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EC adopts conditional equivalence for no-deal Brexit

The European Commission has adopted conditional equivalence for central clearing counterparties (CCPs) and central security depositories (CSDs) post-Brexit, as part of its no deal contingency action plan.

The commission has considered it "essential and urgent" to adopt these measures to ensure that the necessary contingency measures can enter into application on 30 March in order to "limit the most significant damage" caused by a "no-deal" scenario in these areas.

This recognition would allow UK CCPs to continue to provide clearing services to their EU members, and EU banks to meet their obligations to UK CCPs.

The Bank of England stated that the announcement is "a crucial and positive step".

It said: "It provides the necessary clarity and addresses one of the most important financial stability risks associated with the UK's withdrawal from the EU. It also enables UK CSDs to be recognised so that they can continue providing notary and settlement services for securities issued under EU law."

In the UK, HM Treasury and the Bank of England have already put in place a temporary recognition regime for non-UK CCPs and a transitional regime for non-UK CSDs. The Bank of England explained that these will enable EU CCPs and CSDs to continue to provide services in the UK in a no-deal Brexit scenario.

As part of the commission's contingency measures, it found that only a limited number are necessary to safeguard financial stability in the EU27.

As part of those measures, various acts will apply from the withdrawal date if an exit deal is not ratified.

The acts include a temporary and conditional equivalence for a fixed, limited period of 12 months to ensure that there will be no immediate disruption in the central clearing of derivatives.

Measures also include a temporary and conditional equivalence decision for a fixed, limited period of 24 months to ensure that there will be no disruption in the central depositories services for EU operators currently using UK operators.

Additionally, the commission adopted two delegated regulations facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a UK to an EU27 counterparty.

According to a statement from the commission, it will continue to "implement its contingency action plan in the weeks to come and will monitor the need for additional action, as well as continue to support member states in their preparedness work".

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Country Profile
Luxembourg continues to record large net inflows into UCITS, and growth is expected to continue this year
page 20

2019 Outlook
Industry participants suggest SFTR, CSDR and Brexit will all be hot topics for the securities lending industry this year
page 24

Eurex Update
Matthias Graulich and Frank Gast discuss the success of Eurex's Partnership Programme and the expansion into the repo segment
page 28

Technology Overview
Jerry Friedhoff of Broadridge discusses regulatory changes, emerging technologies and more
page 36

Machine Learning
Stephanie Lo and Jian Wu of State Street discuss the intersection of machine learning applications and equity markets in portfolio management
page 32

Regulation Update
Michael Huertas, partner at Dentons, discusses the uncertainty and challenges around Brexit
page 36

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BNY Mellon purchases securities finance software and associated intellectual property of Trading Apps

BNY Mellon has purchased the agency securities finance software and associated intellectual property of Trading Apps.

According to BNY Mellon, the transaction will deliver benefits to its agency securities lending business and its clients.

These benefits will include enhanced price discovery as well as reporting and analytics through the integration of securities finance market data and automated algorithmic execution.

Trading Apps will continue to operate as an independent entity, primarily servicing the securities finance community beyond agent lenders, including broker-dealers and borrowers.

Matthew Harrison and Jeff Lloyd along with eight other Trading Apps staff members will be joining BNY Mellon, all of whom will be based in the UK.

Laura Allen has taken over from Harrison as CEO of Trading Apps. Harrison will now serve as a non-executive director of Trading Apps.

James Slater, global head of securities finance and collateral management at BNY Mellon, said: "This acquisition represents a compelling strategic opportunity for BNY Mellon. The combination of Trading Apps' world-class technology and specialists with our unrivalled agency lending franchise will deliver our clients unprecedented speed, automation and trading efficiencies in this highly competitive marketplace."

SEBI moves to physical settlement for all derivatives

The Securities and Exchange Board of India (SEBI) has notified that all derivatives will be settled physically as part of an initiative to help promote securities borrowing and lending.

Accordingly, stock derivatives which are currently being cash settled will move to physical settlement.

Physical settlement of stock derivatives will be made mandatory in a phased, calibrated manner in descending order. The first 50 stocks will move to physical settlement from April this year onwards, followed by 50 more in July, and the remaining stocks will move by October.

Exchanges have been directed to put in place proper systems and procedures to ensure a smooth implementation of physical settlement.

This decision comes after SEBI published discussion papers in 2017, requesting stakeholders to provide their comments, with a view to improve market integrity and provide better alignment of cash and derivatives segment.

In the paper, SEBI stated: "A prerequisite for the successful introduction of physical settlement of derivatives is efficient and transparent lending and borrowing mechanism in cash segment."

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The board added that a "vibrant mechanism" for securities lending and borrowing is essential to avoid a short squeeze in India's financial markets.

OCC hits record highs for 2018

OCC has set a new annual cleared contract volume record for the US exchange-listed options and futures industry, clearing 5.24 billion total contracts and 5.14 billion options contracts.

These figures surpass the previous records of 4.60 billion total contracts and 4.56 billion options contracts, set in 2011.

Compared to 2017, OCC had a 21.1 percent increase in total contracts cleared as well as a 22.6 percent increase in options contracts cleared.

Meanwhile, OCC's securities lending central counterparty activity was up 3.9 percent in new loans from December 2017 with 107,214 transactions last month.

For the year, stock loan activity increased 17.2 percent from 2017, with 1,374,319 new loan transactions in 2018. The average daily loan value at OCC in December was $70,160,856,931.

Total cleared contract volume, which proved the be the most active December to date for OCC, reached 436,771,941 contracts in December, up 26.2 percent compared to the December 2017 volume of 346,006,092 contracts.

BME Clearing clears first repo trades

BME Clearing has cleared its first repo trades executed on the anonymous dealer-to-dealer trading platform BrokerTec, owned by NEX Markets.

The clearing of these transactions follows the announcement of an agreement last July between BME Clearing and NEX Markets.

This involved the provision by the BME Clearing of repo clearing services to participants connected to BrokerTec.

As an authorised European Securitas Markets Authority central clearing counterparty (CCP), BME Clearing provides clearing services in Spain. It provides equities, public debt repos, financial derivatives, energy derivatives and interest rate swaps.

Ignacio Solloa, managing director of BME Clearing, said: "By clearing the first transactions on BrokerTec, BME Clearing has brought a wider choice for clients operating on this platform."

Solloa added: "We are delighted that BrokerTec offers our CCP services to their clients, which will benefit from the efficiency, transparency and reliability of BME Clearing."

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Equity options volumes reached a total of 376,883,978 contracts, a 27.7 percent increase from December 2017.

Futures cleared by OCC reached 7,693,725 contracts in December, down 23.4 percent from December 2017. OCC's average daily cleared futures volume for 2018 was 417,882 contracts, 24.0 percent less than 2017.

John Davidson, OCC president and COO, commented: "Throughout 2018, OCC delivered operational and capital efficiencies to our participating exchanges, clearing firms, and market users in our role as a systemically important financial market utility."

"As we look forward to 2019, my OCC colleagues remain committed to strengthening our resiliency and risk management capabilities to ensure confidence in the financial markets and the broader economy, and to continue to clear the path for growth in the US equity options and futures industry."

SPCEX launches exchange-traded repos with Bank of Russia

The St. Petersburg Currency Exchange (SPCEX) has launched exchange-traded repos with the Bank of Russia, using The National Settlement Depository's (NSD) collateral management system (CMS).

The initiative, which started on 25 December 2018, will give participants the option of concluding exchange-traded repos with the Bank of Russia.

The basket of securities from the Bank of Russia's Lombard List will be used as collateral for repos with CMS.

The CMS allows market participants to select collateral automatically, to replace bonds in the basket, and to process corporate actions on securities involved in transactions.

The NSD also revealed that Slavneft has been added to its Transit 2.0 platform, which allows companies to optimise their expenses for interacting with settlement banks, with regard to receiving and transmitting payment documents.

The Transit 2.0 is a new system for financial message exchange between banks and corporations developed by NSD on the basis of the previous Transit platform version. The system automatically exchanges payment and other documents.

Stanislav Popkov, head of corporate finance department at Slavneft, said: "The Transit 2.0 platform provides our company with efficient interactions with banks via a single channel. It will allow us to save time and increase transaction reliability. The new instrument gives clear advantages to market players who hold many settlement accounts."

Alexander Nam, managing director for technological services development at NSD, said: "We continue to expand the number of clients connected to the platform, regardless of their profiles. The Transit 2.0 platform is already appreciated by market participants, and we plan to improve its capabilities."

DTCC and Xceptor work together on SFTR solution

The Depository Trust & Clearing Corporation (DTCC) has partnered with Xceptor to enable clients to leverage Xceptor's data transformation capabilities within DTCC's global trade repository for Securities Financing Transactions Regulation (SFTR).

According to DTCC, the partnership will "significantly lessen" firms' operational burden by enabling them to enrich, normalise and validate data before submitting it to a trade repository.

Firms will be able to enrich reporting with both internal and external reference data, manage exceptions leveraging native workflows, and benefit from real-time gap analysis and testing.

Val Wotton, managing director, product development and strategy, derivatives and collateral management at DTCC, said: "With data being one of the main challenges of the SFTR obligations, DTCC provides clients with the ability to capture and normalise any data format from any channel and intelligently connect the right data, in the right format, at the right time."

"Our partnership with Xceptor will enable firms to significantly streamline their operational processes and help simplify the SFTR compliance process. We look forward to helping the industry prepare for SFTR in 2020."

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Andrew Kouloumbrides, CEO of Xceptor, added: "SFTR places a huge importance on data quality and, with low reporting tolerances, the self-serving capabilities of the DTCC service, powered by Xceptor, will enable firms to get their data into shape while also being able to use existing trade file formats."

"DTCC will maintain the rules engine, the platform itself will be operated by DTCC, so DTCC will deploy Xceptor within the DTCC infrastructure and will run that platform operationally. This is the start of a partnership between Xceptor and DTCC that we hope will evolve to mutual benefit."

Also commenting, Marisol Collazo, managing director, business development and global head of strategic partnerships at DTCC, explained: "DTCC is excited to be partnering with Xceptor to simplify the SFTR reporting process. We will continue to explore other opportunities with Xceptor to leverage its capabilities across our platform."

Post-crisis regulation could be 'detrimental' for repo and sec lending

Post-crisis regulation requires further evaluation as it could be detrimental for repo and securities lending markets, according to a Global Financial Markets Association (GFMA) and International Capital Market Association (ICMA) report.

The report explained that regulation is a key driver of change for the way the repo and broader securities finance transactions (SFT) markets operate today and how they will evolve in the near future.

It found that regulatory reforms have had a profound effect on banks' SFT businesses, with a significant increase in capital requirements. While the markets have so far proved to be resilient, the report suggested that they are still some way from reaching a new normality, with regional markets at different stages of that evolution reflecting divergent implementation of regulatory reforms on different timelines.

Further findings from the report showed that securities lenders may have to accept significantly lower returns for their portfolios due to lower demands.

Meanwhile, short sellers may need to seek alternative ways to short securities and improve the price discovery process.

Additionally, the report found that increased costs and reduced capacity for transacting with regulated counterparties could ultimately lead to increased costs for investors in pension funds and mutual funds. The report recommends that the Financial Stability Board and Basel Committee on Banking Standards should review the coherence and calibration

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of the post-crisis regulatory framework, particularly pertaining to how it impacts the repo market.

The treatment of repo transactions backed by the highest quality government bonds should be reviewed in order to ensure that the private sector market has the capacity to absorb quantitative easing unwind and to operate without significant reliance on central banks during normal and stressed market conditions.

Kenneth Bentsen, CEO of GFMA, said: “Repos and other SFTs play a critical role in the global financial system and support the real economy in many different ways. Therefore, it is essential that the SFT markets function smoothly during both normal and stressed times.”

“Our report’s findings suggest the need for several policy revisions and that further work needs to be conducted in recalibrating the global prudential standards, without sacrificing safety and soundness, to ensure better functioning of the repo and broader SFT markets for the benefit of the wider global economy.”

Godfried De Vidts, chair of the ICMA European Repo and Collateral Council, commented: “It is clear that regulation is a key driver of changes in the way the repo and broader SFT markets operate today and how they will evolve in the near future. While the markets have thus far proved resilient, they are still some way from reaching a new normality, with regional markets at different stages of that evolution reflecting divergent implementation of regulatory reforms on different timelines, and the impact of future regulatory reforms remains a key concern.”

De Vidts added: “Hence it is important to conduct a review of the coherence and calibration of the post-crisis regulatory framework, particularly pertaining to how it impacts the repo market, and to ensure that any proposed further reforms are subjected to robust impact analysis.”

EquiLend stake sold to NBC

J.P. Morgan is selling one of its two stakes in EquiLend to the National Bank of Canada (NBC).

Commenting on the sale, Brian Lamb, CEO of EquiLend, said he was “thrilled” to welcome NBC to its ownership group and board of directors.

Lamb said: “NBC is a strong supporter of fintech and automation in the securities finance market, and as such we couldn’t ask for a more fitting partner.”

He added: “We look forward to working with all of our owners and 130 other clients in the global securities finance market as we continue to deliver innovative new technology solutions.”

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Get ready to report

With the EC adopting seven delegated regulations comprising SFTR level II legislation in December, the industry needs to ramp up preparations

Becky Butcher reports

The Securities Financing Transactions Regulation (SFTR) has been the biggest and probably most important regulation to hit the securities finance industry.

SFTR was published in January 2016 by the European Commission following the Financial Stability Board and the European Systemic Risk Board's recommendation to mitigate the inherent risks in shadow banking and increase transparency in the use of securities lending and repo.

As part of the regulation, firms will be required to report their securities financing transactions to a trade repository registered by the European Securities Market Authority (ESMA). On 31 March 2017, ESMA submitted the draft level II legislation to the European Commission.

On 24 July last year, the European Commission sent a letter to ESMA confirming their "intention to endorse with amendments" the draft regulatory technical standards (RTS) and implementing technical standards (ITS) submitted by ESMA. However, on 4 September, ESMA formally rejected the European Commission's request to make minor amendments to its draft SFTR level II legislation.

But the big announcement was made on 13 December, when the European Commission revealed it had adopted seven delegated regulations comprising SFTR level II legislation.

The seven delegated regulations included: the RTS specifying the details of the application for registration as a trade repository, regulation on access to the data held in trade repositories, RTS specifying the details of securities financing transactions (SFTs) to be reported to trade repositories, regulation on fees charged by ESMA to trade repositories, RTS on the collection, verification, aggregation, comparison and publication of data on SFTs by trade repositories, RTS on the details of the application for registration and extension of registration as a trade repository, and RTS on access to details of SFTs held in trade repositories.

Seb Malik of Market FinReg said: "After an inordinate 18-month delay the market can breathe a collective sigh of relief. The legislation will now be scrutinised by the European Parliament and Council."

During the three-month period, the European Parliament or the European Council "may object to an RTS within a period of three months from the date of notification of the RTS adopted by the commission. At the initiative of the European Parliament or the council that period shall be extended by three months".

Andrew Dyson, CEO of the International Securities Lending Association, commented: "After considerable and detailed preparatory work across the industry in recent months it is good to get clarity around the dates we are all now working towards."

Dyson exaggerates how important the first six months of this year will be "in terms of developing a consistent and pragmatic framework to ensure that the industry is able to comply with the Article 4 daily reporting requirements".

Jonathan Lee, senior regulatory reporting specialist at Kaizen Reporting, describes the decision to adopt the RTS and the ITS for SFTR as "the final piece in the puzzle of certainty around the Article 4 regulatory reporting obligation go-live". Lee explained that the decision "dictates the timeline to implementation".

Once the regulation comes into force, credit institutions and investment firms have 12 months to implement reporting central counterparties (CCPs) and central securities depositories (CSDs) have 15 months, pension funds, insurance/reinsurance companies, alternative investment funds, UCITS have 18 months and non-financial counterparties have 21 months. According to Lee, reporting will start in April 2020 for banks, with others to follow in three-month increments. He emphasised that "now is the time to start SFTR budgeting, hiring, planning, building and thinking about testing, controls and governance if your project has not already kicked off".

Also commenting on the adoption, Val Wotton, managing director, product development and strategy, derivatives and collateral management at DTCC, said that "the approval of the technical standards for the reporting rules of SFTR fires the starting gun on the countdown to the implementation of this new regulation which we expect to take place in just over a year's time".

Wotton suggested that in order to be ready in time, the securities financing industry has a "significant amount of work to do, particularly around data availability and workflows".

He added: "We know that large broker-dealers and agent lenders have kicked off their preparations, however, many of the smaller banks and buy-side firms have not yet initiated their response to the regulation and we would recommend that they begin these preparations as soon as possible."

Wotton concluded: "Further, as market participants start to prepare, we urge them to take a more strategic approach to address the SFTR requirements, rather than viewing them as a compliance exercise. In doing so, they will have an opportunity to gain wider advantages such as increased levels of pre-trade matching, reducing trade fails and creating greater collateral efficiencies, which will result in significant benefits such as balance sheet optimisation." **SLT**

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Brexit, clearing and equivalence

A spectre is haunting Europe, the spectre of Brexit. Despite the Bank of England forecasting a severe recession—4.75 to 7.75 percent reduction in GDP—in a no-deal, disorderly Brexit scenario, only two-thirds of firms have a mitigation action plan. As Brexit enters its final act, statements and counter-statements abound.

Predicting the outcome of Brexit is the work of horoscopes but understanding the underlying framework is essential for enacting effective mitigating measures. As the possibility of a no-deal or minimalistic deal Brexit increases, firms must have a clear understanding of the framework that any deal must abide by.

Passporting

The starting point has to be passporting, while in common currency, the term is not fully understood.

As Andrew Bailey, head of the Financial Conduct Authority (FCA), explained: "A passport is a mechanism through which firms may exercise their right to provide services and their right to establishment. With a passport, an entity's authorisation to do business in one EU Member State [...] is recognised by all other member states as an authorisation to do business in their territory as well. As such, a passport obviates the need to obtain separate authorisations from other member states."

It is a common misunderstanding that there is a single passport—there are many. The FCA handles notifications (authorisation) for seven passporting regimes, while the Prudential Regulation Authority (PRA) handles authorisations for two. In total, around 8,000 EU firms use various passports to operate into the UK and approximately 5,500 UK firms utilise passports to operate in the EU.

These include banks, pensions funds, the second Markets in Financial Instruments Directive (MiFID II) investment firms, UCITS, alternative investment funds, trade repositories, authorised reporting mechanisms and clearing houses. After Brexit, all passporting rights will be lost, notwithstanding a proposed temporary regime for certain firms.

Equivalence

The day after the UK leaves the EU, it will be considered a 'third-country'. Equivalence is on a per issue/law basis not a broad sweep designation of an entire country. The statement "the UK has been deemed equivalent" holds no meaning.

The European Commission has stated that equivalence decisions fulfil the following objective: they balance the needs of financial stability and investor protection in the EU with the benefits of maintaining an open and globally integrated EU financial markets; and they are pivotal to promoting global regulatory convergence. Its overarching objective is to oblige "third-country jurisdictions [to] adhere to, implement and enforce rigorously the same high standards of prudential rules as the EU".

In order to be deemed "equivalent" for different aspects, the UK would have to remain very closely aligned to EU laws.

The equivalence regime is unsuitable for the UK because firstly, it is patchy, not covering large aspects of financial services and secondly, equivalence status can be unilaterally withdrawn by the European Commission at short notice, thereby creating permanent business uncertainty. The commission has made clear it will not engage in equivalence discussions at this stage.

Short of a formal cancellation of Brexit—withdrawal of Article 50 notification or effective cancellation (remain in the European Economic Area) some form of equivalence (so-called enhanced equivalence) will be the only realistic solution. This will necessarily mean the UK indefinitely staying aligned to EU law. On this point, Theresa May has my sympathies.

Clearing

The one exception to the UK-EU impasse is clearing. It's not hard to see why £69 trillion-worth of centrally cleared derivative contracts are affected. John Glen, the economic secretary to the UK Treasury said: "The key issues for CCPs are that when the UK leaves the EU, EU CCPs will not be recognised to provide their clearing services to UK firms, and vice versa."

"Secondly, there is legal uncertainty about whether EU clearing members can continue to meet their contractual obligations to UK CCPs. This disruption is particularly acute for EU firms using UK CCPs [...] UK CCPs—principally LCH—clear approximately 90 percent of Euro-denominated interest rate swaps used by Euro area banks. The only industry mitigant available would be to close out or transfer the contracts that EU clearing members have with UK CCPs before March 2019."

Clearly, unwinding trillions of Euros worth of derivative contracts is unfeasible. So, the Bank of England is accepting non-UK CCPs to apply for temporary permission before Brexit, with the EU reciprocating.

Relocate to the EU?

Many EU firms are setting up entities in the UK and vice versa. For example, Regis-TR, the European trade repository, is setting up a UK entity. The European Banking Authority has made clear that token brass-plate shells will not be acceptable—a meaningful presence with infrastructure and staff will be expected. Now we're in 2019, a practical action plan is now critical. Brexit's worst effects can be mitigated, albeit at a significant cost.

Seb Malik
Head of financial law
Market FinReg

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UCITS on the up

Luxembourg continues to record large net inflows into UCITS, and growth is expected to continue this year as more Luxembourg-domiciled funds commence lending programmes for the first time

Maddie Saghir reports

Amidst the busy EU marketplace, Luxembourg holds its own in the niche area of financial services as it remains the largest market for UCITS in Europe. UCITS are synonymous with Luxembourg's financial market, primarily because it was the first EU member state to implement a framework for the highly-regulated fund-type back in 1988.

Back then, the country attracted a large number of promoters from outside the EU who still use Luxembourg as a gateway to the European market. However, there is fierce competition from other European securities lending markets, most notably Ireland and

Germany, who rival Luxembourg in terms of volumes of assets under management.

Discussing the current state of Luxembourg's securities lending market, Joanna Kzsenzova, associate, securities lending finance, treasury and market services, RBC Investor & Treasury Services Luxembourg, says: "We continue to see relatively stable growth in lendable assets, utilisation and returns year-on-year, although the regulatory environment remains increasingly complex."

Kzsenzova adds: "In recent years, providers have spent a considerable effort on automation and efficient integration of lending processes with custody and necessary depository controls."

"However, we are also working proactively with our counterparties to develop new lending strategies and build new relationships. In the current environment, innovation and solutions become real differentiators versus traditional lending."

In terms of the focus of clients, Kzsenzova noted that clients are paying close attention to their programmes, using it as a revenue optimisation strategy, and engaging closely with providers to adapt their programmes to the dynamic environment.

She highlights that it is now more important than ever to have close relationships and an open dialogue with experienced providers who understand the landscape.

As asset management becomes more complex, Kzsenzova notes that "regulatory requirements have an increasing impact on securities lending activity. The continued need for transparency from asset managers and investors all require tailored solutions".

She adds: "There is an increasing demand to have securities lending integrated and connected with custody, fund accounting, trading and other services to minimise involvement from asset managers and have a fully optimised package to ensure that risk and costs are jointly addressed."

Meanwhile, reflecting on 2018, Simon Lee, managing director of Business Development, Europe, the Middle East and Africa (EMEA) and the Asia Pacific, explains: "Over the course of 2018 we saw continued expansion in the number of Luxembourg-domiciled fund structures participating in securities lending programmes."

Driving the growth

Indeed, Luxembourg has experienced a high degree of success and growth in the area of UCITS. By the end of Q2 2017, the largest net inflows into UCITS were recorded in Luxembourg (€70 billion). Luxembourg also recorded the third largest net asset growth of 0.9 percent for the same period.

Additionally, out of twenty registered countries, Luxembourg recorded the largest inflows (€76.1 billion) during the first three quarters of 2018. This was followed by Ireland with €49.5 billion and France €19.7 billion. The figures show that Luxembourg is well ahead of the mark in this area. In Q3 2018, among the major domiciles, Luxembourg once again ranked as the third largest asset growth with 0.9 percent.

Discussing the growth and success that Luxembourg has seen, Chris Chancellor, senior director, EMEA Insights at Broadridge, comments: "Luxembourg remains the largest market for UCITS in Europe with over 40 percent of the UCITS assets in Europe (Broadridge GMI as at October 2018)."

"Despite a tough year for sales flows and markets generally in 2018, Luxembourg has actually moved this share up from 41 percent (December 2017) to 42 percent. Luxembourg UCITS funds gathered €13 billion, this was around half the flows of rival Dublin but Luxembourg remains the leader with almost triple the assets of Dublin."

Luxembourg continues to grow for a variety of reasons, Chancellor explains: "As a pan European distribution hub it attracts managers who have interesting strategies that are often not replicated in local markets while at the same time attracting investors not just from Europe but globally—especially from Asia and Latin America."

He adds: "In 2018, we also saw some Brexit related growth as some groups which were selling UK vehicles across the continent future-proofed their business by creating funds in Luxembourg."

Lee comments: "Similar to other jurisdictions there are a number of factors driving this growth, firstly an increase in passively managed funds, for whom securities lending is often a key component of the funds' investment strategy. Secondly, a downward pressure on investment management fees, which may be offset in part by securities lending revenue, and thirdly rising levels of comfort around securities lending brought on by increased transparency, education, and regulation."

"Luxembourg domiciled lenders continue to utilise a variety of routes to market, including third-party agent programmes, indeed as a third-party lender much of eSecLending's growth this year in Europe has been from Luxembourg domiciled funds."

He continues: "While custody lending continues to play its part for many Luxembourg entities, we are also seeing some of the larger fund management companies bring their securities lending programmes in-house, further signifying the value securities lending can provide as an investment management product."

Kzsenzova cites: "The fact that securities lending requirements defined by the Commission de Surveillance du Secteur Financier (CSSF) are clear to Luxembourg UCITS enables structures to continue to provide liquidity to the market."

She explains that it also benefits asset managers globally, for example, with greater disclosure requirements, which provides comfort to global investors and makes this product broadly acceptable.

"Historically in several markets, investors still remain restrictive to securities lending, but securities lending is being seen more often as an essential element for management companies and the quality and reputation of the lending programme plays an important role", Kzsenzova adds.

Focusing on the future

Focusing on the future, Lee comments: "Looking at this year and beyond we see this growth story continuing as more Luxembourg domiciled funds commence lending programmes for the first time, and established lenders look to enhance performance through programme expansion, be that lending in new markets, broadening collateral schedules, or accessing alternative routes to market."

"As always there will be a focus on regulation over the coming period, particularly surrounding Securities Financing Transactions Regulation and Central Securities Depository Regulation, and of course Brexit will be discussed at length, though accurately predicting how the impact of that shows itself in the securities lending industry is challenging to say the least."

In terms of opportunities and trends that the industry is expected to face, Kzsenzova notes that one of the current trends is increased corporate governance activity and environmental, social and governance focus.

Kzsenzova explains: "RBC Investor & Treasury Services' focus is to balance those requirements and find the most optimal solution for investors' interests with lending and capture benefits from all activities."

"Another trend is the increasing automation of the securities lending market. Cost-efficient lending via automated platforms increases the importance of engagement with clients to deliver value added trades and provide stable returns to beneficial owners." **SLT**

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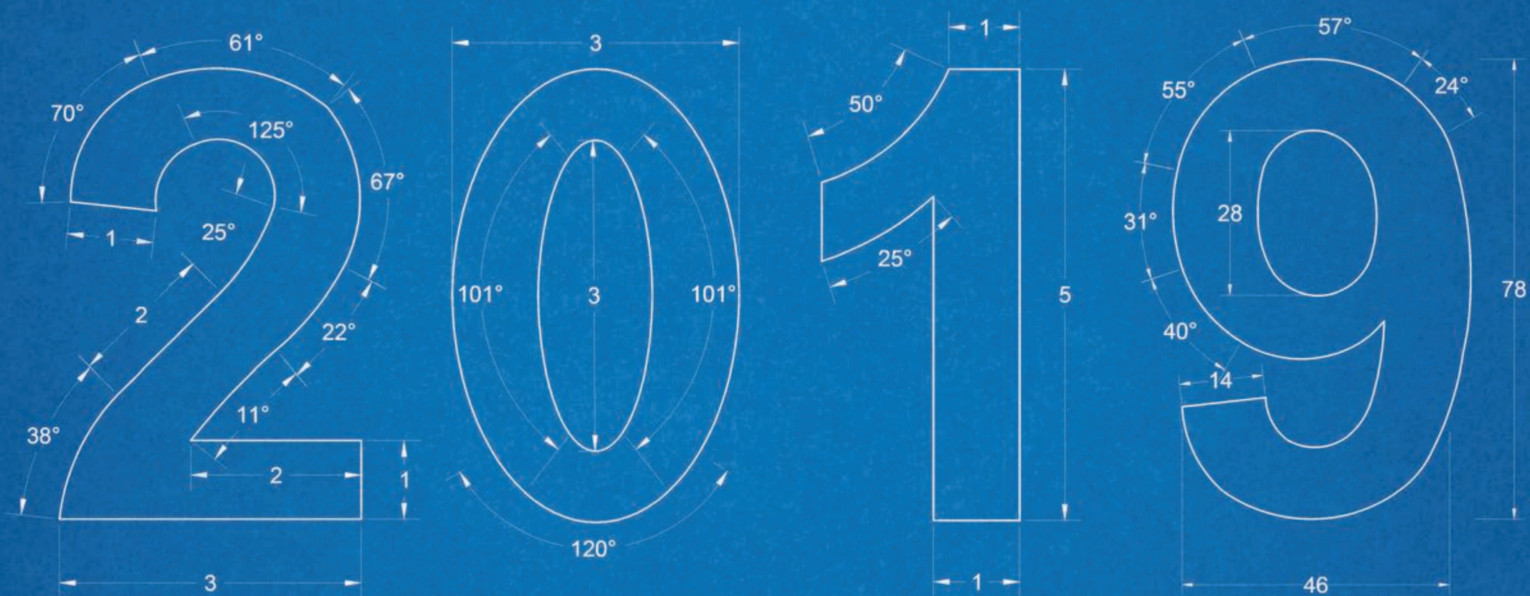


The year of preparation

SFTR will continue to be a hot topic this year as the deadline date draws closer, as well as CSDR and Brexit, meanwhile, a cautious eye should be kept on flows in and out of hedge funds which experienced performance challenges in 2018

Maddie Saghir reports

The hot topics for 2019 include Securities Financing Transactions Regulation (SFTR) preparation, legal challenges around Brexit, Central Securities Depository Regulation (CSDR), macro and geo-political factors leading to market volatility, new entries of participants into securities, as well as challenges around creating innovation.

The securities finance industry kicked off last year with the introduction of the second Markets in Financial Instruments Directive (MiFID II) implementation. The securities lending market was largely ready for MiFID II but perhaps the same cannot be said for the imminent, and most important regulation for the securities finance industry, SFTR. There was much discussion last year on the complexity of SFTR, however, some industry participants have argued that this is in fact a blessing in disguise, which will encourage better practices.

Market participants provide their predictions on hot topics, opportunities and challenges for the year ahead.

What are your predictions for the securities lending market this year? And what do you think the hot topics will be?

Paul Wilson: This year will inevitably be dominated by the build up to the implementation of SFTR in Europe. This regulation is having a fundamental impact on market participants, but it is also a catalyst for change and the way participants think about their business and activities. SFTR is arguably one of the most complex (and technologically difficult) challenges that the industry has faced since the financial crisis, and so it is difficult to see beyond this being anything other than front and centre for all impacted market participants.

> ***This year will inevitably be dominated by the build up to the implementation of SFTR in Europe. This regulation is having a fundamental impact on market participants***
>
> **Paul Wilson**
> Managing director, securities finance
> IHS Markit

This will inevitably lead to drop outs from some lenders where the additional overhead outweighs revenue generation. We think this will lead many participants, especially beneficial owners, to review their lending framework and parameters in order to validate that lending activities are consistent with their investment objectives, and to ensure they are optimising revenue generation. This is considered best practice in any event, but we think especially so this year.

We are hearing a lot of talk and discussion around best execution and transaction cost analysis for securities finance, and while this may have been addressed to some degree with the advent of MiFID II, our sense is that the thought process and approach are continuing to evolve.

> ***Central clearing will continue its onward march and become even more important to the market. Central clearing leads to greater safety and integrity in the financial markets***
>
> **Matthias Graulich**
> Member of the Eurex Clearing executive board

Lastly, it is inevitable that macro and geo-political factors will be dominant this year, which will lead to continued market volatility that creates an uplift in borrow demand. This also translates into the continued positive income generation and profitability from securities finance experienced last year, especially in emerging markets with trade tensions, and also from corporate bonds (partly driven by exchange traded funds creation needs as concerns about the credit markets continues and have been voiced by many senior market participants). A cautious eye should be kept on flows in and out of hedge funds that experienced performance challenges last year.

Matthias Graulich: I believe last years' topics will still be hot. These include everything that drives and impacts the transformation of the securities lending market from a non-standard, bilateral over the counter model towards a more progressive and sustainable operating model.

All items shaping the market globally this year will be centred around the four key areas: legal, legislation, regulatory, as well as infrastructure and technology. More precisely, collateral optimisation, the legal challenges surrounding Brexit, the introduction of central securities depository and SFTR as well as the demand for the enhanced use of technology solutions across the entire securities lending process.

Furthermore, central clearing will continue its onward march and become even more important to the market. Central clearing leads to greater safety and integrity in the financial markets. As safety and integrity are also objectives that buy-side and sell-side market participants have in common, I think demand for the Lending Central Counterparty (CCP) service of Eurex Clearing will also continue.

The challenge is to bring committed participants together to identify and form the next steps towards building an improved securities lending market

Marcel Naas
Head of product design, funding and financing
Eurex

Mark Steadman: We will see the securities lending market spend this year ramping up preparations for SFTR implementation. A significant number of industry participants have already started to mobilise efforts by addressing the regulation's data requirements, which are far more demanding than firms have previously experienced. As such, this year we will see firms continuing to examine their workflows to ascertain how that data will be obtained and sourced, if not already available, in order to comply with the reporting mandate.

Walter Kraushaar: Continuing a trend which can be followed already since 2017, there will be an increased return and new entries of participants into the securities lending market.

This upsurge in interest in lending may be driven by a more passive asset management, where an add on of a lending programme will provide significant bottom line alpha to the fund performance without a parallel increase of inherent market risks.

At the same time, digitalisation helps even smaller asset managers, banks, beneficial owners and other lenders to build a robust infrastructure for their business at a cost which guarantees a decent profitability of their securities finance activities even in a low margin environment.

SFTR's data reporting requirements are more stringent than previous mandates and firms will need to report significantly more data than they have done in the past

Mark Steadman
Executive director, European head of product development and change management for global trade repository
DTCC

Flexible digital IT platform strategies with high connectivity to other competing systems are key to support this trend, and guarantee a true low cost straight through processing and trade matching between all market participants and market service providers (for example, CCPs, tri-party agents).

In terms of products, the trend away from event driven lending activities towards general financing transactions in high-quality liquid assets (HQLA) securities will continue. There is also a clear shift towards term transactions such as 'evergreen' and 'pledge' structures for balance sheet and liquidity management purposes as well as collateral upgrades in every market.

A special market situation is about to occur in Spain, where—after a decade of debate—a law change is on the way to allow Spanish mutual and pension funds to conduct securities lending transactions other than for short cover purposes only. This will create a significant amount of supply of mainly European assets available for securities lending.

Finally, the upcoming of Brexit will move business in general away from London into various continental European financial hubs such as Frankfurt, Paris and Amsterdam.

What are the main challenges and opportunities for the year ahead?

Marcel Naas: The challenge is to bring committed participants together to identify and form the next steps towards building an improved securities lending market. At the end of last year, Eurex Clearing initiated a lending CCP think tank group to encourage dialogue, strategy and initiatives to drive the delivery of a new phase of market access for securities lending with the aim of shaping the growth of Lending CCP utilisation.

A key focus for this year will be to continue our collaboration with clients to bring innovation to the market. At Eurex Clearing, we believe that our clients and key market players are fundamental to drive the growth and transformation of central clearing for the securities lending market.

As far as the Lending CCP is concerned, Eurex Clearing looks forward to maintaining its role as a leading market infrastructure provider and partner to our clients. The Lending CCP signed up a number of major buy-side clients and agent lenders last year. This year we will have the opportunity to extend the range of clients, markets, and assets into our offering. As a result, we expect the daily average on-loan volume to steadily increase over the next year for both equity and fixed income segments.

Steadman: SFTR's data reporting requirements are more stringent than previous mandates and firms will need to report significantly more data than they have done in the past. In addition, inter-trade repository

reconciliation will present a challenge for market participants this year as it did under European Markets Infrastructure Regulation (EMIR). To overcome this, firms should prioritise the four fields required to pair a trade: unique trade identifiers (UTIs), reporting counterparty, other counterparty and master agreement type. Ensuring consistency will at a minimum allow matching to take place.

While a large number of firms are already putting preparations in place, many others, such as tier two banks and buy-side firms, have adopted a 'wait and see' approach to the regulation to gain clarity on the technical standards which have only just been published, however delaying preparations will create challenges in achieving compliance.

If SFTR preparations are approached correctly, the regulation will deliver multiple benefits such as data transparency which, in turn, will result in more accurate pricing, as well as contributing to the creation of greater transparency in the global financial system overall and the mitigation of systemic risk.

Kraushaar: Combined with the immense infrastructural efforts which have to be made by those market participants which will be affected by Brexit, the main challenges this year will most probably not be driven by market events but by significant (IT-) infrastructural challenges caused by those events and regulatory requirements. However, the mentioned challenges are a great opportunity at the same time as they push all market participants towards market transparency and to radically rethink their business strategy. This provides a big opportunity to upgrade and/or change the current aging IT infrastructure into modern digital platform technology, which will allow tailor-made solutions for every market participant at a significant lower cost basis. It will also help especially smaller and more specialised market participants to enter or re-enter the securities lending markets.

James Moroney: The industry challenges this year will be similar to the challenges faced in last year, however, we anticipate the market will yield an improved environment for generating revenue through lending securities. Market participants will need to focus on collateral transformation and regulatory compliance, which will once again drain resources. Last year these hurdles, along with low volatility and steady upward trending equity markets, contributed to annual returns that were well-below historic averages for asset owners.

Hard to borrow securities, as a percentage of overall on-loan securities in the marketplace, has steadily declined over the last 12 months as short-side participants appeared to throw in the towel and ride the 'long wave'. Tax harmonisation also muted securities lending performance last year and we expect it will continue to have an impact on the market this year. Poland, Belgium and possibly France are markets that are considering tax changes that could have similar outcomes to the rule changes seen in Germany early last year.

If asset owners are willing to broaden their acceptable collateral sets, they should continue to maintain as well as grow their slice of market share in securities lending. However, for lenders not able to accept alternative collateral types (for example, main index equities), they could see a continued deterioration in both market share and lending revenue. Market demand for many borrowers is shifting from USD cash collateral to non-cash collateral, and we anticipate this trend will especially be pronounced for general collateral loans going forward.

Optimistically, the markets are setting up for sustained volatility and wildly fluctuating equity market values. Trade wars, Brexit, credit pressures and other global macro uncertainties are beginning to build a 'base' in Q4 that could lead to more two-way risk in the markets for this year.

We are starting to see green shoots that could be indicative of better days ahead for short players and thus securities lenders. Initial public offerings are again trading special for many weeks at a time and single name shorting and borrowing is beginning to pick up around the globe. Similarly, mergers and acquisitions arbitrage has been more active of late, which gives further hope to lenders looking for a shift in momentum next year.

Lastly, there are also significant opportunities for lenders looking to expand lending into emerging markets such as Taiwan, South Korea and Russia, as well as anticipated new lending markets, such as the Philippines, which is poised to open for lending late in 2019. **SLT**

> ***The main challenges this year will most probably not be driven by market events but by significant (IT-) infrastructural challenges caused by those regulatory requirements***
>
> **Walter Kraushaar**
> Head of advisory services, Frankfurt
> Comyno

> ***Market participants will need to focus on collateral transformation and regulatory compliance, which will once again drain resources***
>
> **James Moroney**
> Managing director, head of global equities and corporate bonds trading
> eSecLending

Reaping the benefits

Matthias Graulich and Frank Gast discuss the success of Eurex's Partnership Program and the reasons behind the expansion into the repo segment

Becky Butcher reports

What is the aim of the Eurex Partnership Programme?

Matthias Graulich: The aim of the partnership programme is to establish a true partnership with major market participants by aligning interests and achieving certain objectives. As a market infrastructure provider, we can come up with a new product or a new service but we always need the market participants to support the roll-out and, ultimately, the adoption of these products and services. That is why we decided to go ahead with the programme, we want to develop our provider/client relationship into a partnership and reward those who contribute most to making our projects a success.

The reward has two elements: one is economic, and the other is governance as we now include the best-performing partners into the governance of Eurex Clearing. You could also call this setup "virtual equity" as it has both an economic and a governance element.

What were your motivations behind the extension to cover repo and OTC foreign exchange segments?

Graulich: We started off with over-the-counter (OTC) interest rates derivatives in October 2017 and this was the start of the partnership programme. We always had plans within the initial programme terms for the partnership programme to expand. We started the programme with one product group, as we wanted to test the water and see whether the programme would be successful and would receive support within the major market participants, which was successful. Then we had to find the right timing from a business and product perspective. We felt that the right timing is now—there is dynamic in the market, for example, Brexit is triggering some thoughts around moving the Euro-denominated repo business from London to the continent for a number of reasons like regulatory uncertainty, TARGET2-Securities and netting efficiencies.

Why is the repo market an important element of the partnership programme?

Frank Gast: Currently, we have a very broad client base for both trading and clearing repos with about 140 banks and a number of buy-side firms, who are all connected to Eurex Clearing and Eurex Repo. There are two strategic elements and objectives within the partnership programme for repo. One is focused on the interbank repo market for government bond of general collateral and specials where a very significant portion is currently cleared in London. The other is to build up a cleared repo service for the dealer-to-client business, which today is not cleared to any significant degree. But this is a huge market where people are faced with balance sheet constraints. Bringing this business onto a central counterparty (CCP) has significant benefits

but it is also a challenge to get buy-side firms like pension funds and asset managers directly connected to a CCP where we need the support of clearing brokers and the major dealers in order to facilitate access and provide a solution.

There is also a link between the OTC interest rate derivative (IRD) and the repo programme. The debate in Brussels about bringing pension funds into central clearing for interest rate swaps is still ongoing; so far they have been exempted. In case there is a steep increase in interest rates they are faced with a significant cash requirement to fund variation margin. The question then would be where to source this cash in a relatively short period of time? And here, the solution is the cleared repo market because in the past it has proven that it is very robust in stress and crisis situations; it even has seen liquidity increases in contrast to non-cleared repo, where you could see in certain scenarios an immediate drying up of liquidity.

Since the expansion announcement, what kind of interest have you seen? And are you happy with the interest you have seen? What is your expectation until the programme effectively starts in February 2019?

Graulich: We got a lot of support from the market, with a total of 25 participants and key players in the market who have signed up in the early registration phase. We had a sign-up phase for early registration where you benefit from being an early mover. The 25 participants are from across Europe, with seven or eight countries covered. We are very happy with the number that have signed up in the first month and see this as a very good start to the programme.

We are convinced that we will reach a similar level to the OTC partnership programme, where we currently have 34 participants. We see a significant overlap in both programmes. It was a successful start and the next step will be to generate volume within the early volume phase, which started at the beginning of December and which will hopefully kick-start a volume increase similar to the developments in the OTC IRD programme.

What are the benefits of market participants joining the programme?

Graulich: By participating in the programme, you have the opportunity to get a revenue share and be part of Eurex. If you registered early, you can boost your performance throughout the next year by an additional multiplier 0.25. The performance measurement concept consists of two factors, one is a volume dimension, so the more volume you put through Eurex on the trading and clearing layer the better your performance is. You can enhance the volume performance through a multiplier, meaning you can triple your volume performance by fulfilling certain conditions like early registration, early volumes or supporting our dealer-to-client access models for repo.

We do the monthly performance-based revenue sharing for a period of four years. After year four, we look back at the average performance over this period and fix the revenue shares into perpetuity. Therefore, if someone did a great job during those four years, they will benefit from this indefinitely in the future.

Gast: There is another benefit, one that is very important: balance sheet netting. In the context of T2S and the positioning of Eurex and Clearstream, our clients will benefit from increased balance sheet netting opportunities. Within T2S, customers will be able to centralise the settlement of their entire Euro repo activity against central bank money. For centrally cleared repos we will connect the liquidity-driven general collateral pooling market with the securities driven special/general collateral market and additional balance sheet netting can be achieved.

Do you have any plans to further expand the partnership programme into other segments?

Graulich: Repo has been rolled out now. We have announced to include the OTC FX business. Further products may be added this year, but it is too early to be more concrete.

Right now, we want to make the repo expansion a success and you can't do it all at once. What we currently have on the radar is already significant and OTC IRD is still at an early stage and requires a lot of attention, dedication, and focus. **SLT**

Matthias Graulich
Member of the executive board, Eurex Clearing

Frank Gast
Head of sales Continental Europe, fixed income derivatives, funding and financing, Eurex Repo

Technology takeover

Jerry Friedhoff, managing director of securities finance and collateral management of Broadridge, talks regulatory changes and emerging technologies

What regulatory changes are currently impacting the industry?

The Securities Financing Transactions Regulation (SFTR) is currently high up on priority lists, along with Central Securities Depositories Regulation (CSDR) and Brexit in Europe. We also expect to see additional securities finance trade reporting mandates in other regions once SFTR is behind us. In the US, Regulation Rule SHO204 is a real concern that many brokers are seeking to address.

A recent International Securities Lending Association (ISLA) market report suggests that high-quality liquid assets (HQLA) driven trades remain prevalent due to liquidity coverage ratio needs and the slowing of quantitative easing (QE). As more firms fall under the uncleared margin rules in 2020, the role of securities finance in sourcing larger quantities of high-quality collateral should also become more prominent. The International Swaps and Derivatives Association (ISDA) is currently lobbying to reduce the number of firms that will need to exchange bilateral initial margin. The amount of additional collateral required could, therefore, vary widely if this is successful.

In the repo markets, firms are evaluating their front-office trading tools to manage the complexity of increasing electronic trading and fragmented liquidity. This is linked to a broader role for repo in managing balance sheet, liquidity and capital, along with centralising the sources and uses of collateral across financing and margin-based activities.

Are you seeing new or different types of market participants, services and routes to market emerging in the industry?

On the buy side, more beneficial owners are recognising the benefits of securities finance. We are seeing a trend for some of the more active participants to consider lending directly and in some cases, setting up in-house stock loan and repo desks.

This is largely driven by a growing awareness of the alpha generation opportunities provided by financing their assets. A desire for greater control over collateral and the value of central collateral desks is also a key factor for the buy side, as firms look at how to adapt to central clearing of derivatives and uncleared margin reform.

We are also seeing new sources of supply coming to market through clients engaging in fully paid lending in North America to unlock retail inventory in brokerage accounts. Likewise, in Europe, the provision of lending services to a wider market of investors is a trend to watch. More firms are seeking to add new revenue streams to their securities lending activities by reaching further into their relationships with retail/institutional clients and the assets they control.

How will new technologies affect the industry?

The impact of disruptive technologies such as blockchain and artificial intelligence (AI) is a topic for discussion at every industry conference right now. There is a growing understanding of these technologies in the market and various pilots, use cases and production ready systems are also emerging. However, we have not yet reached a tipping point in terms of widespread adoption. Electronic peer to peer/ all to all markets and, in some cases based on blockchain platforms, are another area where innovation in market structure and technology is taking place.

There is a more general trend for firms to look at ways to reduce their IT costs. They're evaluating existing technology stacks and replacing ageing legacy solutions with a more modern front to back single system approach. This allows them to meet the new demands of the market environment while lowering total cost of ownership. This includes an increasing preference for vendor-hosted solutions as cloud and software as a service (SaaS) models become more widely accepted.

How are you helping clients adapt to regulatory trends?

The acquisition of 4sight and Anetics in 2016 has greatly enhanced Broadridge's global front to back securities lending, repo and collateral solutions and increased our ability to help clients adapt to the changing environment.

Firstly, in Europe, we are working closely with customers to help them prepare for SFTR. Broadridge has in-depth expertise in both securities finance and trade reporting regimes such as European Market Infrastructure Regulation (EMIR), the first and second Markets in Financial Instruments Directive (MiFID I/II), and the US Commodity Futures Trading Commission (CFTC). This will enable clients to adapt to SFTR smoothly while minimising operational disruption and reducing the resource impact of complying with multiple concurrent reporting mandates.

From a CSDR perspective, helping clients to minimise the impact of settlement fails and mandatory buy-ins through the use of technology is also a key priority for Broadridge.

In terms of the buy side, we recently implemented our front to back office securities lending solution at both a large European investment manager and a sovereign wealth fund that both set up internal lending desks. We are seeing interest in this model from others, although it is not for everyone. Many beneficial owners continue to place a high value on the services provided by their lending agents and the indemnification they receive.

In the US, a large broker-dealer went live with our RegSHO 204 solution last month. This resulted in reduced regulatory risk and significantly less manual effort required to maintain RegSHO 204 compliance for the client.

In the repo space, we are seeing an uptake in our repo order quote market aggregation and execution solution. One of Europe's top 15 largest banks recently went live with the product, and more are in the pipeline as firms seek to maximise trading opportunities and make sense of increasingly complex data with the latest trading tools.

What's next for Broadridge in terms of emerging technologies such as blockchain and AI?

Broadridge has been actively investing in emerging technologies. We recently conducted a blockchain pilot with Natixis and Societe Generale to transact bilateral repo and found the solution resulted in several operational efficiencies and a more streamlined process. In the securities finance industry, there is still widespread debate over the benefits of blockchain versus the current market infrastructure and there are pros and cons to either side of the argument. While there are a number of hurdles that must be overcome, we expect to see more blockchain-based platforms appear over time.

With regards to AI, there are myriad use cases for these technologies such as trading automation and decision support, collateral optimisation and streamlining back-office processes. We believe AI has the potential to greatly benefit the industry and our clients in the long term. We are therefore actively investing in AI, including machine learning (ML) and robotic process automation (RPA) to assess where we can combine ML and RPA to drive benefits for our clients.

All of this means it is an exciting time for the industry. While we may not see a radical change in the next two years, in 10 years' time the market and technology landscape could look surprisingly different than what it looks like today.

In 2008, Google started its self-driving car project and the iPhone had recently launched. By 2018, Google's self-driving cars have clocked over two million miles and are being tested on the streets of major cities across the US and there are around two and a half billion smartphone users globally. Perhaps we will see similar leaps forward in the securities finance industry. **SLT**

Machine learning in equity markets

Stephanie Lo and Jian Wu of State Street discuss the intersection of machine learning applications and equity markets in portfolio management, exploring the potential market segmentation that will arise

Artificial intelligence (AI) and machine learning (ML) are poised to change the way financial institutions operate. Yet the transformation will not impact all market players equally. In this piece, we examine the intersection of ML applications and equity markets in portfolio management and explore the potential market segmentation that will arise due to different adoption strategies of ML driven by each players' mandates and goals.

The potential use cases for ML in portfolio management are broad, and in our view, likely segmented across different types of portfolio managers, with some representative considerations shown in figure one.

Factors driving resistance to machine learning in institutional investors

For most institutional investors, ML may be used in the research stages of portfolio construction, but are unlikely to enter the decision-making function. This is driven by several factors:

- **Transparency:** Industry surveys have found that respondents view communication/transparency as one of the top considerations for hedge fund allocation decisions.
- **Overfitting:** With fast-changing financial markets, overfitting is often a concern, particularly for investors that do not develop the underlying models themselves.
- **Lack of historical data:** An estimated 90 percent of data in existence today—much of it alternative data—was created in the past two years; without crisis-relevant data, ML might not behave in a suitable way if another Great Recession were to happen. Indeed, many researchers cannot wait for full validation, as it could require decades of data to develop confidence that an algorithm is robust in a statistical sense. Several factors, such as regime shifts, higher-order interactions, and changing sources of data mean that there can be a leap of faith for researchers leveraging these methods.
- **Algorithm aversion:** People tend to prefer human forecasters over statistical algorithms, and more quickly lose confidence in algorithms than human forecasters after seeing them make the same mistake. Interestingly, giving individuals some control of the algorithm's forecasts—even if extremely restricted—helps people overcome this "algorithm aversion".
- **Mismatch of talent and needs:** As quantitative methods have evolved quickly, many institutional investors may not have the necessary talent in-house to build or maintain ML models.

Case study

State Street Global Advisors has introduced three exchange-traded funds (ETFs) built with proprietary index methodologies developed by Kensho Technologies. The ETFs track companies that provide AI-relevant products and services; natural language processing (NLP)

Figure one: Potential use case of machine learning equity inputs/factors, by group

Group	Primary driver	Potential use case
Quant/systematic hedge funds	Reach for alpha	Develop ML-driven factors that drive systematic long-short strategies
Fundamental/discretionary hedge funds	Process new and alternative large datasets	Use ML algorithms to process novel data to enhance company-relevant metrics and contribute to earnings predictions
Institutional investor (pension, endowment)	Transparency and simplicity	Use ML to guide backtesting and portfolio construction, e.g. use of shrinkage methods such as LASSO to guide the choice of input variables in regression models

is used to parse through regulatory filings to understand company exposure to AI technologies.

Matthew Bartolini, head of SPDR Americas research at State Street Global Advisors, said: "The indices are constructed themselves using the very advanced technologies that the ETFs are trying to invest in."

He added: "The ETFs are built around the fact that algorithms can dissect information in a very systematic way, processing data in 45 seconds that would take a human a full day to understand. In this case, AI is doing exactly what an investor would expect an intelligent human would do—while being highly efficient."

Opportunities in ML for quant-driven hedge funds

Equities-focused hedge fund usage of ML has been substantial. One estimate is that pure ML players have about $10 billion in assets under management; this number would not include "commingled" strategies, in which ML methods are used to inform trades but there is still some discretion involved. Some drivers include:

- **Increased hedge fund investor comfort with algorithms:** Multiple quant funds use AI-based models. For some of these funds, assets have grown rapidly as investors have flocked to algorithmic traders.
- **High barriers to entry:** Many asset managers are not willing to enter the ML space, posing an opportunity for those willing to make the investment. Multiple industry surveys have found that the toughest obstacles that financial executives see in introducing ML technology are the cost of systems and adoption, shortage of relevant specialised skills, and senior management buy-in. State Street's head of trading and algorithmic strategies, Nick Delikaris said: "There are still a lot of barriers to the adoption of ML and other newer quantitative methods, including lack of transparency, expensive hardware and data needs, and the shortage of talent. Those willing to make the investment may benefit from opportunities others are not seeing from more conventional techniques."

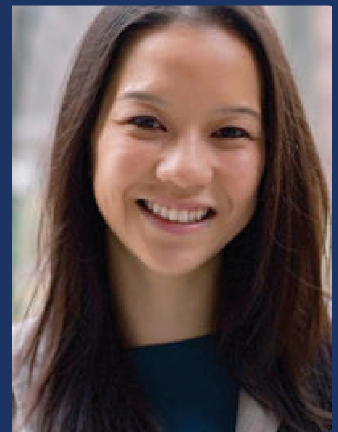
Outlook for ML in beyond equities

In this piece, we have focused on ML in equity markets. While equity managers have taken some time to embrace ML technologies, it appears that interest is nearing the steep part of the curve, with usage expanding fairly rapidly. Looking at other parts of finance, we see multiple opportunities for ML:

- **Research:** Rajeev Bhargava, head of investor behaviour research at State Street Associates, noted the growth in alternative data and ML in the financial research space. Bhargava explained: "There has been a massive increase in interest in leveraging alt data in financial research. Driven by this interest and increased computing power, alternative data will become increasingly accessible to the masses."
- **Treasuries:** Despite the fairly mature nature of the market, there may be room for investors to leverage ML to shape their trading strategies. For example, some studies have found that off-the-shelf ML programmes were a value-add in predictive 10-year treasuries strategies, which is pretty significant given that market is mature and most gains are viewed to have been arbitraged away.
- **Corporate debt:** Unlike in equity trading, where electronic trading is nearly universal, most corporate debt transactions are still carried out via phone or messaging. There have been some steps toward trying algorithmic trading in corporate debt, with UBS testing a computer programme to price and trade bonds as of early last year. ING has also taken a step toward adopting ML, with its adoption of AI-driven bond trading tool Katana. Going forward, we anticipate that ML will be increasingly adopted in the corporate bond space as the entire space moves toward increased implementation of electronic trading.

As with all new technologies, the adoption curve for ML may be steep. As storage becomes cheaper, calculations become faster (for example, via graphics processing units, field programmable gate arrays, quantum computing, and so on), and data sources become increasingly diverse—and as ML becomes part of a standard academic curriculum—we anticipate that ML will become more commonplace in financial analysis. We are already starting to see more widespread adoption of ML in equity trading, and anticipate other financial markets—such as corporate bonds and treasuries—to follow. Until that future state, early adopters may benefit from the lack of widespread adoption to find alpha in differentiated strategies. SLT

Click here for more research into machine learning in equity markets.



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Back to the future and beyond

Michael Huertas of Dentons discusses the uncertainty and challenges around Brexit

Looking back in time, 1986 was not only a remarkable a year for an evolving European securities lending market but also for Great Britain as the UK leader on European integration. Skip forward 30 years to 2016, and the Brexit referendum started what has for some time now been the UK's rather difficult journey of leaving the European Union. Almost 1,000 days since that referendum and with less than 100 days until exit date, time is rather tight.

What's ahead?

As the EU faces a tough year of Brexit challenges, it also faces a shift in the EU political executive and supervisory policymakers. A new first-time Romanian presidency of the Consilium, representing the helm of EU executive governments, took up its role on 1 January 2019 and will contribute to the debate on deciding on Brexit. A new set of members of the European Parliament will be voted in following the May EU Parliamentary elections, and a new European Commission will guide financial services regulatory policy as well as a possible Capital Markets Union 2.0 reboot and finalisation of Banking Union, Pillar III.

That sense of change is also being at the level of EU financial services supervisory authorities, who started the year by strengthening calls for greater supervisory convergence in the EU27. As the UK begins to diverge, greater powers for the ECB and the European Supervisory Authorities (ESAs) will focus on the conduct of business supervision and on-site inspection as well as greater and direct oversight in respect of financial services firms as well as market infrastructure providers.

Moreover, many non-bank financial services providers undertaking 'bank-like activity' may find they are under greater scrutiny as shadow banking and increased reporting is back on the agenda.

Reporting is likely to be a familiar topic for most firms affected by the Securities Financing Transactions Regulation (SFTR), which itself has been partly delayed by Brexit. This is partly due to technical discussions on revisions to European Market Infrastructure Regulation (EMIR). The European Commission has now set out the final seven commission delegated regulations, which include clarity around regulatory reporting start dates and clearer timelines so firms can focus on other forward-proofing of arrangements as phased reporting obligations come in place.

For many, that has also meant picking up the pace on Brexit-proofing legal entity structures as well as documentation. This trend is likely to continue, not only due to supervisory pressure from the European Central Bank (ECB) and the ESAs, who each published further updates to prescriptive Supervisory Principles on Relocations (SPoRs), but also because the securities lending market, not having fully found a consensus on whether the bulk of pre-crisis documented financial transactions need to be repapered and how to document new post-Brexit transactions on the first day of trading and notably from where.

While there is talk of the ESAs and/or the ECB potentially getting powers to issue no-action relief letters or similar measures, the mood is—as with SFTR-compliance—that firms need to prepare and work towards compliance by a specific date that is set by the supervisor and do so in a manner that meets the SPoRs.

Any equivalence measures granted to permit access from the UK's new status as a third-country are very much conditional and can be withdrawn.

Work still to be done

An area where further action is required is still around contractual continuity for existing contracts as well as the documentation terms for future financial market transactions—and thus securities financing transactions. The term 'contractual continuity' in itself encompasses many concepts as well as concerns under one hat. Chief among them is the risk that, post-Brexit contracts, and obligations thereunder, will not be able to be performed or disputes enforced without amendment to existing terms or documentation architecture. Some of that may be alleviated by moving contracts to the new and expanded EU27 legal entities from contractual counterparties historically in the UK or other third-countries, but other issues also present themselves in need of a solution.

On the assumption that existing contracts will not benefit from grandfathering, there is no panacea to contractual continuity and the resulting repapering that would be needed to move potentially multiple millions of terms and conditions. Concerns remain of how to deal with optionality that exists in various master agreements across asset classes and transaction types. Add to that the bespoke nature of bilateral contracts, cross-default provisions and the paper headache becomes clearly in need of operational heavy-lifting. Solutions may start with a document/risk exposure analysis, involve novation or other permitted means of transfers but will require perhaps greater and more frequent inter-institutional cooperation amongst market participants and dialogue with supervisors.

Securities lending documentation is certainly not spared. While the International Swaps and Derivatives Association (ISDA) has moved ahead of other industry associations to publish updated guides on model clauses in arbitration and new master agreements that are subject to governing law of an EU Member State and/or enforcement in the EU27 Member States, some association are yet to respond. The absence from standardisation is worrying as firms may come up with their own solutions, some of which may not be interoperable across the market or suitable for existing arrangements. Existing documentation also needs to be revised to see if it suits firms' new post-Brexit operating

models, the SPoRs or other supervisory expectations and priorities of the relevant EU27 authorities. EU-level and national supervisors can easily police compliance by reference to existing as well as new post-Brexit contractual documentation on top of policies and procedures.

All of this has a potential impact on liquidity as well as pricing during what many predict, including the International Securities Lending Association, to be markets of ongoing heightened volatility. This may not cause a repeat of the 1968 Paper Crisis, but settlement failure or digital deadlock is a concern and there is no indication how market supervisors might or even would coordinate (temporary) market suspensions or trading restriction. The ECB has already announced that 2019 will be a year of increased on-site inspections, market-wide liquidity stress tests, a deep dive focus on liquidity models and generally testing of the resilience of market-based financing channels as well as the quality of collateral arrangements.

ISDA has exercised first-mover advantage in ensuring that the new French and Irish Master Agreements work without completely overhauling a sound and trusted architecture. The agreements also work on the premise of collateral being located in the EU27 and interoperable with legally robust and enforceable security interests. The association has communicated standardised concepts for designated replacement entities and other fallbacks. In terms of immediate pressures, beyond what may sound like a broken record to some, many firms need to do more and do so quickly. Repapering exercises take time and even longer without appropriate legal and operational support. If industry associations are silent or not leading on certain issues then repapering also needs extensive coordination with peers beyond wider contractual counterparties.

The only constant certainty is uncertainty

SFTR compliance, Capital Requirements Directive V/Capital Requirements Regulation and a range of International Financial Reporting Standards are on the agenda for most EU financial services. Other more recent reforms such as the second Markets in Financial Instruments Directive/Markets in Financial Instruments Regulation, the Benchmark Regulation, as well as the Short Selling Regulation, are all in supervisors sights.

What is more, 2019 might mark 30 years since the fall of Communism in Eastern Europe and 20 years since the introduction of the Euro, but Brexit's culmination has been a further catalyst. It has united the EU27 while dividing Britain. What this could mean is that within the EU27 the amount of goodwill for Whitehall's warring factions is growing ever less regardless of who might be in Number 10.

So too is the likelihood of the EU providing the UK with further assurances or interpretations of the current withdrawal agreement, which the EU has already approved, let alone an indication on the future state of financial services deal, which can only be discussed if Westminster approves the withdrawal agreement. If you thought the negotiations till now have been tough, any discussion on the future financial services deal could be a whole lot tougher and certainly different—why would the EU need to do a deal if larger businesses (including those from outside of the UK) are already moving of have plans to move?

Furthermore, if the UK does somehow decide to stop the clock on the 29 March's exit date and/or go a step further and withdraw the Article 50 Notice and, thus, somehow stay, then all the spent efforts and extended assistance from the EU27 to the UK may still pose a problem. This could be met with a renegotiation of some legacy terms that Thatcher secured in the early 1980s, including the cash-back rebate.

Irrespective of whether Brexit does eventually materialise into what some hope is a Big Bang two for a global island nation. In the meantime, all of this presents the potential for even greater uncertainty, especially as the EU could have a very different parliament and commission in place during this year. **SLT**

"All of this presents the potential for even greater uncertainty, especially as the EU could have a very different parliament and commission in place during this year

Michael Huertas
Partner
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EU equities underperform in Q4

Sam Pierson of IHS Markit explains that the revenue picture for EU assets is less upbeat than expected, however, there have been some pockets of opportunity

With EU equity returns suffering in Q4 last year it is surprising to see no rebound in lending revenue. The $377 million in revenue is the lowest for EU equities in Q4 since 2013.

While the market declines partly explain the lower balances, the percentage of total market cap on loan relating to short sales has declined by four basis points in Q4, meaning that short balances fell more in absolute terms than the overall market. Despite these positive returns for short sellers, demand has been limited, following on a trend from earlier this year.

While overall revenues have dipped, there have been some opportunities to achieve returns by lending out stocks in demand by short sellers. For example, Sweden saw a $20 million revenue uptick in Q4, with three stocks contributing 58 percent of the $63.4 million in revenue. Those three stocks were Intrum, Mycronic and H&M.

The special rates for the first two drove the increase in the country's Q4 weighted average borrow fee to 1.5 percent, up from 0.9 percent in Q3. The increase in fees pushed up revenues, making Sweden the second most revenue generating EU equity market, leapfrogging over the UK and Germany.

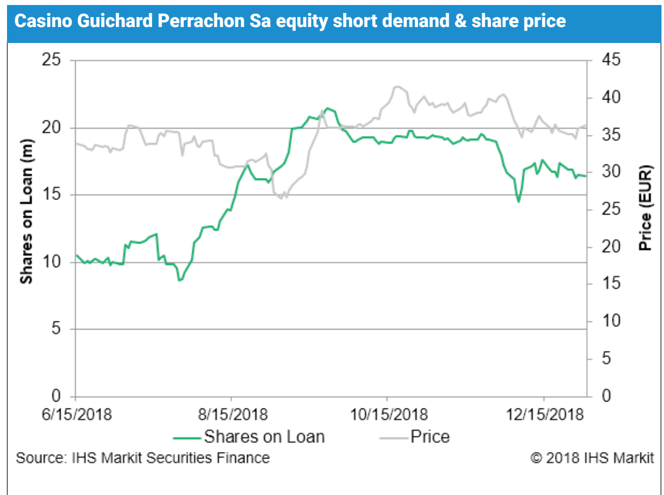
France was the most revenue generating EU country with $90.6 million in Q4 revenues, an increase of 11 percent compared with Q4 2017. The

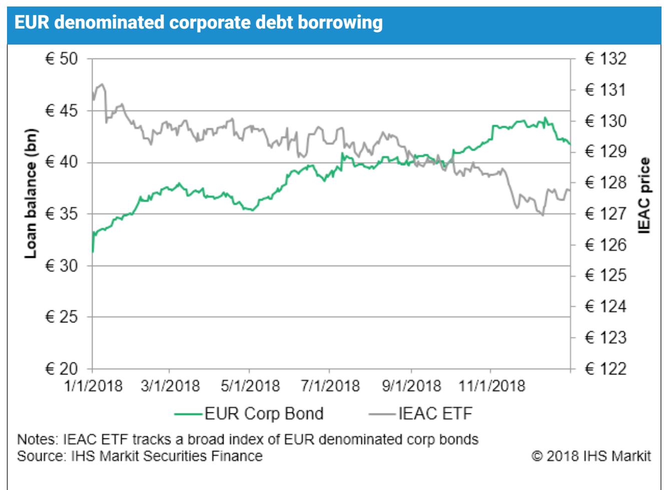
revenue uptick was aided by special lending fees for Casino Guichard Perrrachon (and parent company Rallye), along with Vallourec and Bourbon Corporation.

UK equities turned in a lacklustre Q4, with $47 million in lending revenues, the least since Q1 2017. Declining fees drove down returns, with balances slightly higher in Q4 versus Q3. The most revenue generating UK equity, IQE, saw surging lending fees in Q4, which appeared to dampen demand from short sellers, despite the 24.9 percent decline in share price during the quarter.

While equity shorts haven't maintained exposure to EU issuers, credit shorts actively increased borrowing of EUR denominated corporate bonds. The total EUR denominated corporate issues on loan at the end of 2018, €41.7 billion reflects an increase of 3.6 percent in Q4. The IEAC exchange-traded fund which tracks an index of EUR denominated corporate debt declined in value by 0.7 percent in H2. Taken together, the implication is increasing short positioning, which was sufficient to more than offset the decline in market value.

The revenue picture for EU assets is less upbeat than one might hope as an offset to market declines, however, there have been some pockets of opportunity which lenders have seized on. The 9 percent decline in balances in 2018 is less than the 19 percent decline in EU equity share prices, suggesting that while shorts didn't add enough to positions to offset market declines, they did increase some positions. Whether equity short sellers will increase bets on a further market decline, and potentially allocate short exposure from emerging markets (which reached a post-crisis peak in June 2018) to the EU, remains to be seen. **SLT**





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Director of securities finance
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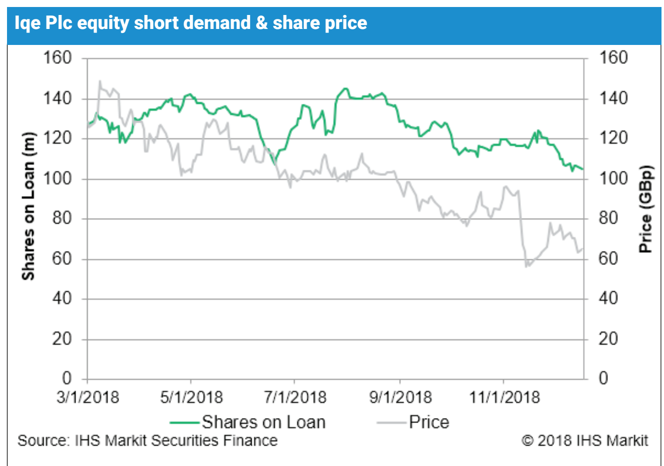

Comings and goings at Digital Asset, Caceis, OCC and more

Digital Asset CEO Blythe Masters has requested to step down for personal reasons.

AG Gangadhar, who joined the company's board of directors in April, has been appointed the board chairman and will serve as acting CEO until a permanent CEO is named.

Masters, who has served in the role since 2015, will remain involved in the company as a board member, strategic adviser and shareholder.

Masters commented: "Digital Asset has evolved from an ambitious idea to a truly global software engineering firm. We are fortunate to have a deep bench of accomplished executives on the management team and board, including Gangadhar, who have the requisite experience to take the company to the next level."

Gangadhar said: "Blythe Masters has built an impressive foundation with incredible progress to date, helping the company emerge as an industry leader. I'm honoured to lead Digital Asset and work alongside the talented management team during this transition until a new CEO is appointed, at which point I will focus on my responsibilities to lead the board."

Mike Bodson, president and CEO of DTCC, added: "On behalf of the Digital Asset board, I would like to thank Masters for her leadership and vision, which has propelled the company from a promising startup to a globally recognised leader in distributed ledger technology."

John Davidson, current president and COO of OCC, has been promoted to CEO, while Scot Warren, the current executive vice president and chief administrative officer, has been promoted to COO.

As CEO, Davidson will report to the OCC board of directors and will have oversight responsibilities for OCC's information technology. He will also have oversight responsibilities for financial risk management, corporate risk management, as well as legal and compliance functions.

Davidson joined OCC last year as president and COO where he was responsible for OCC's technology and operations functions. Prior to OCC, he served in several key leadership roles at Citigroup.

He also held senior leadership roles at Morgan Stanley and CME Clearing.

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As COO, Warren will report to Davidson. He will have oversight responsibilities for OCC's operations, project management, business process optimisation functions, finance, business development, and human resources.

Warren joined OCC in 2015 as executive vice president of business and product development.

In this role, he was responsible for OCC's business and new products development as well as strategic and corporate planning.

Before joining OCC, he held senior roles at CME Group and Goldman Sachs.

Meanwhile, Craig Donohue, currently executive chairman and CEO, will remain at OCC as executive chairman.

Donohue, who joined OCC in 2014 as executive chairman after serving as CEO of CME Group from 2004 to 2012, will continue to facilitate board leadership and management oversight on behalf of the board of directors.

As well as this, he will focus on strategic issues and OCC's industry leadership role, including OCC's engagement with policymakers in Washington, DC.

Additionally, he will have oversight responsibilities for OCC's government relations, communications, Options Industry Council and internal audit functions.

According to the OCC, these changes will become effective upon receipt of regulatory approval of by-law and rule changes necessary to effectuate this structure.

Donohue commented: "In 2016, at the request of the board of directors, I took on the combined role of executive chairman and CEO to drive toward accomplishing our goals and to assemble an accomplished leadership team capable of ensuring that OCC remains the preeminent global derivatives clearing house well into the future."

"Given our strong track record of progress since then, the critical role that John Davidson and Scot Warren have played in helping us achieve these results, and the importance of leveraging their skills and experience as we undertake our ambitious new 'Renaissance' initiative to replace our core clearing, settlement and risk management systems, the board of directors has unanimously accepted my recommendation to promote Davidson to CEO and Scot Warren to executive vice president and COO."

Davidson said: "I am proud of the progress and momentum we have created at OCC, and I look forward to serving our clearing members, exchanges, market participants and the investing public as we continue our transformation to a best-in-class provider."

Warren added: "I look forward to continuing to work with Donohue and Davidson to strengthen OCC and ensure its secure foundation for the future. Replacing our core clearing and risk management systems is fundamental to OCC's vital role as a systemically important financial market utility, and I am eager to lead this initiative with Davidson."

In addition, the firm has appointed Vishal Thakkar and Timothy Dwyer as senior leaders.

Thakkar, formerly first vice president of financial risk management and risk advisory services, has been promoted to senior vice president and head of enterprise risk management.

In his previous role, Thakkar oversaw a transformation roadmap that enhanced OCC's process effectiveness while meeting stringent regulatory requirements.

Dwyer was appointed senior vice presidents of strategic systems, a new position at OCC.

Xconnect Trading has appointed Ray Hainsby to a securities finance flow role.

As part of his new role, Hainsby will work on enhancing liquidity in hard-to-borrow, illiquid or low-grade securities across Asia and Europe.

Previously, Hainsby served as director at Jessannell, which specialised in secured financing services. Hainsby joins Xconnect with experience in sales, trading and operational experience with securities finance, prime services and delta one products.

Citi has appointed Nikola Todorovic as director of Securities Services Sales and client coverage.

Todorovic, who started the role in December, is based in Switzerland.

Previously, he served as head of sales and relationship management securities finance and collateral management at SIX.

Todorovic also served as senior sales manager at SIX where he was involved in clearing, cash equities clearing, global custody, securities lending, CCP securities lending, securities finance, collateral management, tri-party repo, tri-party services, carbon trading, electronic trading/execution/connectivity.

He has also worked at NYSE Euronext, Aramid Capital Partners and ABN Amro Mellon.

Securities finance trader Aurélien Manson has left Caceis.

Manson's role included developing a stock loan rate pricer using machine learning and linked to a tailor-made auto-response robot.

As part of his role, he was responsible for pricing revenues from stock lending activities and cash reinvestment (bond and equity portfolios), handling liquidity requirement, capital requirement and leverage ratio for the desk.

Yip Wong has been appointed as director of TR Expert Services.

TR Expert Services helps investment firms with their transaction and trade reporting obligations. Most recently, Wong worked for KPMG and prior to this, he served as vice president of Morgan Stanley for almost five years.

Wong has also served as senior consultant at Detica. **SLT**

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