues to examine are those suggested as being allegedly germane to ETF lending. If these can be shown to carry some weight, then these may act as warning signals for the securities lending ecosystem.

Figure 2: MSCI UK IMI Low Carbon SRI Leaders Select index

**TOP 10 CONSTITUENTS**

| | Index Wt. (%) | Parent Index Wt. (%) | Sector |
|---|---|---|---|
| UNILEVER PLC (GB | 12.99 | 6.23 | Cons Staples |
| ASTRAZENECA | 11.07 | 5.38 | Health Care |
| RIO TINTO PLC (GB) | 5.86 | 2.85 | Materials |
| RECKITT BENCKISER GROUP | 5.06 | 2.46 | Con Staples |
| RELX (GB) | 3.65 | 1.77 | Industrials |
| VODAFONE GROUP | 3.58 | 1.74 | Comm Srvcs |
| PRUDENTIAL | 3.30 | 1.60 | Financials |
| NATIONAL GRID | 3.22 | 1.57 | Utilities |
| LONDON STOCK EXCHANGE | 2.77 | 1.35 | Financials |
| BARCLAYS | 2.52 | 1.23 | Financials |
| **Total** | **53.03** | **26.27** | |

## Restrictive collateral parameters

It is entirely appropriate that lenders apply the same ESG filtering criteria that they do for their front-end stock selection to their collateral. Historically that has been dealt with by i) ignoring it as too difficult to deal with (we have seen other examples where funds have excluded collateral from their management criteria – see here) ii) by sector exclusion (I have argued this is a very blunt tool that disadvantages companies in target sectors that make progress towards meaningful ESG oriented change) or iii) individual security approvals at an ISIN level (theoretically possible today but operationally unsustainable or reliable).

I am confident 2021 brings better solutions – ask us for more information.

## Regular recalls

This is a contentious area and DWS is correct to call attention to it. On the one hand, borrowers want as much certainty as possible of a continuous borrowing opportunity. On the other, ESG conscious investors should be purposefully voting when they determine voting is in the best interests of their stakeholders. Can the two co-exist? They already do in many countries where domestic investors lend callable stock and within many individual investor lending policy guidelines.

It would be interesting to canvas end-borrowers on whether increasing availability in less liquid stocks would encourage more trading activity or whether they would be concerned over getting caught out. That might argue against an individual lender's portfolio making a difference, but liquidity often begets liquidity.

## Ethics of short selling

The DWS representative is at pains to make it clear they have no view on the ethics of short selling as such, rather they are there to deliver investor results. Readers and followers will know I feel very strongly on the issue, but rather than repeating myself, I'll remind you that we had a guest blogger - Eric Jensen CEO, Antrim Investment Research - provide his views in 'On the Ethical Implications of Short Selling' in August this year.

## Unnamed ESG challenges

Might I suggest two and ask for your thoughts on others: transparency and tax.

The issue of transparency was used by the Japanese Government Investment Fund as one reason for their suspension of equity lending, so this is a real 'thing'. Transparency has many angles – that a fund lends, their governance policy, why borrowers borrow, collateral criteria and holdings, voting activity – and more. These are all important issues for focus, but I am not convinced that they unduly disadvantage ESG funds. Nevertheless, fiduciaries involved with oversight on securities lending should be cognisant of how these are dealt with and oversight applied. A potential complex area requiring specialist expertise and advice.

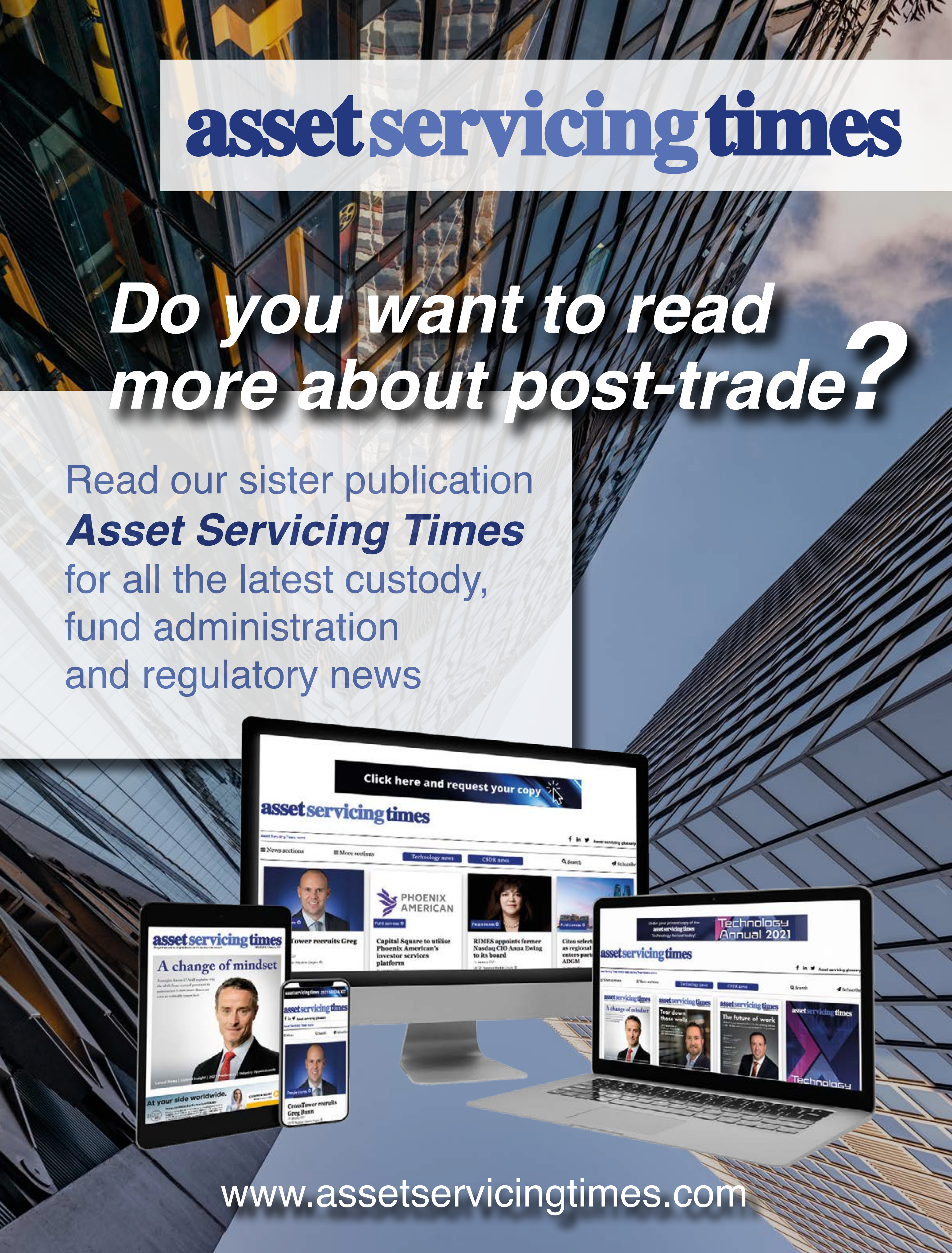
The other issue is tax and given that 2020 has seen the first court cases related to alleged tax abuse with Cum-Ex trading, it too deserves attention and focus. Much has been done since the turn of the century to tighten practice on this topic and perhaps more is required. If securities lending is a niche speciality, securities lending taxation is super-niche and I repeat there is value in expert guidance (I recommend Ali Kazimi of Hansuke Consulting).

## Summary

Is the DWS decision to withdraw this one fund from lending a sign of things to come? As noted earlier, irrespective of historical demand for the fund, I don't think the repurposed fund at the current size is particularly well-suited for lending. To me, this is an individual decision for a specific fund that is entirely sensible.

However, the issues raised by DWS apply more broadly and must be addressed by the securities lending ecosystem to ensure that what is manageable today, does not become disruptive tomorrow. Fortunately, the spotlight is on all the stakeholders including vendors and this is driving engagement which will, in my opinion inevitably lead to a better operating environment.

The new year we find ourselves in will likely be remembered as the year the vaccines had an impact on getting the world back to 'normal'. Specifically, for securities lending, 2021 is likely to be remembered as one where ESG debate became mainstream.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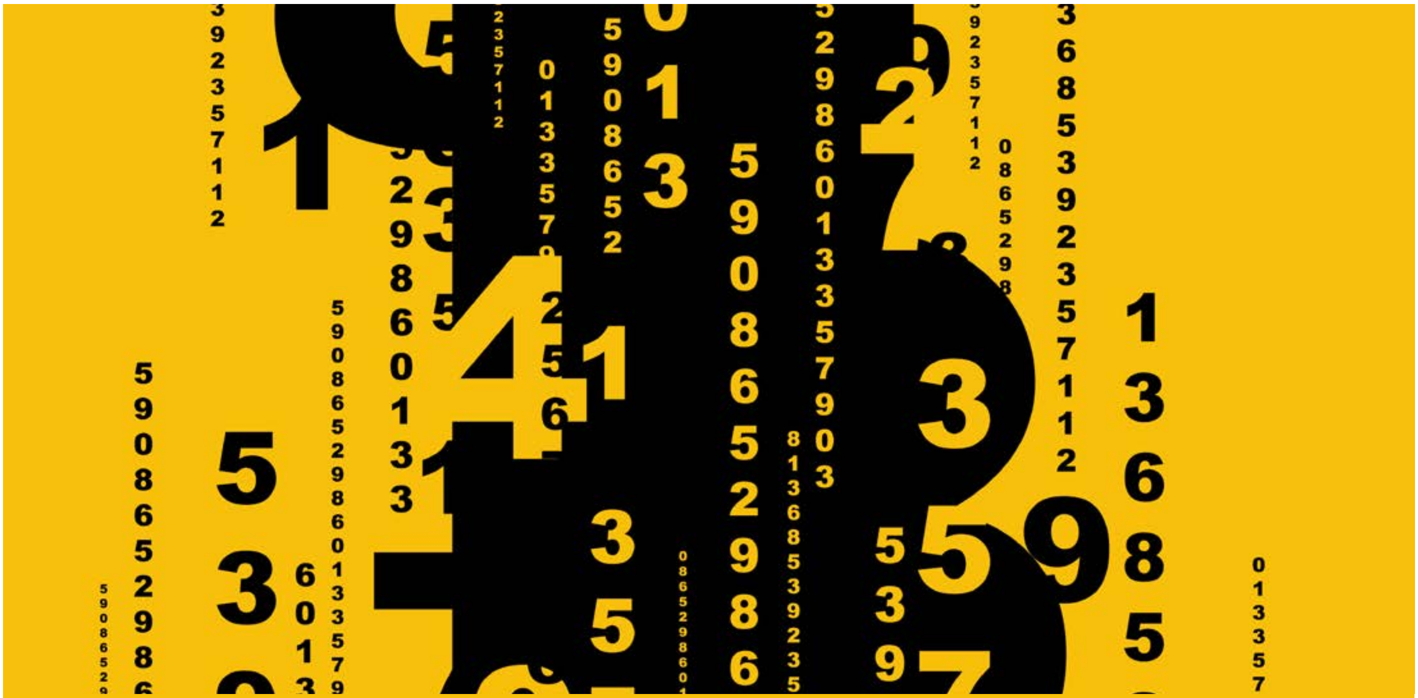

# December securities finance revenue

*IHS Markit's Sam Pierson crunches the numbers for the final act of 2020 and explores whether securities lending markets can maintain the positivity seen in December going forwards*

Global securities lending revenues increased by 12 per cent year-on-year (YoY) in December, with $909 million in monthly revenue the most for any month since June, when revenues totaled $971 million. That marks the fourth consecutive month of increasing returns, albeit starting from 2020's least remunerative month in August.

US equity revenues continued to trend higher throughout December, as the initial public offering (IPO) market turned white-hot. Equity exchange-traded funds (ETFs) also saw an increase in borrow demand, with loan balances reaching an all-time high on 21 December. In this note we will review revenue drivers from December within the context quarter-to-date and year-to-date results.

## Americas equity

Americas equity revenues came in at $434 million for December, a 32 per cent YoY increase, and the largest monthly return since July ($436 million). The upswing was largely the result of increased special balances, with average fees increasing 26 per cent month-on-month (MoM), however loan balances also increased by 10 per cent MoM. Americas Q4 equity revenues of $1.0 billion reflect an increase of 4.8 per cent YoY.

US equity revenues came in at $408 million, a 49 per cent YoY increase, and a similar MoM increase. The most revenue generating US equity in December 2020 was Quantumscape Corp (QS) with just over $60 million, an impressive feat considering Quantumscape only went public via a special purpose acquisition company (SPAC) combination on 4 December. The surging demand for QS shares was emblematic of borrow demand for recent SPAC and conventional IPOs, which reached new heights in December. US equity ‘special’ balances, defined here as loans with a fee greater than 500bps, increased 51 per cent MoM from an average of $11.1 billion in November to $16.7 billion in December (nearly reaching the $18 billion peak for 2020, observed in June).

Utilising the IHS Markit Situational Analytics dataset we aggregated current and former SPAC IPOs which went public since the start of 2018 to review the impact on overall US equity finance revenue. In December current and former SPACs delivered $105 million in equity finance revenue, 26 per cent of all US equity revenue. The December SPAC revenue is just more than three times the November tally, however, it’s still only the second most revenue generating month of 2020. In July Nikola Motors generated $106 million in revenue, 95 per cent of the recent SPAC IPO total; In December the most revenue generating recent SPAC was QS, which generated 61 per cent of the SPAC total.

Borrow demand relating to non-SPAC IPOs was also strong in December, with the 2020 vintage of US IPOs generating $62 million in equity finance revenue, more than doubling the November return. Canadian equity lending returns held steady MoM but remain well below the YoY comparable, which has been the case since March. December revenues of $25m reflect a 53 per cent YoY decline. Cannabis related returns have declined steadily as increased issuance has translated to additional lendable shares and lower fees. Canadian equity average specials balances increased by 9 per cent MoM but remain less than half the average observed over H1 2020.

## European equity

European equity revenue increased 26 per cent YoY for December, following November where revenues increased by 25 per cent YoY. The European upswing continues to be concentrated in relatively few equities. EMEA specials balances declined MoM, partly driven by demand relating to the November Unibail EGM subsiding by early December. German equity lending revenues continue to be bolstered by Varta Ag, which delivered $16.9 million in November revenue, however, the German battery maker was upstaged as the top revenue generating security globally after four consecutive months atop the leaderboard. German equity lending revenues totaled $30.4 million for November, an 86 per cent YoY increase.

French equity finance revenues were boosted by Casino Guichard Perrachon Sa, owing to the average borrow fee reaching the highest level since January 2020, a four-fold increase since August, while the firm’s increasing share price boosted on-loan balances.

## Asia equity

Asia equity finance revenues notched a small win with December being the most revenue generating month of Q4, however the YoY shortfall persisted with December completing a year where each month delivered less revenue than the 2019 comparable. The largest market, Japan equities, delivered $49 million in December revenues, a decline of 17 per cent YoY and a 15 per cent increase compared to November. Hong Kong equity finance revenues continued to trend higher in December with $32 million in revenue reflecting a 27 per cent YoY increase and the most monthly revenue for 2020. The short sale ban in South Korea continues to limit lending revenue, with $9m in November revenue reflecting a 79 per cent YoY decline. The South Korea ban is set to remain in place until March; Malaysia allowed their short sale ban to expire at the end of December. Asia equity special balances continue the fledgling recovery from the 2020 low point in early November, with December’s $7 billion in daily average special balances being the most for any month since July.

For the full-year 2020 global securities finance revenues totaled $9.3 billion, a 7.4 per cent YoY decline. The year ended on a high note, with December generating the second most revenue for any month of 2020. Looking ahead, the IPO market in the US is likely to generate a lineup of borrow demand events ahead lockup expiries throughout 2021, which will only be bolstered by the surge in SPAC deals. In Europe the expected reinstatement of dividends in 2021 will likely boost lending returns and arbitrage trades driven by capital raising, such as rights issues and convertible bonds, may continue to drive specials balances as well. In APAC the conclusion of short sale bans may be a tailwind for 2021, while some markets such as Hong Kong are currently seeing increased borrow demand. At the end of a tumultuous year there is cause for optimism heading into 2021.

# The latest appointments at MUFG, MarketAxes and Stonewain

## Christopher Morley is the latest Deutsche Bank defector to resurface at MUFG since Tim Smollen left the German bank in December 2019 to take on overhauling MUFG's securities lending business.

As of 4 January, Morley is leading the Luxembourg branch of MUFG's global securities lending enterprise.

He left Deutsche Bank after just under five years as a director in global transaction banking.

Morley reports to Jay Schreyer, another ex-Deutsche Bank employee, who heads up global securities lending services across Europe, the Middle East and Africa, and Asia.

Locally, Morley reports to senior management of Mitsubishi UFJ Investor Services & Banking (Luxembourg), a wholly-owned subsidiary of MUTB that provides a range of products including custody, fund administration, foreign exchange and Securities Lending to MUFG clients worldwide, and is the European hub for its securities lending services.

Prior to joining Deutsche Bank for the second time in 2016, Morley held several senior positions within State Street's securities finance business for 12 years.

Morley follows several other Deutsche Bank staff to MUFG, including Charlotte Clode, JT Zamecnik, Anthony Toscano, and Bronwen Simms.

## MarketAxess appoints new COO for EMEA and APAC

MarketAxess has appointed Raj Paranandi as chief operating officer of Europe, the Middle East and Africa (EMEA), and Asia Pacific (APAC), effective 1 March 2021.

Paranandi, who is based in London, will have day-to-day operational oversight for EMEA and APAC, including technology and product development, client and account services, data operations, regulatory operations and controls, settlements and middle-office functions.

He will play a leading role in setting the long-term goals for the international business and lead new strategic change management initiatives.

Paranandi will report to Christophe Roupie, head of EMEA and APAC at MarketAxess, and work closely with Chris Concannon, president and chief operating officer at MarketAxess.

Paranandi joins MarketAxess from UBS, where he spent nearly 10 years and most recently served as global co-head of digital transformation for UBS global markets and global head of change for UBS Investment Bank.

He also spent four years as global chief operating officer for foreign exchange, rates and credit at UBS Investment Bank.

Paranandi has also worked as a director for Credit Suisse, head of finance tax and treasury IT for Barclays and manager of financial services for Accenture.

Previous roles include technology and operational leadership roles at Barclays, Credit Suisse and Accenture. He has also served as a board member of the Global Financial Markets Association (GFMA).

Asked about the possibility of further hires to underpin Smollen's ambitious plan to make MUFG the first Asian make to truly compete with US and European banks in the securities lending arena, he tells SFT that "we are building a global team through a combination of both internal and external hires and aim to grow across Europe, the US and Asia".

He adds: "This stage, I am absolutely ecstatic at the team we have been able to put together from across the globe."

Elsewhere, MUFG recently went live on the EquiLend Spire trading platform, which is powered by Stonewain, as its core global platform to expand its front, middle and back-office securities lending systems.

## Stonewain recruits veteran Patrick George from FIS

George is well known throughout the industry and will be primarily focused on managing and developing the EquiLend Spire suite of solutions for the broker dealer community.

George has been appointed to the product management team and will spend a great deal of time focused on the flagship EquiLend Spire offering for broker dealers, retail brokers, agent lenders, collateral management desks and beneficial owners.

EquiLend Spire, offered by global fintech EquiLend and powered by Stonewain technology, is a modern system featuring flexible modules including domestic and international books and records, fully paid lending, order and inventory management, trade entry, locates and a variety of other components.

Chris Valentino, head of business development at Stonewain, says: "We are very excited to bring Pat onboard during this tremendous period of growth for our firm.

"Pat's experience and subject matter expertise as it pertains to this space is unprecedented in the industry and will serve our team and platform extremely well for many years to come."