SLT
SECURITIES**LENDING**TIMES
ISSUE010
05.10.2010 TUESDAY

First blood for Northern Trust in Diebold case

CHICAGO 30.09.2010

Northern Trust has part-won a ruling on a motion to dismiss ERISA breach of fiduciary duty and prohibited transaction claims involving an investment manager's securities lending programme.

The motion formed part of the case of Diebold et al v Northern Trust et al, which is ongoing in Illinois. A lawsuit was filed in 2009 by two employees who were part of the defined contribution plan that invested in funds managed by the defendant.

The funds took part in securities lending in a programme that involved the lending of securities held by borrowers who posted 102 per cent collateral. The collateral was placed in a pool, and then invested in fixed income instruments. The pools generated an income to the funds, part of which was paid to the securities lending programme manager, who is also a defendant.

It is alleged that the collateral pools were not managed prudently, causing the plaintiffs to lose money.

It is further alleged that no changes were made to the strategy of the pool or securities lending programme even after the liquidity crisis began, which incurred further losses.

The case continues.

In a separate case reported earlier by Securities Lending Times, The Briscoe Law Firm, PLLC, founded by a former state prosecutor and enforcement attorney for the United States Securities and Exchange Commission, and the law firm of Powers Taylor, LLP are investigating potential legal claims available to purchasers of Northern Trust Corporation stock during the period of October 17, 2007 and October 20, 2009.

It has been alleged that NTRS and certain of its officers and directors violated the Securities Exchange Act of 1934 by issuing materially false and misleading state ments regarding the Company's business and financial affairs, leading the Company's share price to be artificially inflated during the class period. Specifically...

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NEWS**IN**BRIEF

SGX bolsters SBL service

Singapore Exchange (SGX) is enhancing its securities borrowing and lending (SBL) service to bring additional benefits for investors and SGX central depository account holders.

With the enhanced service, over 80 per cent of the total listed stocks on SGX Mainboard and Catalist are now eligible for lending or borrowing via the Central Depository (CDP). The number of stocks eligible for lending increased from approximately 150 to over 600. Investors now have an expanded opportunity to lend out their stocks and institutional borrowers can have access to a larger pool of different stocks from CDP.

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TradeStation to add securities lending to its offering

TradeStation Securities has announced the hiring of Robert Sackett to start up and lead the securities lending department of, and co-head, its TradeStation Prime Services division.

"Securities lending services are a critical component of our plan to build a first-class prime brokerage offering to small and mid-sized hedge funds and other buy-side traders who can no longer receive important prime brokerage services directly from the large firms," said Salomon Sredni, CEO of TradeStation Group, the parent company of TradeStation Securities.

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SGX bolsters SBL service

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Lai Kok Leong, vice president, depository services at SGX said: "Many retail investors keep shares directly with CDP. When these shares are pooled together, they form a substantial block, which could be borrowed by institutional investors. By enhancing the service, retail depositors can gain a return on their stock holdings and access to institutional borrowers. With access to a large pool of stocks, institutional investors can consider new trading strategies. This will also improve overall liquidity of the stocks."

CDP, which currently safe keeps securities for retail investors and institutions, will be the counterparty for all lenders and borrowers. This will provide a single point of processing for all activities including corporate actions as well as borrowing and lending of securities. Stock lending activity could help CDP account holders to lend out their shares to earn lending fees and improve the total earnings on their assets.

TradeStation to add securities lending to its offering

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"Securities lending services are a critical component of our plan to build a first-class prime brokerage offering to small and mid-sized hedge funds and other buy-side traders who can no longer receive important prime brokerage services directly from the large firms," said Salomon Sredni, CEO of TradeStation Group, the parent company of TradeStation Securities.

"We believe TradeStation's position as a self-clearing broker-dealer serving this market allows it to offer a more compelling value proposition compared to other firms that cannot directly provide custody, clearing, settlement and securities lending and must instead rely on the large firms to which they introduce all of their accounts."

"We believe Rob's 15 years of experience and relationships in securities lending will allow TradeStation to compete effectively in a market that continues to see industry fragmentation and where small to mid-sized buy-side institutional traders continue to seek prime brokers capable of directly delivering to them basic, critical prime services," added Lance Baraker, senior managing director and co-head of TradeStation Prime Services.

Sackett is leaving his position of managing director at Citigroup Global Markets to join TradeStation Prime Services as senior managing director and co-head of the division. He has over 15 years of securities lending experience at Citigroup and its predecessors, and has been a NYSE-approved Securities Lending Representative since 1995 and a NYSE-approved Securities Lending Supervisor since 2002.

He is scheduled to begin his employment with TradeStation after the Thanksgiving holiday, following the expiration of his 75-day garden leave period with Citigroup. TradeStation Prime Services expects to begin offering securities lending services in the 2011 first quarter.

EquiLend to open Asia Office

EquiLend has announced it will open an Asian office in Hong Kong in the first quarter of 2011. The company says the opening is designed to improve its service offering to its predominately global clients who have operations in the region and build relationships in Asia.

The office will be headed up by Andrew McCardle, who is currently based in the EquiLend's London office. A recruitment process is due to get underway for other roles in Hong Kong.

"We want to enhance our service offering to clients and take better advantage of the opportunities available to us in the region," said Brian Lamb, CEO of EquiLend.

This will be the fourth office for EquiLend; it already operates from its New York headquarters, as well as London and Toronto.

Eurex Repo reaches new record volume

Eurex Repo, which operates CHF repo, EUR repo and GC Pooling markets, grew by 33 per cent y-o-y and all markets combined reached a new record average outstanding volume of 255.3 billion euros compared to 191 billion for the same period last year.

The electronic trading platform Eurex Bonds, which rounds out Eurex's fixed-income product range, saw volume of 7.25 billion euros (single counting) in September. The volume was 6.5 billion euros in September 2009 and 6.4 billion euros in August 2010.

Fears of manipulation at Barker

Barker Minerals has contracted STP Advisory Services to provide, through a review of data and documents an independent expert opinion to determine if the company's stock is the subject of a range of manipulative market activities.

STP's review specifically examines "failures to deliver", commonly referred to as "naked short selling." Upon the receipt and review of the STP final report, which is imminent, Barker will provide a summary of the results of the independent review.

First Blood for Northern Trust in Diebold Case

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NTRS allegedly failed to disclose the extent of its delinquent commercial real estate loans and certain risks associated with its securities lending programme.

During the class period, and while the stock traded at artificially high prices, top officers and directors for NTRS sold over 1.5 million shares of their stock, for proceeds of over USD106.5 million. Then on October 21, 2009, the Company announced that its third quarter results would not reach expectations, partly because of the serious decline of its securities lending programme and its non-performing commercial loans.

On that same day, NTRS's stock price fell more than over six per cent.

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Sedona case heading for trial

Andreas Badian and other defendants are set for trial in early 2011 in the SEC's lawsuit over naked short selling.

Badian, who worked for Rhino Advisors, is alleged to have used short selling to drive down Sedona's stock. This benefitted another Rhino fund, which had invested in a convertible loan issued by the Philadelphia-based software developer.

The case has been beset by delays; it was originally due to go to trial in June this year, which was then delayed to August.

Badian has left the US since charges were originally filed.

J.P. Morgan Selected by AQR Capital Management

J.P. Morgan Worldwide Securities Services (WSS) announced today that it has been selected by investment management firm AQR Capital Management, LLC (AQR), adviser to the AQR Funds, to provide a full suite of fund administration, prime-custody, and related securities services for the firm's mutual funds with more than USD2 billion in assets.

Founded in 1998, AQR is based in Greenwich, Connecticut and manages approximately USD27 billion in assets for some of the largest institutional investors in the US, Europe, Australia and Asia. The AQR Funds were created to provide mutual fund investors with access to alternative and innovative investment strategies.

"When we decided to move our business from another service provider, we were looking for a strong firm that would help us build for the future by offering us leading technology, a highly automated environment, and excellent customer service," said Marco Hanig, president of AQR Funds. "As we prepare for our next phase of growth, we felt that J.P. Morgan was the right firm to help us reach our business objectives."

Robert Caporale, head of new business development - Americas, J.P. Morgan Worldwide Securities Services, said: "AQR is an important client to J.P. Morgan Prime Brokerage and to the firm overall. We are very pleased to expand this relationship with AQR by providing a broad and integrated package of fund administration, prime-custody, and securities services."

Carlson settles with SEC for USD2.6 million

The Securities and Exchange Commission has charged Dallas-based hedge fund adviser Carlson Capital, L.P. with improperly participating in four public stock offerings after selling short those same stocks.

Carlson has agreed to pay more than USD2.6 million to settle the SEC's charges, but has made no admission of liability.

According to the SEC's order, Carlson violated Rule 105 on four occasions and had policies and procedures that were insufficient to prevent the firm from participating in the relevant offerings. For one of those occasions, the SEC found a Rule 105 violation even though the portfolio manager who sold short the stock and the portfolio manager who bought the offering shares were different.

"Investment advisers must recognise that combined trading by different portfolio managers can still constitute a clear violation of Rule 105 when short selling takes place during a restricted period," said Antonia Chion, associate director of the SEC's Division of Enforcement. "This is true even when the portfolio managers have different investment approaches and generally make their own trading decisions."

In its order, the SEC found that the "separate accounts" exception to Rule 105 did not apply to Carlson's participation in that offering. If certain conditions are met, this exception allows the purchase of an offered security in an account that is "separate" from the account through which the same security was sold short.

The Commission found that the combined activities of Carlson's portfolio managers violated Rule 105 and did not qualify for the separate accounts exception because the firm's portfolio managers:

Could access each others' trading positions and trade reports, and could consult with each other about companies of interest.

Reported to a single chief investment officer who supervised the firm's portfolios and had authority over the firm's positions.

Were not prohibited from coordinating with each other with respect to trading.

The SEC further found that the portfolio manager who sold short the particular stock during the restricted period received information - before the short sales were made - that indicated the other portfolio manager intended to buy offering shares.

Without admitting or denying the SEC's findings, Carlson agreed to pay a total of USD2,653,234, which includes USD2,256,386 in disgorgement of improper gains or avoided losses, a USD260,000 penalty, and pre-judgment interest of USD136,848. Carlson also consented to an order that imposes a censure and requires the firm to cease and desist from committing or causing any violations and any future violations of Rule 105. During the SEC's investigation, the adviser took remedial measures including implementation of an automated system that helps review the firm's prior short sales before it participates in offerings.

Industrial's Shanghai IPO hits target

Industrial Securities Co raised the maximum amount it sought, 2.63 billion yuan, in its Shanghai IPO.

The broker, based in Fujian, sold 263 million shares at 10 yuan each, the top end of its price range.

The funds will be used to expand the company's brokerage business and build new businesses, including margin trading and securities lending. It will also boost its underwriting capacity and direct lending.

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Clearstream celebrates 40 years

The International Central Securities Depository (ICSD) Clearstream (previously Cedel) has reached its 40th birthday. It was founded on 28 September 1970 by 66 financial institutions from 11 countries to reduce the costs and risks of settling securities in the Eurobond market. Settlement and safekeeping of Eurobonds is still Clearstream's core business, accounting for 47 per cent of its revenues, and with a market share of 37 per cent (August 2010).

The post-trade business is sometimes referred to as the "plumbing of the financial system". Indeed and simply put, it is about a worldwide network of tubes through which securities are transferred in return for cash between banks, exchanges or other clients and a large depository. In essence, Clearstream handles the property rights of the participants of the worldwide financial markets when it is looking after, eg, dividends and stock splits are being booked and securities are correctly entered into the account of the clients.

Clearstream started as a provider of the post-trade infrastructure for the Eurobond market. As a central securities depository (CSD) based in Frankfurt, Clearstream also provides the post-trade infrastructure for the German securities industry, offering access to a growing number of markets in Europe. But Clearstream also offers additional services in the areas of cross-border custody, investment funds services and global securities financing where it is one of four global providers of collateral management services.

Jeffrey Tessler, CEO Clearstream, said: "Clearstream's goal was and continues to be to bring simplicity to the post-trade services industry by offering the complete range of our services through a single window. We will take advantage of the emerging European market infrastructure and will continue to build competitiveness in the cross-border securities processing area through interoperability and partnerships."

SunGard improves reporting capabilities

SunGard has launched Asset Arena Investment Book, a new module of Asset Arena Investment Accounting designed to provide asset managers and servicers with simultaneous back- and middle-office views of investment portfolios.

Asset Arena Investment Book helps eliminate the complexity and redundancy of maintaining separate systems to report fund valuations from different perspectives. Relying on a single set of records, Asset Arena Investment Book creates the alternative views of accounting data, which customers can use to support internal and external reporting requirements.

Without this capability, asset managers and servicers have typically had to cope with multiple sets of records, often housed on separate platforms. Asset Arena Investment Book has been developed with a global asset servicer to address the issues arising from this scenario. Incorporating this functionality within Asset Arena Investment Accounting helps ensure that the flow of data between a customer's back- and middle-office functions is automated and seamless.

Each investment accounting view is fully supported by the general ledger and provides the customer with a comprehensive and accurate view of portfolio values, cash flows and accounts according to the associated time-based rules. This flexibility can be used to accommodate diverse customer business needs in areas such as end-of-day / start-of-day books, performance measurement and period end ("as of") reporting.

Doug Morgan, president of SunGard's institutional asset management business, commented: "We believe that Asset Arena Investment Book represents a unique solution in an area that has traditionally employed expensive, redundant processes. The enhanced capabilities of Asset Arena Investment Accounting allow for the deployment of a global model with valuations occurring throughout the day to support middle-office functions and culminating in the official Net Asset Value calculation. Using one solution, our customers can represent each portfolio according to specific governing rules, support the official books and records of a fund, and give the investment manager real-time visibility into the portfolio."

NY Fed cuts asset requirements for reverse repo

The Federal Reserve Bank of New York has announced that the amount of net assets for money funds to be eligible to take part in reverse repo transactions has been halved.

The Fed is also expanding counterparties for reverse repo transactions. The latest rules mean money market funds must now have net assets of at least USD10 billion for six consecutive months before application, half the previous amount.

COPIC's securities lending departure improves its rating

Following COPIC Insurance Company's withdrawal from the securities lending business, A.M. Best Co. has revised the outlook to stable from negative and affirmed the financial strength rating of A (Excellent) and issuer credit rating of "a" of the firm.

The revised outlook reflects COPIC's improved level of risk-adjusted capitalisation that has arisen from profitable underwriting results and a continuous stream of net investment income. Furthermore, the impact of COPIC's investment portfolio on total returns has improved as a result of realised capital gains as well as the company's ongoing withdrawal from a securities lending programme.

In addition to COPIC's excellent risk-adjusted capital position and strong operating performance, the ratings reflect the company's conservative underwriting leverage and its leadership position in the Colorado medical professional liability market. COPIC also maintains an exceptionally high policyholder retention level, which is supported by the company's distribution of favourable operating results to its policyholders and its value added offerings to its insureds.

South Carolina to go it alone

The South Carolina Pension Fund is to create a management firm to look after its assets, in a move that could see it offering its own securities lending services.

The management firm will initially control the fund's illiquid assets, including the private equity and real estate portfolios, and is due to launch at the start of October.

The USD15 million start up has been created, said Allen Gillespie, commission chairman, to reduce costs and "mitigate certain risks associated with illiquid asset classes." Gillespie estimates the enterprise could save the fund 25 per cent on private equity costs through reduced fees.

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USA

The world's largest financial market has suffered more than most as a result of the downturn, and its recovery has not been easy. But while confidence builds, regulation looms large

BEN WILKIE REPORTS

At over USD300 billion a year, the US equity lending market dwarfs that of other markets, and represents almost half of the global securities lending industry. But as the biggest market, it was in the eye of the storm when the financial crisis hit, and has taken some time to recover.

2009 was actually not too bad a year in terms of transaction volumes, but in fact this was skewed because of the Citigroup trades. In February 2009, an exchanged was announced converting common stock for publicly held convertible and non-convertible preferred shares in an attempt to build the company's equity and increase confidence in the company. The market reacted by selling the underlying shares and buying the preferred shares, creating huge volumes in securities lending. Take Citi out of the equation, and 2009 was a year to forget for the country, however.

2010 has been better, however. There have been no large market surges and stability, it feels, is what is needed as the industry gathers itself. While volumes are steadily increasing, fees have fallen, and specials are still scarce.

"The US is predominantly a cash collateral market therefore it is no surprise that the US securities lending market experienced a slower recovery following the credit crisis than most other developed securities lending markets," says Peter Bassler, managing director at eSecLending.

"In addition, the uncertainty of the implications of global regulations and particularly the Dodd-Frank Act in the US has resulted in lower borrower demand. However, in 2010 supply has returned to the market as many beneficial owners are re-engaging in securities lending and re-starting or expanding their programmes after temporarily suspending activity during the credit crisis. We are also seeing new supply from certain beneficial owners starting lending programmes for the first time."

As hedge funds retrenched to lick their wounds and beneficial owners withdrew to reduce their risk, many participants really started to struggle. While Lehman was the biggest and most public casualty, many smaller firms bit the dust while others cut costs wherever they could - it's estimated that there are 40 per cent fewer people working in the securities lending industry now then there were three years ago,

Of course, some of these cuts will end up being good for the market. Even though budgets are tight, new technology has been introduced, which has improved efficiencies and reduced some of the risks. The emergence of providers such as OneChicago and Quadriserv has also created a more welcoming environment for some of the more cautious borrowers and lenders.

These platforms have opened the market, and while they are certainly cannibalising some of the existing securities lending business, they are designed to "increase the size of the pie," says Greg DePetris, co-founder of Quadriserv. OneChicago has seen huge increases in the number of trades in 2010, and has increased the number of instruments for trading accordingly. It says it has attracted many of the major European organisations to the American securities lending industry, as well as increasing business from the main domestic players. Quadriserv, meanwhile, is accumulating members.

While the hedge fund market is now keen to participate strongly in the market, beneficial owners have been a little slower coming forward. Some, such as Ohio pensions, have returned strongly but others have been less forward. CalPERS, which was hit hard in the downturn, is still a major player, but its activities are muted compared to three years ago.

"The perception of lending continues to shift toward viewing the product as an investment and trading function rather than a back office custodial product," explains Bassler. "When ben-

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eficial owners evaluate lending, particularly in the US, they are realising that it encompasses two separate and distinct skill sets; lending (financing and repo activity) and collateral management (investment management function if cash). Beneficial owners are now more focused on generating returns from the lending component (intrinsic earnings) rather than potential returns from the reinvestment of cash collateral."

Of course, in terms of participation, everyone who is anyone in global financial services has a stake. The big US banks such as J.P. Morgan, BNY Mellon, State Street and Northern Trust remain major players, but competition from European and Asian providers keeps fees low and ensures constant innovation

Regulation

The elephant in the room however remains regulation. Just as in many other parts of the world, there has been a huge public focus on the financial services industry and widespread anger at the banks' activities leading up to the financial crisis.

The need for transparency in all markets, including securities lending, has been on the agenda both within the participating organisations and the regulators, and the forthcoming Dodd Frank legislation will push organisations to be more open. This opaqueness has been recognised by most organisations, and irrespective of legislation, available information is greater now than ever before - at a recent conference in London, Data Explorers gave a potted history of the securities lending market over the past couple of decades and showed how the amount of data available now is a magnitude larger than three years ago. But there are still concerns. "The uncertainty of regulatory implications is the key focus at the moment," says Bassler.

One effect of the new legislation could be a greater move to CCPs and exchange-based trading, something that many in the industry would welcome - although others are not so sure about. There are a number of CCP cheerleaders in the US, who push the benefits of automation, reduced counterparty risk, lower costs, increased liquidity and a level playing field for all participants.

"The main benefit we are seeing of the introduction of services introduced by firms such as OneChicago and Quadriserv is that it is encouraging those who may have been scared away by the banking crisis into securities lending," says Marco Ancona, a pension fund consultant based in Austin, Texas.

"They are used to buying and selling stocks on exchanges, and often have experience with exchange-traded derivatives. They understand how these trades are settled. The idea of entering securities lending in an OTC market may have proved a bit daunting, but seeing a recognisable process for a new market helps them to get their heads around it. It's not for everyone, but it certainly will build the market - as we have seen in Europe."

This won't mean everything moves in this direction - even one of the market's biggest proponents, Quadriserv's Greg DePetris believes there is room for all types of trading in the market - but new entrants are certainly looking at market-based systems more closely.

"We only dipped our toes in securities lending [until 2010] says a representative from one mid-size pension plan based in the MidWest. "And we're staying cautious. But we prefer the mitigation of risk that you see with CCPs and while we're in business to make money, it's more important that we don't lose it."

There are also proposed new rules on cost basis reporting for securities lending transactions. The rules, which were proposed almost a year ago and are still being discussed, aim to ensure that gross sale proceeds from covered securities transactions are accurate and complete.

They would require everyone undertaking a transfer of covered securities to a broker to provide the broker with a written statement to the broker. The new section will also require brokers, upon disposing of the transferred securities, to divulge various pieces of information to help taxpayers work out their profits or losses.

The problem has arisen because the wording has been changed to include non-covered securities, which according to the Risk Management Association (RMA) "appears to include transfers resulting from securities lending transactions".

The RMA has asked for securities lending to be made exempt from these rules. In a letter to the US tax authorities, the association said the required information is not relevant as securities lending agreements are not classed as taxable. The lender's position within the transaction is preserved throughout the life of the loan and rights are not necessarily transferred to the borrower.

If securities lending transactions are included in the new rules, says the RMA, the regulation could also affect participants when they are exchanging collateral or returning borrowed shares. A further reason for the exemption is that many of the securities lending participants affected - pension and mutual funds for example - have a different tax status to conventional investors.

The future

Securities lending appears to be becoming an increasingly specialised activity and while the major players will always be able to win mandates based on their suite of middle and back office offerings, the focus on how securities lending fits into an overall strategy means the teams responsible for this side of the market are become more and more important. There is also the possibility that more specialised providers build up their market share.

"The securities lending landscape continues to evolve," says Bassler. "The industry is showing a renewed focus on intrinsic returns and developing customised solutions for clients.

"The increased focus on counterparty risk management and view of securities lending as an investment management product rather than an operational function tied to custody has encouraged beneficial owners to more explore alternative routes to market. As evidenced by some of the new mandates we have won thus far in 2010, beneficial owners are seeking differentiated solutions and a proven process. As a result of these trends, we expect to see continued unbundling of securities lending, custody, and cash management. These trends have already been underway for several years but we expect they will only accelerate as a result the increased focus on securities lending." **SLT**

Security rankings by total daily return

Rank	S&P 500	Russell 2000	US equity (others)
1	Citigroup	Synaptics	Chipotle Mexican Grill
2	Sears Holdings	Under Armour	Factset Research Systems
3	General Motors	Sunpower	Alliance Data Systems
4	AIG	Netflix	Mead Johnson Nutrition
5	M&T Bank	Mannkind	Nordic American Tanker Shipping
6	Ford	First Solar	MGM Mirage
7	Wynn Resorts	Buckle	Freddie Mac
8	Merck	Green Mountain Coffee Roasters	Fannie Mae
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The right place, the right time

An all electronic direct access CCP-based securities lending market may have been seen as unnecessary a few years ago. Not any more

COMPANY PROFILE

Timing is everything, they say. Whether it's competing in the Olympics, launching a political career or just proposing to your partner, it's only going to work if the stars are aligned. And that's most certainly the case for Quadriserv.

While its products have been developed over several years, the industry wasn't too sure of the benefits it was going to bring, admits Greg DePetris, co-founder of the company. "I think that prior to some of the challenges people faced in recent years it was considered a solution in search of a problem," he says.

"But as it turned out we built what was needed. After the [financial crisis] different user groups found we could solve some of their issues. It was a good solution for agent lenders as they looked to maximise the intrinsic value of securities on loan, for broker dealers it worked by responding to their shrinking balance sheets and need for more risk controls, while for hedge funds, it provided market access and gave them options they never had before."

The priority for the development has always been economic, explains DePetris: "It's always been about overcoming the challenges of the market, but fundamentally participants are always going to ask if they can make comparatively more money on AQS than with another more traditional route."

The right place

The development involved all sectors of the market, who all had an input into how a centralised market operated by a regulated entity would eventually function. The key, says DePetris, was making sure that all participants got exactly what they needed out of it, adding that "our first version was around 60 per cent off the mark, but we succeeded because we invested the time and money to get people onto the system."

This is key, he says, when listing the company's achievements: "We were willing to be wrong a lot - we were wrong more than right for much of the development, but we adapted, did the work and stayed connected to our members. We had to make sure we were solving a real problem for the market. We also needed to make sure we made it easy and cheap for people to gain access to the solution, and that's where our collaboration with SunGard has helped not only AQS but the industry broadly - the new functionality works with systems people already have.

"We had to incorporate the whole industry and make sure we understood their needs - banks, brokers, hedge funds, market makers and so on were all part of the design process. There was a view that this is an insular market and one of our crowning achievements was to get everyone involved."

The recent economic conditions make it difficult to understand whether the business that Quadriserv is generating is taking activity away from other areas of the market, or whether it is able to encourage new participation in the securities lending industry.

"A primary purpose of what we do is to grow the pie," explains DePetris. "And the way you do that in any sector with interdependencies is to allow it to interact with other markets and invite new participants to join. Our collaboration means that people treat the market as a new liquidity source and an alternative route to market. We've introduced a lot of new people to the securities lending business."

But a new service isn't enough. One of the most common criticisms of securities lending is that not enough people - particularly beneficial owners - understand how securities lending works, and how it can benefit them They are unsure of the risks, and they don't understand where they can fit.

"One of the most important aspects of our marketing strategy was in education," explains DePetris. "In a way we were the beneficiaries of the structure we built. Using a CCP feels less risky to many players, and having a public market operated by a regulated entity, with deals being done transparently also feels more like the way that major market participants do business in financial products.

"We started as a reputable public market, and that demystifies the process. Everyone is treated the same, and it increases the amount of information available, which reduces risk. There's only one set of guidelines, which simplifies everything."

However, an exchange-like system is unlikely to become the de facto standard. There have been questions raised about an exchange model's ability to manage specials, but DePetris says this is a red herring. "Proportionally, we process just as many specials as OTC," he says. "They are not inherently more complex than other trades. Specials really are more likely to trade in an environment where the interaction between one and many is more efficient - you're essentially dealing with one market rather than having loads of different one way discussions, and this is likely to improve liquidity.

"However I do think it's unhealthy to have only one way of doing things. Certain securities lending activities don't belong in this market and I don't think an electronic market can service everybody. It's all about growing the pie."

The right time

Electronic trading and CCPs may be about to come of age. The new Dodd Frank legislation is calling for greater transparency in the markets over the coming years and it appears that the favoured method is the increased use of CCPs. While DePetris says that the company is following the regulatory debate closely, and contributing where appropriate, he says that it would be a shame if the only reason companies moved to this model was to fulfil their obligations.

"At the end of the day you want the business case to stand on its own merits," he says. "We want to advocate things that are good for the market. I think the regulatory changes will encourage people to look at new ways of doing securities lending, but whether they go down this route will be about whether it is right for them."

But as the success of Quadriserv grows, there is likely to be growing competition. Lendex is due to launch a service that some have seen as a direct rival to Quadriserv, while other firms are also looking at how they can enter the market. This, says DePetris, can only be healthy.

"Every good market has several liquidity pools," he says. "In Europe, there is competition and that works well. Without competition, there is no incentive to build a better solution."

Challenges

The securities lending industry is recovering from the downturn, but it's not out of the woods yet. Volumes remain down, and available assets are sometimes still scarce. Regulation means that participants are weighed down by the costs and time of implementation, and there remains a general market nervousness about the future.

But this, says DePetris, is an opportunity. "We give people the opportunity to integrate and give them the leverage to reduce the costs of implementing new rules. We can increase liquidity through encouraging new entrants and we can help people focus on their businesses, not the challenges of doing business." **SLT**

Greg DePetris
Co-founder
Quadriserv

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The Prime Brokerage Revolution

Investors now have to think the unthinkable - how to manage the fallout from the failure of a prime broker, writes Phillip Chapple of KB Associates

EXCLUSIVE

The prime brokerage industry has been through a tough couple of years. A combination of reducing Hedge Fund AUMs, reduction in demand for leverage and bouts of short selling restrictions have meant that the prime brokerage business model needed re-inventing.

Investors into hedge funds have become more institutional and this has caused extra pressure on prime brokers to provide a model which both provides the security required by ever more demanding underlying investors but which provides a level of fees to justify its existence.

We now see a hedge fund market where supply exceeds demand and where investors can afford to be picky about where they invest. Due to a "flight to size" all but the largest funds are open to new investment and now the focus of investors is not simply on performance. Safety of their assets and operational infrastructure and control are also critical, as there is no point in making great returns if all the assets are then lost due to the collapse of a counterparty or custodian. Due to the pain caused to the investor community in the wake of the above, investors understand the importance of the correct infrastructure and controls to protect their assets.

The combined effect is that both structurally and operationally the industry has had to mature to try to meet investors' expectations. In a competitive market for new capital, it is no longer enough for a fund to have a strong alpha proposition. Investors now require an infrastructure be put in place to protect their investment and also to grow and develop into the future.

> Previously there was no real focus on the implications of a prime broker failing

One of the main areas of this focus has been on re-hypothecation by prime brokers, in no small part due to its devastating effect on some of the funds that used Lehman Brothers International Europe as a prime broker. Before Lehman failed little or no interest was shown by investors in the protection of fund's assets by prime brokers, the name recognition was usually enough.

Re-hypothecation is a mechanism whereby a prime broker will take ownership of, then lend out, the stock of a fund through its stock loan desk to earn extra revenue. It has always been argued that this was required to subsidise the other services provided by prime brokers such as consultancy and capital introduction, as well as to enable the prime broker to keep it's financing rates low for funds to gain leverage.

The disadvantage to the funds of this mechanism was that when an asset was re-hypothecated, legally it no longer belonged to the fund. The funds simply had a contractual obligation from the prime broker that it would replace the stock at a later point. Previously there was no real focus on the implications of a prime broker failing. As investors now understand, there is a large difference between assets in their account and an obligation from a prime broker for those same assets. In the former the fund legally

owns the assets so can remove those assets if the prime broker fails. In the latter the fund is left with a claim on a bankrupt entity and may well be treated as a general creditor.

Negotiation around re-hypothecation in prime broker agreements was historically based on a multiple of the level of "exposure" that the prime broker had to the fund. The multiple typically ranged from 140 per cent of exposure up to unlimited re-hypothecation. In the US re-hypothecation was limited to 140 per cent of exposure by regulation (Federal Reserve Board Regulation T, commonly known as "Reg T") hence the lower figure.

One major difference in Lehman's base model for prime brokerage from other prime brokerage models of the time was that Lehman took legal title of all assets rather than holding them in the fund name (the standard model was to hold the assets in the fund name then remove the assets required for re-hypothecation into the prime broker's name). This was to enable the circumvention of "Reg T" and to allow re-hypothecation of all assets held to maximise revenue for the prime broker and hence allow them to be more competitive with financing. In its latter years there were moves away from this model towards a more standard "limited" model but still many clients/funds continued to use the old model.

Lehman's model was the worst kind to have in the event of a prime broker failure. In effect all assets in this model were simply obligations on the prime broker rather than fund assets held by the prime broker and therefore further down the chain of creditors when recovering monies in the bankruptcy process.

Another discovery made as a result of the Lehman failure was that even where re-hypothecation rights were limited by the prime broker agreement, systems and controls were not in place to ensure the limits were observed. In this scenario, a fund had a case for breach of contract but this was of no real comfort against a bankrupt entity.

Once investors began to understand the effects of the above they quickly realised the importance of re-hypothecation, the limitation language and the systems and controls in place at the prime brokers. There was a flurry of activity to determine their exposure to each of the prime brokers and to push the investment managers to protect the funds' assets. The focus on prime broker exposure intensified over the fear of other institutions failing and how some prime brokers behaved when managers tried to remove assets from them in response to this fear.

In the aftermath of the failure of Lehman, due to investor demands, the prime brokers had to re-evaluate their models and change their offerings to satisfy concerns of a Lehman scenario recurring. The prime broker landscape changed rapidly as investors drove managers to evaluate and manage their fund's exposure to prime brokers.

There are now a variety of products and models available, provided by the prime brokers to satisfy investor demands. There are also some new participants offering "Prime Custody" to meet the demand for safety of assets, and it is now extremely rare to see a fund with only one prime broker due to the need to diversify exposure.

Re-hypothecation is still an important element of the prime broker landscape. It is an important revenue stream for prime brokers, especially with low levels of leverage, restrictions on short selling and trading volumes down in many strategies, all key drivers of prime broker revenue. Without re-hypothecation many prime broker models are not viable and the financing rates attainable without the subsidy of re-hypothecation would not be attractive to managers.

The prime brokers had to re-evaluate their models and change their offerings to satisfy concerns of a Lehman scenario recurring

Investors now also look through the prime broker model to the quality of the custody services provided and the liability and limits of sub-custodians. There is focus on where the assets are held, in whose name and where the liability sits on the safe-keeping of these assets.

The combination of prime brokers and models used is in part driven by the strategy of the manager and in part by the risk appetite of the investor base. The more institutional the investor base, the less tolerant of exposure to prime brokers and the greater security of assets required.

The majority of current prime broker models fall into the below categories:

1. Prime custody

This is arguably the safest model and is an extension of the global custody product used by institutions to safe-keep assets. In global custody re-hypothecation is not usually used as financing is not part of the traditional global custody product. Fees are paid for custody services unlike in the standard prime broker model where custody is subsidised. Custody is sold on the reach, strength and security of the custody network, whereas in the historical prime broker model, custody was usually of variable quality and in many cases outsourced. There was little focus on the name in whose the actual assets were held and where. Liability is often limited for the custodian where the assets are held by a sub-custodian so many custody networks are marketed on the basis of how much of the network is proprietary rather than serviced by third-party sub-custodians.

Under the custody prime model, a core custody product is supplemented by standard prime broker services such as stock borrowing, FX hedging and financing. Starting from a custody model means the default position for assets is in the name of the fund at the custodian, with no re-hypothecation.

Financing can be arranged either by way of a charge on the fund's assets or by using a combination of charge and re-hypothecation. The main difference in the use of re-hypothecation here is that positions have to be actively opted into re-hypothecation and often needs to be physically moved to a different account to be re-hypothecated, which allows for control and transparency.

This infrastructure tends only to be available for larger funds and some argue that it is not as appropriate for funds requiring larger amounts of leverage due to the increased costs involved. The providers will argue that this should not be the case as re-hypothecation is available and also that the main providers of these services are custodian banks with available internal cash for funding so should be competitive on financing. Such providers do tend to be risk averse so not all funds will satisfy the terms of their credit teams for approval as a new client.

2. Prime with fully outsourced custody

A model some larger prime brokers have adopted is to sweep unencumbered assets out of the prime broker account into a custody account in the fund name at an independent custodian. A re-hypothecation limit is agreed upon and a charge is put in place over the fund's assets to cover any financing. Assets outside of the re-hypothecation amount are then swept to a third party custodian account to be held in the fund's name. In some cases a "charge account" is held separately to the unencumbered account at the custodian to keep the assets legally in the fund name and outside of the prime broker account.

3. Prime with legally outsourced custody

This is again a model utilised by a number of prime brokers who have created a "bankruptcy remote" new entity to custody assets. This is not a fully outsourced custody solution as the custody entity has been created solely for bankruptcy remote purposes rather than to provide a full custody service. The upside of such a solution is that it is usually cheaper as there

is no third party to pay for a custody solution. The downside is that the solution may not offer the same quality of custody network in terms of sub-custody liability and may not offer the ability for the assets to be held in the fund's name at sub-custody level. As with the previous model a re-hypothecation level is agreed and a charge is created for financing. Some models have an automatic sweep for the remainder of positions plus the ability to negotiate which positions, within reason, are left for re-hypothecation. Other models rely on the manager to instruct positions to be moved to the custody account which can be operationally challenging.

4. Original prime brokerage model

Some prime brokers have stuck to their original model, or run the original model in tandem with one of the above models. This entails an agreed re-hypothecation limit ranging from 140 per cent of exposure up to an unlimited level. All assets would be held at the prime broker in its custody network on an omnibus basis (as a default) with the potential to be held in the fund's name in some scenarios.

The benefit to this model is that it is the cheapest and easiest to manage operationally both for the prime broker and for the fund/manager, although it can be argued that many prime brokers using the above three models have reduced much of the operational "sting" for their clients of moving and tracking the assets.

Many say that for funds with higher trading volumes and higher levels of leverage, that the traditional prime broker model is the easiest and most economical model to use. This is also the hardest model to justify to institutional investors as it can be hard to prove to their satisfaction that re-hypothecation has been limited only to the limits agreed at any given point in time. Even if a prime broker produces a detailed report of what is being re-hypothecated the liability on the accuracy of the report will be limited and recourse could be limited to suing a potentially bankrupt entity. Some prime brokers have taken additional insurance coverage to protect such assets and to provide more comfort on this.

There are no "right" or "wrong" models from the above to use. The main factors in deciding which model come down to price versus both current and potential investor comfort. The most suitable model will depend in the main on the strategy and size of the fund and the liquidity of the assets, credit rating and market reputation of the prime broker, financing requirements of the fund plus the future capital raising plans of the fund.

The prime brokerage market has moved a long way from the generic models available up to the Lehman implosion. No two options appear quite the same and the current trend for funds to have at least two prime broker relationships for diversification of risk means selecting the right combination of services to efficiently run the business and satisfy current and future investors requirements for security of assets is a challenge, but no more of a challenge than it is for the prime brokers to ensure they have the necessary revenue streams in a changing market. **SLT**

Phillip Chapple
Executive director
KB Associates

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Balancing risks and rewards

Kevin McKenna from Credit Suisse Prime Managed Lending explains what clients need to look for in a securities lending partner

EXCLUSIVE

Every investor knows that the basic calculus of building a successful portfolio involves keeping expenses under control, identifying, understanding and mitigating risks and ensuring that the expected rewards of an investment are commensurate with those risks. The same discipline that is so important to investing generally applies equally to securities lending.

With interest rates and global economic operating leverage - in a post-bubble world - exceptionally low, investors are searching harder than ever for alpha. For many investors, that search includes taking a first look at, or re-examining securities lending. Whether an investor lends securities itself, has the custodian do it, or employs a third party agent lender, it is important to successfully solve the risk/reward equation.

An obvious risk associated with securities lending relates to the creditworthiness of the entity borrowing the lender's securities.

Will the borrower be there to return the securities when the lender wants them back? Has the lender or its agent assessed the borrower's credit profile? If the borrower encounters problems, will the collateral it posted (in the US, that's usually cash and in Europe that's usually securities) be sufficient to buy back the lent securities? Most custodial and third party lenders are willing to offer their lending clients indemnification against a collateral shortfall in the event that a borrower fails. It's important to assess the creditworthiness of the entity providing such indemnification. Are they sufficiently capitalised for the gross value of their indemnifications across business lines?

Additionally, it is important to consider explicitly the risks associated with the re-investment of the cash collateral that a securities lender receives from a securities borrower. In this regard, the usual rules of short term investing surely apply and most investors know how to assess these risks and how to select a capable cash manager.

However, it is useful to bear in mind that the strategy driving a lending programme can subtly drive its re-investment practices as well. Specifically, a programme that emphasises its ability to always lend a large percentage of the available portfolio (also known as achieving a maximum "utilisation rate") will generally require a more aggressive re-investment policy, so as to accommodate the higher rebates associated with collateral for which there is not much demand. Alternatively, a programme that emphasises lending "specials" (securities that are in high demand) and general collateral with positive intrinsic value can generally be executed with a more conservative re-investment strategy.

In light of the lessons of the last three years, it seems logical that securities lending should focus on conservatively extracting the value in a portfolio's securities, not on aggressive leverage. Indeed, clients are best served by optimising their utilisation rates rather than necessarily maximising them.

That is, an agent serves its clients well by ensuring that all securities with value are out on loan. Importantly, we also believe that re-investment portfolios should include a liquidity buffer to account for the unexpected. Additionally, we have found that clients appreciate having access to

research analysts and portfolio managers with regard to matters other than securities lending. Sometimes, unbiased market colour is its own reward.

Often taken for granted is the actual act of lending a security. As an over-the-counter market, securities lending requires dedicated traders who understand the market and its supply and demand dynamics. A good trading team not only strives to achieve the lowest rebate rate at a point in time, but can also work to minimise loan returns and keep expenses low.

Additionally, if an investor's portfolio is globally oriented, it only makes sense that its lending agent should be too. Global investors should look for providers with lending teams in more than one geographical area, though, at the same time, these teams should be inter-connected. Such an approach can help ensure that lending agents are thoroughly familiar with the idiosyncrasies of local markets. A global approach can also provide maximum flexibility with regard to collateral types. Additionally, a global lender with multiple live operating sites provides a natural advantage from a business continuity perspective.

Less obvious, but equally important, are the operational risks associated with any investment strategy. In the case of securities lending, it is critical to ensure a strong control environment with regard to corporate actions. One missed corporate event can undermine an otherwise successful lending programme. Having dedicated middle office specialists working closely with the trading desks can help foster such an environment. Indeed, a trade management oversight committee can provide a forum to ensure not only best execution, but can also keep a focus on operational excellence as well.

Perhaps the most under-appreciated challenge associated with securities lending is to achieve top-notch reporting. In-house information systems that are entirely serviceable for an investor's regular day-to-day requirements may prove to be lacking in a securities lending environment.

At the same time, the off-the-shelf reporting packages of many large providers, while on point for securities lending generally, may not serve the specific needs of a particular client. At Credit Suisse, we believe that a fundamental part of knowing our clients' requirements and risk tolerances is our ability to deliver customised reports that deliver the information they need, with a look and feel that works for them. This allows the client to design reports that provide the snapshots of the business that best help them manage risk, prepare management reporting and reduce the time necessary to extract the information they seek. Many of our clients start with our standard package and migrate to customised reports as markets and their own circumstances evolve. Many agents have the ability to deliver client reporting through multiple delivery mechanisms including web portals, pushed reporting and file data transfers. Credit Suisse offers a cutting edge web platform, PrimeView, that offers agency lending data in a comprehensive and flexible fashion and provides the ability for clients' to write their own customised reports.

A difficult-to-assess risk involves the day-to-day interaction between lenders and their agent. All too often, once an agent is hired and the paperwork is signed, clients find themselves introduced to a new team for their day-to-day needs. It is important to know exactly who will be supporting the lender and how this interaction will take place. Will the investor have one point of contact, or will they deal with a team? Will they have direct access to subject matter experts?

At Credit Suisse, part of the prospecting process involves introducing staff to their lead point of contact responsible for ensuring that all client inquiries are handled expeditiously. However, clients are also introduced to our subject matter experts. This not only helps us respond to client inquiries, but also helps us intelligently anticipate their needs.

Nothing worth having is ever free, and that includes a robust securities lending infrastructure. However, a client should always understand what it is paying for. We believe that clear, unbundled pricing allows clients to appropriately perform their own due diligence.

Once a beneficial owner has decided to utilise the services of a lending agent, it needs to evaluate all of these risks, but not in isolation. Indeed, just as with any investment approach, it is usually the overall process that defines success. Is the agent's process easily explained? Does it purport to be all things to all people? Does the process produce consistent, explainable results? Importantly, does the provider address the unique needs and circumstances of each of its clients?

While it is easy to emphasise the more quantifiable attributes of an agent lender, it is equally important to consider the subtleties. When investors evaluate an agent's estimate of the revenue that might be achievable for a given portfolio, it is critically important to evaluate the risks as well. **SLT**

Kevin McKenna
Managing director - Prime Services
Credit Suisse

> Most custodial and third party lenders are willing to offer their lending clients indemnification against a collateral shortfall in the event that a borrower fails. It's important to assess the creditworthiness of the entity providing such indemnification.

View from the top

Collateral management has become a hot topic for securities lending and risk management. Our panel answer the key questions

Ben Wilkie, editor

Maria Carina
Euroclear
Director, collateral services and securities lending

Gösta Feige
Clearstream Banking Luxembourg
Sales manager
Global Securities Financing

Paul Wilson
J.P. Morgan
Global head of client management & sales, financing and market products

Christopher Poikonen
eSecLending
Global head of trading

Paul Harland
BNY Mellon
Managing director, European sales director, broker dealer services

Jane Milner
SunGard
Securities strategy and business development

Blair McPherson
RBC Dexia Investor Services
Head of technical sales,
Market products and services

Next issue....
South African securities lending panel discussion
Justin Lawson, publisher

What do you see as the key new demands in the collateral management space?

Blair McPherson: Despite subdued volumes, the events of the last two years have created a very dynamic market with constantly shifting requirements, there is a heightened need for service providers to have an extremely structured risk management and control process on a global scale. Having dynamic risk and collateral management capabilities is crucial and makes providers more responsive to a client's changing strategies and market conditions. The emphasis on a strong risk management infrastructure and framework enables firms to identify and manage risk. It also offers the opportunity to help clients by accepting and managing a wider variety of collateral types, a definite advantage for lenders in mitigating risk.

Maria Carina: The financial crisis has intensified the need for firms to collateralise exposures across all market segments. A trend we see is the move towards complete collateralisation of all exposures arising from any type of transaction. This has led to new entrants in the collateral management space, such as money market funds, corporates and supra-nationals, which are now using our triparty collateral management services to collateralise previously unsecured exposures.

We're also seeing more demand to define collateral profiles with greater precision. Different types of securities are still accepted as collateral, but there is much more focus on specific collateral types, haircuts, concentration limits and on how the collateral profiles are actually put together. Valuation of the securities and price transparency also remain key concerns.

Higher haircuts requested for some collateral have also led to growing demand for solutions that mitigate credit risk for collateral givers as, in essence, the margins constitute an unsecured part of a secured transaction. We're seeing many collateral profiles being built specifically to handle margins separately. In response, we have created the means to segregate margins in a Euroclear Bank pledge account.

Paul Harland: BNY Mellon operates two distinct collateral management businesses; tri-party collateral management and OTC derivatives collateral management. In both businesses we have witnessed major change in the way collateral management is used and viewed during the last two years.

> Carina: The financial crisis has intensified the need for firms to collateralise exposures across all market segments

We have been at the forefront of tri-party collateral management since the early 80s and have constantly sought to innovate and develop our platforms according to market need, however the credit crisis placed increased scrutiny upon tri-party agents. The model was validated and the transparency and control afforded by tri-party meant it was extensively utilised by regulators and governments in efforts to restore confidence and stability to the markets with whom we worked closely.

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In the OTC derivatives space, we have seen an increased focus upon counterparty exposures and collateral management has become a cornerstone of counterparty risk mitigation.

Paul Wilson: We have seen a considerable amount of change in client approach to collateral. The demand has been for greater flexibility, transparency and granularity with regards to non cash collateral eligibility as well as in some cases for client specific non cash collateral custody accounts. Across our programme we haven't seen much change in these things relating to cash collateral, as we have always offered our client's individual segregated cash collateral accounts. Overall, there has been a trend to greater reporting and for information as well as greater frequency when clients make changes to their collateral parameters

Jane Milner: We are seeing the breaking down of silos across different business units, each of which historically had their own collateral management solution. Firms are looking to get a more holistic view of exposure, and to manage the margin call process in a more consistent manner. They are also looking to optimise the use of available collateral across multiple different business areas, making best use of their own assets, as well as assets which are available for re-hypothecation.

Gosta Feige: From the trading perspective, we see clear movements towards collateralising not just the classical central bank operations, triparty repos and securities lending transactions, which were our bread and butter business for many decades, but more and more also other types of activities such as OTC derivatives, CSAs and CCP margin collateral. At the same time, we're also being asked to manage more complex and inter-connected transactions such as combined collateral upgrade and consequent repo trades or committed lending facilities where advanced re-use strategies need to be implemented and handled reliably. Also, we see a clear trend towards one single collateral pool covering all types of exposures across the globe, thus avoiding cross-border collateral transfers and the risks, delays and costs attached to it.

Do you see collateral management primarily as a risk mitigation tool or as a revenue generator?

McPherson: Both. We are not a major cash taker, but that doesn't mean non-cash collateral can't generate revenue. It is important that one understands the risk adjusted returns being generated based on the type of collateral held. Risk mitigation will always be the primary function of collateral. Whether you're dealing with an AAA-rated retail bank or a hedge fund, the risk of default is still there. By allowing more collateral flexibility and understanding that doing so does not necessarily equate to taking on additional risk is still an ongoing educational process. The better the communication and strategic partnerships between providers and underlying clients, the better is the recipe for creating additional value and returns in the market while minimising risk.

Harland: Again, we see this from two sides. Tri-party has been and is still used as a way of raising liquidity by financing desks and revenue generation is the key driver for such businesses.

Feige: we're also being asked to manage more complex and inter-connected transactions such as combined collateral upgrade and consequent repo trades

In the OTC derivative space, whilst re-hypothecation of collateral is a revenue generator from a sell side collateral taker, collateral is seen as a risk mitigant on the buy side.

Feige: The answer to this question can be found in our history: 1970, Clearstream (at the time called Cedel) was founded by the biggest market players to mitigate risks in securities markets. Nowadays, it is more than ever at the centre of our business where years of unique expertise in collateral management in addition to our neutrality are our natural strengths.

Milner: Once again, what was true in the past is now changing, previously the prime purpose for collateral management was risk mitigation, and clearly this is still a key motivator, however, we are increasingly finding clients on the sell side looking at the potential for revenue generation through effective collateral management. This ties in with increased balance sheet pressure, and the need to ensure that all available assets are being best utilised to contribute to profitability.

Chris Poikonen: First and foremost, we view collateral management as a risk mitigation tool. On a daily basis, we ensure sufficient margin is received and that adequate liquidity exists given the collateral pledged. That said, a conservative but flexible collateral profile will appeal to a broader set of borrowers and therefore can generate increased revenues compared to an overly restrictive profile. Therefore, in certain instances collateral management can also be viewed as a revenue generator.

Carina: Collateral management is primarily a risk mitigation tool, as collateral is used to mitigate counterparty and credit risks. Collateral management services offered by a triparty agent further mitigate market and liquidity risks, as well as operational risks linked to the management of collateral positions.

Cash collateral from securities lending deals can be reinvested via reversed repos using triparty repo services and, as such, benefit from double-name risk management.

By fully automating the burdens of collateral substitutions and margin calls, while integrating this process with settlement and corporate actions processing, our triparty service is a compelling outsourcing arrangement for market participants to reduce operational risk.

Wilson: From ours and our client perspective it's primarily risk management.

How will the new regulatory framework soon to be implemented impact the collateral management business?

Harland: The frameworks embedded within Basel III and the UK Liquidity Regime will impose long term financing bias on the industry.

Tri-party, with its efficient collateral substitution during term trades, will aid firms as they seek to comply with the long term funding requirements imposed upon the industry by such regulatory frameworks.

McPherson: Regulatory changes will progressively change the competitive landscape. Variable capital charges on haircuts and margins mean participants will be able to factor in the cost of capital and differentiate by collateral and trade type. As the true cost of capital to

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firms become clear, the days where variable haircuts are applied to securities loans may well be close, or at least closer. In today's sophisticated world, the market practice of applying a standard flat margin does not appear to be the most efficient process. Securities lenders are set to gain from this new emphasis on collateral. As long as beneficial owners have the right framework in place, with advanced models to track and validate all activity – such as exposures, concentration and diversification – there are good opportunities to benefit from higher utilisation and increased lending revenues.

Wilson: Our view has not really changed insofar as collateral is the primary tool for mitigating counterparty risk

Carina: We expect pending regulations to have a positive impact on our collateral management services. The new regulations will provide incentives for firms to pursue longer-term funding arrangements and greater operational efficiency in order to benefit from reduced capital requirements. As our triparty environment has been designed to support term business in a very efficient way, we expect more business flows.

Milner: Whilst the requirements around the new regulatory framework are more formalised for the ISDA/CSA governed OTC derivatives collateral, there is still some way to go to get full clarity as to the implications for securities lending collateralisation. We are working with our customers to more fully understand this changing aspect of the landscape, in order to support them in addressing the new requirements.

Feige: It will (or actually does already as organisations are currently preparing for the changes) impact the maturity of transactions; these will more be adapted to suit exactly the regulatory requirements. Also, collateral quality will be adapted (eg, to reflect certain liquidity requirements).

In general, we see an increasing trend towards triparty collateral management as more and more transactions, eg, in the field of swaps, CSAs and OTC derivatives, are being outsourced to us as triparty service provider to benefit from our neutrality. Also, the increase in CCP-transactions (last not least driven by regulatory demands) does lead to more triparty collateral management transactions as we are the triparty collateral manager for several CCPs already, with more in the pipeline.

How have your firm's views towards collateral management been impacted post crisis? Is collateral management supporting the recovery?

Feige: Absolutely. On the one hand, we see new players who did not use collateral management services before (eg, asset managers, corporate clients, (sovereign) pension funds) so the client base has developed on a truly global scale. On the other hand, the usage of collateral management types had developed too. We've seen a massive increase in central bank pledging (again, worldwide) while also CCP-traded platforms boom, too. Eurex GC Pooling is now at more than EUR100 billion meaning that the CCP and related collateral management services helped to develop reliable liquidity in those markets and consequently support market recovery.

Also in the field of securities lending, where Clearstream Banking Frankfurt as only provider has been certified as "organised system" by the German BaFin (German Supervisory Authorities), the existence of reliable neutral collateral management services supports increasing trading activities among market players.

Wilson: Our view has not really changed insofar as collateral is the primary tool for mitigating counterparty risk. We are maniacal about understanding, managing and mitigating the risk across our securities lending program both for ourselves and for our clients and then working with our clients to provide them a programme and a structure which is consistent with their own views of risk management.

McPherson: For all lenders, counterparty risk, the quality of collateral accepted in their programmes and the correlation of both loan and collateral portfolios came under scrutiny. The focus on ensuring that concentration, correlation, liquidity and counterparty risk remained within stringently set and continuously reviewed parameters was unparalleled. As the collateral preference from borrowers can change from cash to non-cash, lenders have to become more flexible in accepting both types of collateral. Regardless, it is important that the risk return profile is understood and professionally managed. Loan and collateral correlation will become increasingly important as a means to reduce risk with variable margins becoming more common.

Carina: All of the market infrastructure service providers were tested during the crisis and all performed well. Euroclear Bank's triparty collateral management services were no exception.

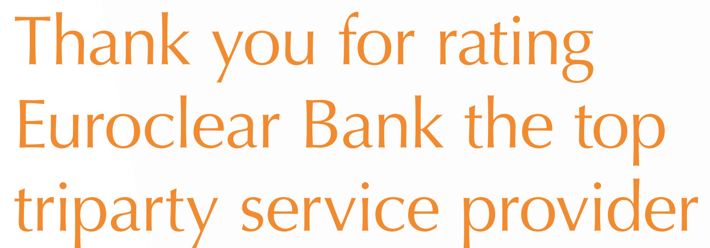
Taking on board the lessons learned from the crisis and by request from our clients, we have implemented several triparty service upgrades at Euroclear Bank. We have taken into consideration the growing importance of easing access to central bank credit and have complemented our portfolio with new services to automate the collateralisation process for clients to obtain this form of credit. One of our continuing key objectives is to provide a risk-controlled and scalable environment to help our clients optimise use of their assets as collateral.

Harland: Our views toward collateral management haven't particularly changed, clearly as one of the largest tri-party collateral managers we have always understood the operational efficiencies and risk mitigation that collateral management delivers.

However, we have seen the market view change. Collateral is a seen as critical, not a 'nice to have' and there is a growing recognition that we are no longer in a world where collateral management can be done effectively on a spreadsheet. Many are choosing to pass the task to a proven third-party provider.

Feige: We see an increasing trend towards triparty collateral management as more and more transactions are being outsourced

In terms of the recovery of markets and confidence, collateral management has, and will continue to play a critical role. Regulators have realised again just how important control and transparency are to market stability.



We owe it all to you – it's your feedback and co-operation that help us shape our services to meet your needs. We're listening – let's keep talking!

From all of us in the Euroclear Collateral Management Team: Frank, Maria, Fouad, Cédric, Jose, Deirdre, Olivier and Leonardo.

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During the near total collapse of confidence in the unsecured markets in late 2008 secured markets proved critical and BNY Mellon played a critical role. One of many examples was our mandate from the US Fed to run the TARP program. We continue to work very closely with regulators in all developed markets to restore order and confidence.

Milner: Our view is that some lenders did tighten their profile of acceptable collateral and/or increase their margin requirements

Milner: There has certainly been heightened interest in the market for enterprise collateral management solutions since the crisis, and this seems to be one of the key areas that many of our customers and prospects have an interest in. The ability to consolidate collateral solutions is driven from the need for a more holistic view of risk, and also by the desire to access the additional liquidity that collateral assets can provide in the market.

Poikonen: We remain committed to viewing collateral management as a critical component of the overall risk management philosophy of the organisation.

We hear a lot about a 'flight to quality'. Is it a reality?

Poikonen: If you are referring to transitioning from a "risky" asset such as global equities towards a historically "safe haven" asset such as AAA government bonds, then I would say yes it is a reality. Balance sheet "quality" is certainly improved in that instance.

McPherson: Whereas there was a flight to quality at the start of the credit crisis on the quality of the collateral accepted, as the months passed, a growing recognition of the importance of liquidity occurred. While the markets themselves were volatile, the liquidity of the cash equity markets, as well as their correlation to equity loan positions, meant that more lenders considered accepting equities as collateral. There has been more interest from beneficial owners both in equities as collateral as this forms part of major indices, there is good correlations, good liquidity and transparency in pricing.

Milner: Our view is that some lenders did tighten their profile of acceptable collateral and/or increase their margin requirements, however we do not think that this has substantially changed the asset classes that have been favoured perennially.

Carina: Absolutely. Through the triparty collateral management services we provide as a market infrastructure, we can clearly see that the elevated focus on risk management has led to a flight to quality. By this we mean a move towards high-quality and highly liquid government debt.

Feige: Yes and no. On the one hand,regulatory requirements and more conservative risk policies drive the collateral up the curve. Also, the increased use of CCPs (eg, Eurex GC Pooling) with its rather high-grade baskets follows that trend. Last but not least, recent market developments (eg, in Greek government debt markets) increase the "flight to quality", too. On the other hand, we do see other collateral quality being traded too. However, these are very individual and structured deals between distinctive counterparts which are given to us for triparty processing to benefit from sophisticated risk management and neutral and reliable pricing, valuation and reporting procedures.

Harland: As one of the most highly rated global financial institutions, that is certainly our experience.

Early on during the credit crisis we saw huge cash balances quickly moving into our custody, in particular hedge funds that had amassed significant liquidity looking for a safe haven for cash.

That continues, however during the last two years decisions have been a little more strategic and we have experienced a very strong demand, driven by hedge funds, for what we call prime custody, in other words provisions of bankruptcy custody solutions.

Wilson: Yes, flight to quality does exist and is in existence in the securities lending market. This can occur when clients determine to narrow collateral requirements or as we have seen in the use of an agent, where our financial standing and quality of our service has resulted in a very positive increase in new mandates, especially in the third party (non-custody) space.

Do you see a trend towards greater use of non-cash collateral?

Wilson: Not especially. The market has always been bifurcated with the US market having a bias towards cash collateral and the European market having a non cash collateral bias. As always, collateral flexibility remains key for clients wishing to maximise revenue within their risk tolerance threshold, as this gives the ability to maintain loans balances as changes on the demand side occur. Right now we do see a good demand for equity collateral and equity repo – both can add value in terms of earnings but with minimal incremental risk as the collateral is highly correlated to the loans, haircuts are higher and the pricing more readily available which adds to liquidity.

Harland: Again we would have to offer two answers. In the traditional' tri-party markets we have always seen broad acceptance of equities and bonds as collateral as well as cash.

In the OTC derivative world, we have seen increased interest from buy side firms (especially from equity based asset managers) but the reality is the major sell side counterparties have very little enthusiasm to take anything other than cash or government securities.

McPherson: The market has seen an increase in non-cash collateral by some lenders over the past year

McPherson: The market has seen an increase in non-cash collateral by some lenders over the past year. For agent lenders such as RBC Dexia that run our programme more towards realising the intrinsic value of the loan as opposed to relying on the earnings from additional spreads from an aggressive cash reinvestment, there was no requirement to rapidly change to a more risk-averse profile. Instead, the focus was on ensuring concentration, correlation and counterparty risks were within stringently set parameters. Cash collateral remains a legitimate option for

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lenders to consider but has its own unique risk-return profile that must be clearly understood. Beneficial owners are seemingly open to collateral flexible but they need to understand the risk/rewards attached to any securities lending programme and customise it to match their level of risk tolerance.

Feige: Yes we do. While especially OTC derivatives used to be cash-collateralised, we see a clear change here. We believe this would to a certain extent be due to the existence of a sophisticated global and single collateral pool from where eligible collateral can easily and efficiently be used, in line with greater flexibility and less risk when activating cross-border collateral, even on same-day basis.

Also, the possibility to benefit from re-use advantages allows collateral givers who had so far preferred to post cash as collateral to simplify this collateral usage while at the same time generating profits – an example: Instead of placing cash as collateral, the collateral giver invests this cash in triparty repo at very appealing repo rates and re-uses the securities collateral that he receives from that repo trade to cover the actual OTC derivatives exposure, all handled fully automated and STP.

Poikonen: Yes, we have witnessed a trend towards toward greater use of non cash collateral including sovereign debt and main index equities – both with appropriate excess margin. Interestingly, main index equities (as collateral in a securities lending transaction) with sufficient excess margin, performed well during the crisis when paired against properly correlated loans of equities.

Carina: The securities lending services offered by Euroclear Bank are based on non-cash collateral. We believe triparty securities lending is helping the market to build confidence and regain lost ground. The volumes in our triparty securities lending service are now back to pre-crisis levels. However, securities lenders have modified their risk profiles and have revised many of their risk assessment benchmarks.

Milner: In the US, where there was the greatest impact from losses on cash re-investment, there has certainly been more interest in the use of non-cash collateral – we can tell this from the number of our clients wanting to get a better understanding of the functionality of our solutions to support this area. There are, however, some restrictions around the types of collateral that can be taken by funds such as ERISA pension funds, which will add to the lead time for any changes in this area.

Are asset managers/fund managers demanding more information regarding collateral held – and what are the challenges in providing this?

McPherson: The biggest challenge we have seen over the last year is the level of attention clients are giving their lending programmes. They have taken a much keener interest in their collateral and their counterparty exposure. Service providers need to work with lending clients to develop a reporting package customised to meet client's information requirements. As a result, there is a continuous upgrade of technology and enhancement of reporting packages to provide clients with a wide range of customisable options that is transparent to all lending and collateral activity.

Milner: A greater demand for transparency in this area has been a natural outcome of the post-Lehman awareness of having more granular, and more timely information on the collateral held

Poikonen: Beneficial owners are increasingly looking for more information about their programmes whether it is on lending or collateral management. Understandably, they want to know how returns are generated, what risk they are taking to achieve these returns and how much collateral is held on their transactions on a daily basis. Delivery of such reports to clients should not be a challenge for agents.

Harland: In general we see much more attention to collateral and granularity around collateral schedules. From our perspective, we see it as positive that the importance of robust collateral management has moved up the list of competing business priorities.

In our OTC Derivative Collateral Management business we are working with multiple asset managers and fund managers and what we are increasingly asked to provide is comprehensive and bespoke reporting across various business lines and functions for example to depobank/custodians, to counterparties and fund administrators.

Wilson: This has been a trend that has existed even before the market crisis. It's not only the demand for more information, it's the depth and breadth of the information needs that has changed as well as the frequency. We see clients also wanting this at different levels, with every permutation from programme level to cusip level. The key for us has been the development of our on-line reporting tools, including our fourth generation dashboard, that allows our clients to access information and reports on line and receive data in numerous different formats.

Milner: A greater demand for transparency in this area has been a natural outcome of the post-Lehman awareness of the importance of having more granular, and more timely information on the collateral held. The challenges arise in providing a consolidated view of all collateral held to the asset/fund manager, as sometimes this data is only available at a different level of consolidation (for example by borrower), or it may be dissipated over multiple locations, for example when using tri-party collateral management agents.

Feige: Mainly driven by their typically very conservative risk and controlling departments and by regulatory requirements, asset managers require certain procedures and specialised reporting. For example, asset managers often require individual settlement and reporting on a sub-fund level which can be tricky in terms of managing and setting up every single sub-fund also from a legal and operational perspective. Therefore, solutions where the regulator (eg, German BaFin) certifies providers (eg Clearstream Banking Frankfurt as so far the only provider) as an "organised system" allows according to the German Investment Act to aggregate and pool collateral at an asset manager level and hence explains the increased usage and appreciation of this service by eg, German asset managers and their borrowers.

Carina: Euroclear Bank offers a unique value proposition. We help clients access a very large pool of collateral comprising a wide range of securities that is continuously refreshed since it is integrated with the transaction settlement

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- Many of my operational activities are highly labor intensive - I only have time to sort out the large billing discrepancies - I am missing corporate actions that impact the profitability of a trade - I have to work very long hours to sort our billing discrepancies - I can't take risks when choosing the supplier for my mission critical solutions.

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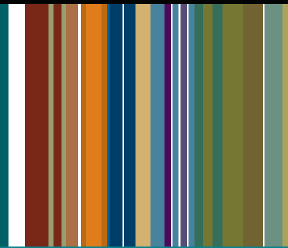

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process. As a result, we are able to optimise their use of collateral and manage term financing business in a seamless way, identifying and substituting collateral using automated processes. Real-time reporting keeps clients informed of these movements at all times.

The recent financial crisis has proven Euroclear's expertise in this area, which is supported by a solid legal and operational environment. By outsourcing their collateral management obligations to a triparty agent like Euroclear Bank, clients can collateralise all types of exposures arising with a wide range of counterparties. The deals are agreed bilaterally between the two counterparties, or a central counterparty (CCP), but all of the back-office administration is done by us on an end-to-end STP basis.

What role will CCPs have in the future?

Harland: The future is uncertain. In less than 90 days, the Dodd Frank Title VII legislation rules will be published with implementation due six months thereafter. That will form the earliest tangible basis for predicting the future of CCPs in the US. Our best guess is that they will play an expanded role in clearing derivatives that are OTC's today.

In Europe, the latest published proposal for legislation in this area is light on specifics, but seems to provide a framework in which CCPs will play a large role in derivative clearing. The timeframe for conclusion of the legislative process is unclear and will likely be significantly

> Poikonen: CCPs appear to have a bright future in the securities lending and financing industry. We view them as another potential route to market

longer than in the US, so the future of CCPs there will remain in doubt for a longer period.

That said, and notwithstanding the clear benefits around netting and risk management, common to all CCPs is collateral management. How each handle this will be a differentiator from a cost of doing business perspective.

From an industry perspective, the apparently inevitable multiple CCPs will result is multiple pools of collateral leading to additional expense and reduced collateral optimisation.

McPherson: Central counterparty (CCP) has been a common topic of discussion as a means managing credit risk within the industry for quite some time. The concept of a securities lending CCP is fundamentally sound, and the overarching benefits are clear from their application in other financial markets. But the challenge for most is in developing a thorough understanding as to how it will work in practice and in identifying the inherent risks within the context of a securities lending environment.

For a CCP in this industry to truly be successful, it also requires the cooperation and collaboration from all market participants and we haven't progressed to that stage. However, the speed at which the debate has progressed in the last 18 months has been rapid. CCPs are here already, the question is will they be widely adopted. On this point the obstacles are now well known and if the CCPs make similar progress in providing market participants with the solutions needed to address them then their role in the securities lending market could become significant.

Poikonen: CCPs appear to have a bright future in the securities lending and financing industry. We view them as another potential route to market that helps improve distribution and lowers the counterparty risk of the beneficial owners we service. Provided that better spreads and the AAA rated exposure can truly be obtained, net of all associated costs, the CCP option will become an integral part of the industry going forward.

Carina: The role of CCPs as intermediaries will only increase in the future, especially in view of the regulatory focus on this activity.

Euroclear Bank's services complement the risk mitigation objectives of CCPs and extend a high degree of collateral management efficiency along the whole post-trade processing chain. And, as CCP interoperability becomes a reality in the future, our services can also be of assistance in this context.

Many CCPs are already active users of our collateral management services to manage their core margining processes, as well as for their General Collateral (GC) products.

Wilson: That remains to be seen. CCPs do on the surface afford a centralised way of mitigating risk, but how this works for the securities lending market needs to be really determined. We do remain open minded and continue to participate in industry discussion, but frequently we hear clients ask what would happen to indemnification and a concern that risk management would navigate to the mean and only be as good as that of the worst participant. These points and many others need to be considered and worked through.

> McPherson: For a CCP in this industry to be truly successful, it also requires the cooperation and collaboration from all market participants

Milner: CCPs will certainly impact the way in which collateral is held and margin is managed in the future. The requirement for all parties, including the lender, to pay margin to the central clearer requires a shift in mindset from the current state where the lender always receives the collateral, and this is one of the major obstacles that is hindering the uptake of the central counterpart model. However, decisions in the move towards central counterparty clearing are more likely to be around timing rather than whether or not to participate, particularly as there is some regulatory pressure to move in this direction.

Feige: We believe that the importance of CCPs will increase even more. As in the past, the move from unsecured markets or bilateral repos to CCPs is expected to continue.
While CCPs for repos, for example, are already very established and reach record outstandings, we see market developments towards CCP to also cover securities lending and OTC derivatives transactions more and more. In addition, regulators like CCPs for supervision, control and standardisation purposes. **SLT**

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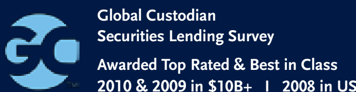

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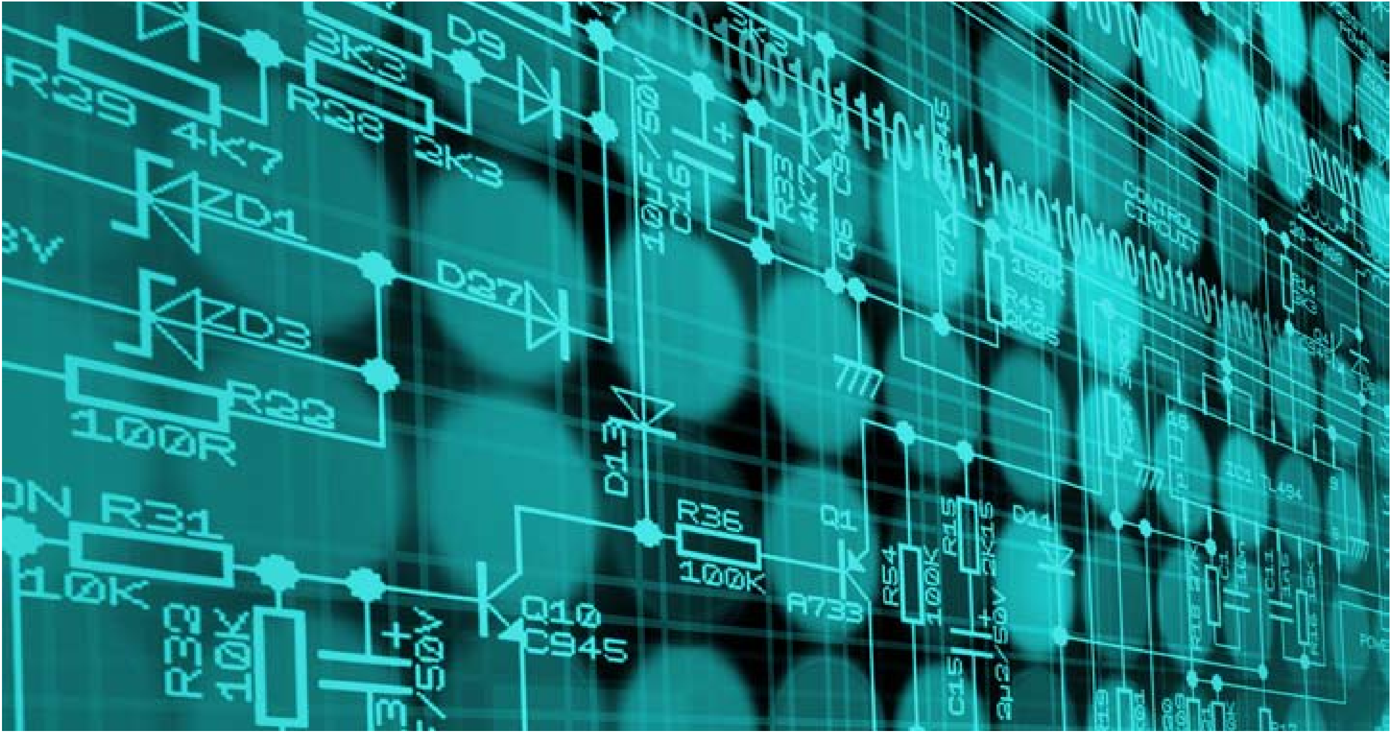

The bionic plan

The fallout from the global crisis precipitated by the Lehman default has had a crippling effect on the industry, but the increased adoption of technology systems has the capability to rebuild confidence

MARKET RESEARCH

The Lehman Brothers default still, to this day, has a lot to answer for. Careers, confidence and global reputations took a major hit after one of the world's, if not the world's, leading financial players was forced to capitulate when its eye for risk eventually became more than it could stomach.

But, like the fabled phoenix before it, rising from ashes of this debunked institution has been a sobering of thought towards cavalierism, an increase in protective and robust regulation, and a certain introspection within financial institutions as to how to improve the way they operate.

One key area of focus is the automation of operating systems. As profit margins become squeezed, firms involved with securities lending are realising that a more streamlined approach to trading can offer flexibility, efficiency and greater optimisation of assets. "People's previously perceived lack of risk has changed since the Lehman default," said Adrian Morris of MX Consulting. "Institutions are more focused on making sure that processes work, and that their business is better regulated internally. This may mean the removal of the spread sheeting process, or removing the number of 'touch points' a transaction has to go through before it hits the market."

Oddly, the multi-billion dollar securities lending industry has suffered previously from a lack of investment in its IT support structure. The received wisdom is that it is relatively simple to make money from the process of lending and short selling if the core systems are in place. However, to make real money, now and into the future, companies are waking up to the need to diversify. "The better players – either big or small – who've invested at a more normal business level have done better in the past couple of years, as they were able to invest in other businesses, such as cash reinvestment, which made money last year," said Morris, whose firm, MX Consulting, specialises in running IT projects for clients. This ranges from implementing new, vendor-supplied trading systems, including Global One, Martini, 4sight and Finace, to advising on, and building, proprietary systems, such as income and fee systems, cash collateral and payment, and messaging systems.

The post-Lehman era has, says Morris, seen a rise in financial institutions looking more to vendor solutions than to proprietary trading systems; however, implementation of such systems can be tricky, added Morris. "The actual migration across of data onto a single platform can sometimes be more expensive than the actual cost of purchase."

Understanding this perceived risk over changing platforms is one of MX Consulting's strong suits. "We don't necessarily advise against migration in these instances," said Morris. "We instead look at the risks and structure and programme in a way that's likely to give them delivery. What clients want is a skill set that means that when the business talks to us about their requirements, we understand what they are saying. For some clients, that might mean building a proprietary system, while for others it might be the implementation of a vendor system replacing another legacy system."

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"The market is pretty much a replacement market," affirms Igor Salzgeber of Swiss-based solution providers COMIT, which has been servicing the finance industry for more than 30 years with professional IT services across the whole value chain. Heading up COMIT's leading IT solution, Finace, Salzgeber is another who is well placed to assess the state of the technology purchasing industry.

"It has always been pretty competitive, as it is largely a closed circle of vendors competing for similar clients. However, some are predetermined to serve certain businesses, and vice versa," he adds.

This is a view echoed by 4sight Securities Finance, another solutions provider. It offers an integrated front-to-back office solution which supports lending and borrowing, repo, swaps and collateral management for financial institutions of all sizes. Judith McKelvey, global sales director, says: "The technology market for securities lending is currently highly competitive. In recent years, we have replaced a number of competitor systems as banks re-evaluate their providers. On the flip side, our customers regularly benchmark us against our own competitors."

But in such a small market, how does one provider set itself apart from the rest? "Finace has a flexible architecture that allows it to respond to individual client demands in a more agile way," says Salzgeber. This is an important consideration, because working across a big organisation with a creaking legacy system is not always as intuitive as it would be if working within the business organisation from where the actual problem originated.

On this, Salzgeber is quick to point out another differentiator. "Finace strongly propagates a higher degree of integration across individual businesses – be it stock lending, repo, or synthetic finance – if properly managed.

"We are in fact the first vendor to have put forward this integrated and vertical approach to the industry."

The reception from clients has been welcome; however, says Salzgeber, this often depends on the scale and size of the clients. Some may simply scale up their initial problem to onboard others within synthetic finance, repo and OTC, say, to arrive at a companywide solution; while others, with more diversified business models, may require a higher degree of diversification for each transaction but also a system that is adaptable to cover certain, similar aspects of these transactions.

This complexity surrounding the adoption of technology solutions for the securities lending market is not restricted to the UK. It is, says Jane Milner, market specialist at SunGard, also one that affects the global market.

"The securities lending market originally started in the US, but it is very different there to the rest of the international market - which includes London, Paris, Frankfurt and Amsterdam - largely because it is more heavily regulated, but also because the weight of protection lies in favour of customers, who are the source of a lot of the securities funding."

SunGard, long the dominant element in the securities lending technology sphere, is unique in that, as a result of its global presence, it is able to provide solutions for both the US and international space. One key package, almost universally adopted in the US, is Loanet, which offers a holistic approach to managing the life cycle of a transaction, something that has yet to happen in the international market.

"As margins decrease, participants in securities lending are looking at ways to reduce costs"

Judith McKelvey

This US market knowledge puts SunGard in a position to implement new technologies in the international market, where applicable. As Milner adds, SunGard currently enjoys a strong standing as a solutions provider, with firms now popping up from under the parapet to consider investing in IT. "Whereas just after the crash it was a case of firms window shopping without the power to spend, they are now looking strategically at providers and technology solutions, as they consider moving away from silos to having a greater transparency," said Milner.

Despite its established presence, SunGard is still looking to innovate its systems to meet demand. Milner explains: "SunGard originally built up a lot of products, so we have already been looking at where there are synergies and integration between these products, and where we can facilitate information sharing in specialist areas. We have been working increasingly in that space, and that has dovetailed nicely with market requirements."

McKelvey says that a key area of advancement noted by 4sight was in collateral and risk management. "This is probably the main area that has seen a lot of interest, as firms look to gain greater control over eligibility, concentration limits and collateral haircuts, particularly for OTC derivatives. We have also recently released a Recalls module, which helps to reduce the manual effort involved in the recalls process and increases operational efficiency.

"Synthetic trade structures are becoming more widespread and require corresponding functionality to support this. We are also developing features to support the increasing use of central counterparties, and electronic trading platforms," she added.

With regard to the cost of implementation, SunGard comes out tops. "The likelihood is that integration will involve some of our other products, such as a clearing settlement system, so this will enable us to bring greater efficiencies than from any outside group."

As with the financial services industry as a whole, the securities lending industry has also been subject to regulation, and with technology systems in use across the world, this can present its own issues. Milner explains SunGard's position: "We monitor and tailor programmes according to regulations as best we can, but securities finance covers areas as diverse as hedge funds, pension funds, insurance, asset managers and prime brokers, all of whom use our solutions, and all of whom are based in different countries with different regulations. We try to keep abreast of them, but our strength is that because we have more than 400 clients, we can work with them to understand their interpretation of the regulations to see what will be required."

Salzgeber, whose aim is for Finace to garner up to 25 per cent of the market share in the next few years, is more sanguine about the spectre of regulation. "We have a dedicated team that continuously assesses and evaluates regulatory decisions that may arise concerning tax reporting and restrictions on planned domiciles and, when delivering solutions, we incorporate a release policy that includes two windows of opportunity - in February and in October - that allow us to respond to regulatory changes in a timely manner."

So what does the future hold for providers servicing the securities lending industry? Salzgeber from COMIT said: "We think there will be a higher diversification of supported business models to be able to service a mainstream agent lender or prime broker or asset manager with the help of the same system that could service other businesses. So, diversification and coverage of the individual business models is the ultimate decision-making element, together with having a scalable system that can run run on 24/7 basis in a global context."

McKelvey, however, sounded a note of caution in her prediction: "As margins decrease, participants in securities lending are looking at ways to reduce costs and this will certainly play a role in how technology systems are used going forward."

SunGard's Milner says: From an expansion perspective, we're seeing Asia and some places in Eastern Europe as a place where firms are looking to expand their relationships, where possible, with different local banks with whom they already have connections."

But perhaps the final word should go to Morris from MX Consulting, who says: "We expect to see more investment from firms who previously considered automation a low priority, as they come to realise that there is money to be made from it." **SLT**

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The new era

Securities lending across the world is maturing into a transparent, efficient and open market as a result of the recent downturn - all of which bodes well for the future, says SunGard's Tim Smith

MARKET RESEARCH

As attendees at this year's annual RMA Securities Lending and Repo conference gather in Boca Raton, the industry stands at a crossroads. Naturally, oversight and transparency are the general themes governing today's business landscape. However, many facets of the business are changing globally – throughout regions, within countries and among all of the securities lending stakeholders – making change the only common factor.

Global changes

Securities lending has gone through three main phases of its lifetime: opacity, scrutiny and transparency. Up until two years ago, the business operated in an opaque environment of two types. First is the necessary confidential opacity required to protect the personal details of any investor, public or private, and also the understandable competitive opacity to enable participants to maximise trading efficiencies and without sharing with competitors the proprietary nature of their businesses. The second type is the unnecessary opacity of insufficient reporting, lack of clarity around risks, little or no regulatory reporting, and the presumption that non-participants 'would just not understand'.

This era of opacity has given way under significant bombardment to an era of scrutiny by the regulators, the press and customers. In a rare showing of global unity, the regulators have adopted similar approaches around the world to control short selling, and by default, securities lending activity. Driven in part by public outcry and spurred on by occasionally informed but mostly uninformed press commentary, regulators have in turn banned, reviewed, allowed and restricted short selling of all or certain types of securities.

This scrutiny and control has led to the era of transparency. While transparency had been talked about in the past, today it is a virtual requirement. All participants on a global scale are seeking ways of turning transparency into an asset in gaining favourr with clients and regulators alike. What once was the perception of doing the right thing has turned into actuality.

Transparency drives changes in relationships on a global scale, which then leads to more need for transparency. Causing a breakdown in the lines of demarcation between the various global participants, this has led to a change in the rela-

tionship between borrowers and lenders. When coupled with the general lack of any real economic growth, arbitrage activities and real short selling ideas, the result is a shift in the balance of power, as demonstrated in the two charts.

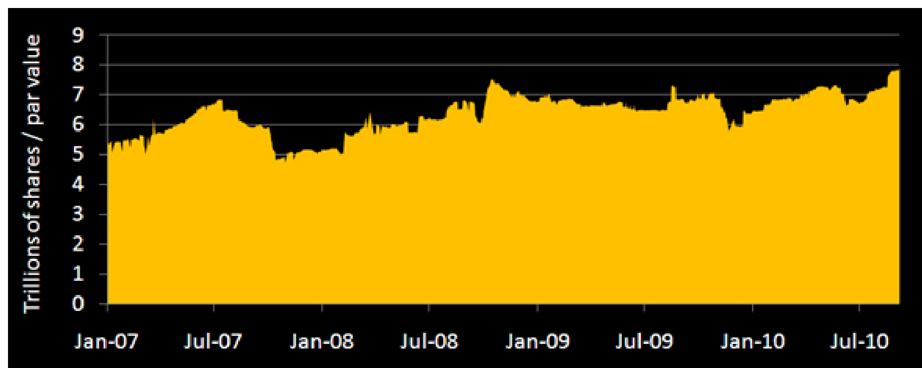
Taking the changes in market value out of the equation, the first chart shows that during 2009, there was a slight decline in global availability of shares to lend. In fact, there was a steeper decline than this as, although securities were shown as being available, risk concerns led beneficial owners and investment managers to lend or not to lend in a pragmatic fashion. In the last year, old and new lenders have made their portfolios available. Restrictions built around lending in terms of collateral types and amounts are in place; however, the fact remains that funds all around the world desire the return of income they achieved from lending.

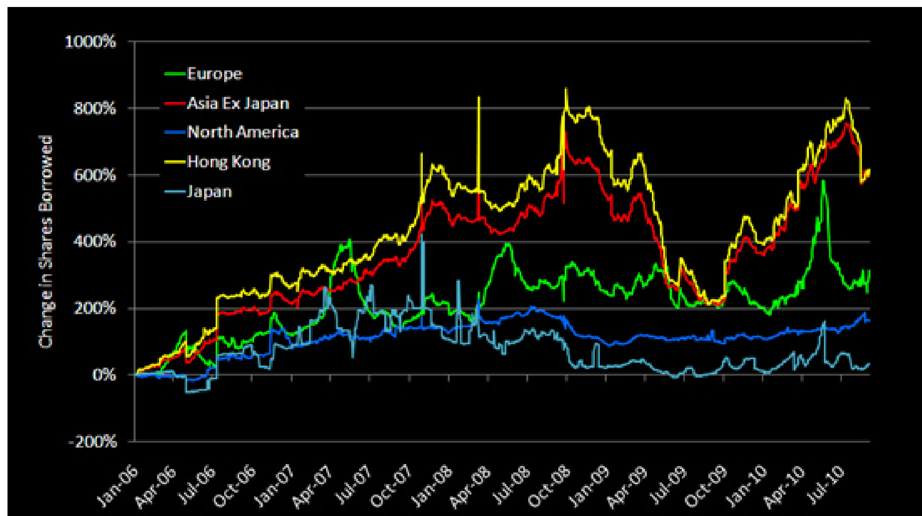
However, looking at the demand side for the last couple of years as shown in the other chart on the right, there has been no real change in the amount of overall demand. In fact, global demand in numbers of shares remains slightly down except for some regional exceptions. As a consequence, during the time when lenders were pulling out of lending, the demand was declining and thus there was no real undersupply (the Citibank trade excepted). In the last year, the supply increase has outstripped the demand, thus leading to a more discerning borrower and a more desperate lender, as well as a lender with more knowledge, awareness and caution.

Changes in transparency have also spilt over into the public domain. Previous academic articles, much criticised a few years ago because of their paucity of data, have now been replaced by a more engaged academic debate using data from the various industry bodies around the world that have begun a programme of education and information dissemination. This is a global change that has recognised the inadequacies of the past. ‘How can we expect anyone to understand what we do and why it is so beneficial to the world markets when we do not tell anyone all of the details?’

In the last year, the supply increase has outstripped the demand, thus leading to a more discerning borrower and a more desperate lender

The global market has changed in shape and internal relationship, but despite this global framework, there are still regional nuances that have developed separately and look to continue to diversify.





Regional Changes

The demand side chart above graphically displays what we intuitively know and feel as market practitioners. Japan, once the wonder country of securities lending demand driven by seemingly endless convertible and warrant arbitrage possibilities, remains flat or even slightly below. However, Japan remains one of the top four markets when it comes to consistent demand throughout the year.

The North American market remains fairly flat as well. Although this includes Canada, which has seen a fair amount of growth, the overall business levels are down, with demand from hedge funds being held back for a variety of reasons.

Europe also appears to be on a generally flat line with the seasonal bumps of yield enhancement activity keeping it interesting and traders employed.

The one region showing signs of life is Asia, where new markets and anticipation about new markets such as India and China, embryonic yield enhancement, and increasing numbers of hedge funds have led the way.

While these differences are noteworthy, this has also caused regions to move in different directions in terms of business development. Taking Asia as the most dynamic region, the promise of the last 20 years, apart from occasional leaps, has never really fulfilled its real potential. The crisis of the last two years seems to have acted as a catalyst to the development of a controlled system of short selling and securities lending - so much so that this region still is alone in showing an increase in the number of new recruits to the securities finance business.

The crisis of the last two years seems to have acted as a catalyst

However, various countries throughout the region have shown slow progress in developing their processes. Starting from a non-short selling, non-securities lending base, they have developed a tentative, centrally controlled system in the main, and then allowed more freedom into each one as they become more comfortable with it. **SLT**

The South Korean model is considered a fairly good one to follow. Naturally, progress has been painfully slow and sometimes movement has been backwards (eg, Malaysia, although this has now changed), but careful lobbying by industry groups like PASLA have meant that the current lending markets are open for business, albeit on a different model and with idiosyncrasies not seen in the other regions. When China and India open up to offshore lending, there will be another sea change. Japan has remained aloof but not unaffected by the changes going on around it. It still remains the most mature regional market, but awaits the general economic upturn to reawaken the interest levels.

In Europe, the economic downturn has affected business, but there have not been any major procedural wobbles to inspire wholesale market practice changes. The cash collateral reinvestment issues were mostly a non-European phenomenon, and both lenders and borrowers have now realized this. There is a fair amount of discussion regarding the advisability of one form of non-cash collateral over another with perhaps different margins being taken, but this is a grown-up argument in a mature market. Demand, however, remains seasonally firm with occasional gusts of event-driven, hot stock breeze in between.

> This episode in the history of securities lending will be seen as another blip

The growing number of lendable ETF assets is another feature of the change, noticeable in other regions as well, but especially in Europe. Access to borrowing, sometimes in a swap backed created way, has led to a seemingly unstoppable supply of securities with which to establish a short position to mirror a traditional or fabricated index. Although this seems an efficient way of creating the right position, it does somewhat militate against the traditional way of borrowing the underlying or constituent assets of a specific index.

Turning to North America, we discussed the regulatory environment as a global trend. However, the old adage of “when Wall Street sneezes, then the rest of the world catches a cold” works well for regulatory change as well. By and large, regulatory controls and changes have been driven out of the US, and it is these changes and market aspects we need to consider.

Country Changes

The US is said to be all about choice. This has historically been the case in the US securities lending market, and the changes that are taking place at the moment are certainly carrying on this tradition. Just as the move and call for more transparency are affecting new and emerging markets, so they are having their impact on the most mature market in the world.

Much has been written about cash collateral versus non-cash collateral and it is not the purpose of this paper to assess the merits or demerits of either. Suffice to say that cash collateral reinvestment is NOT securities lending and should be analysed separately and secondly, cash has remained king in the US and looks likely to remain so, but the emphasis has changed as we will discuss under the stakeholder changes.

The main change that is taking place in the US is around the way business is conducted between market professionals. Given its origins as a mainly back-office activity, systems and processes also have been driven from this area. As the business moved towards a trading type model, new uses were discovered and new outlets and ways to manage balance sheets were unearthed, leading to an overflow of ideas and uses internal to broker-dealers in particular. Systems have had to catch up, and new methods have been developed to ensure that inventory within market participants are handled in the most efficient manner with increased automation and integration. With the additional choice of a central counterparty model, participants will increasingly require integrated technology to support higher levels of business activity when demand grows. Having all the different flows in one system will become a necessity.

As the business becomes more automated, exception reporting becomes the norm, mirroring what has happened in normal settlement processes the world over. However, when you factor in increasing demand for regulatory reporting and maintenance of a plethora of financial ratios, the demands on the current system technology will increase exponentially yet again. There are at the moment very few technology providers working on or implementing these necessary upgrades or enhancements.

Stakeholder Changes

There is a continuous change in the relationships between the stakeholders in the securities lending process.

Beneficial owners have changed from focusing on reward, then risk, and now back to reward again as they seek to regain lost income flows. There is an understanding, however, that greater responsibility needs to be taken for monitoring the programme, and where cash is provided, in using their own resources to cover this business where appropriate and the expertise exists. They are also looking at other ways to interact with end users of their securities, such as through exclusive bidding and central counterparties, even if via a third clearance agent.

Agent lenders have always sought to provide relevant information to their beneficial owners, but it has only recently had the reporting capability in place. In addition, the agents are reassessing their relationships with the demand community as the balance of power has changed.

Whereas the broker-dealer/prime broker appears to have the pick of its demand except for the very hot stocks, they are still influenced on the other side by their hedge fund clients. Just as the agent lenders were compelled to be more transparent with their beneficial owners, the prime brokers are going through the same exercise.

Although hedge fund demand is much lower than it was – assets under management are at about 65 per cent of their 2007 levels and the strategies involving shorting securities are at an even lower percentage – they are now much more active in the lending side as well. There is some confusion as to why they cannot earn as much on their long lending as they had to pay on their short borrowing, but it is still income nevertheless. In addition, the proposed spinoff of the investment banking and trading arms of retail banks in some countries is creating the potential for a whole new breed of independent hedge funds.

Conclusion

All of these issues likely will be discussed in some detail as the great and the good of the securities lending industry assemble in Florida. New relationships will continue to be forged and old ones consolidated. Given time, this episode in the history of securities lending will be seen as another blip. Certainly there are major challenges ahead. While this has been said at many previous conferences, there is still no getting away from the fact that securities lending is a basic requirement of any functioning securities market. Therefore, one form of activity or way of conducting business may be dead, but a new form will take its place and will continue to do so for the foreseeable future.

Tim Smith
Executive vice president
SunGards securities finance

Short selling and delivery

Part four of our series on the ICMA White Paper looking at the European repo market, looks at the role of short selling and failure to deliver

MARKET RESEARCH

During recent episodes of market turbulence, particularly after the failure of Lehman Brothers and during the financial crisis in Greece, political attention has been focused on uncovered or "naked" short-selling, where a short sale of a security is made before being covered by borrowing. The traditional concern with uncovered short-selling is the belief that it permits unlimited selling of a security, allowing speculative forces to massively leverage negative sentiment and thus manipulate the market.

It is incorrect to assume that all uncovered short positions are trades with an abusive intent. Abusive uncovered short-selling is where the seller has no intention of borrowing and delivering the securities he has sold short. Attempts to prohibit abusive/intentional uncovered short-selling by means of a regulatory requirement that borrowing should always precede short-selling make the mistake of assuming that the relative timing of short-selling and short-covering is a reliable indicator of intent. Many, if not most, uncovered short positions are either temporary or unintentional.

Temporary uncovered short positions arise routinely where short-selling is covered retrospectively. There are sound reasons for such delays. Establishing a short position is more urgent than covering that position, because of the need to contain the market risk on the short position. On the other hand, a short position can be covered at any time until settlement, so there is inherently no rush. Indeed, because repos settle at T+2 or sooner, while most fixed-income securities settle at T+3, short covering in the repo market could quite properly be delayed for a day. In practice, however, the bulk of temporary uncovered short positions are only intraday.

Unintentional uncovered short positions are the result of short-sellers being unable to cover their positions because their attempts to borrow securities have been frustrated by market illiquidity, or because the counterparties from whom they have borrowed have failed to deliver to them, also as a result of market illiquidity or due to operational error interrupting settlement.

A "pre-borrowing" regulation is not needed to address temporary uncovered short positions, as they are not a problem, nor is it a sensible way of addressing unintentional uncovered short positions, as it does not address the causes and there are better solutions. Moreover, a preborrowing regulation would impose undesirable costs on all market users.

There would be a direct cost from a pre-borrowing regulation that would arise because enforcement of such a regulation would require the imposition of a detailed reporting regime on market users. Although primary dealers and other designated market-makers would have to be exempted from the pre-borrowing requirement, they could not prudently be exempted from the reporting requirement, so the cost of marketmaking and of government debt would be adversely affected.

There would also be an indirect cost from a pre-borrowing regulation, as a consequence of the fact that such a regulation would effectively prohibit all delivery failures, whatever their cause. This would have the serious unintended consequence of constraining all selling activity, both short-selling and the liquidation of long positions. Legitimate short selling would be especially affected, given the occasional uncertainty about the supply of securities available for borrowing, but the prohibition is likely to constrain even the liquidation of long positions, as market users would need to ensure that securities being financed in the repo market were delivered back to them in time for onward delivery. In addition to costly delays in completing transactions, there is likely to be wasteful "over-borrowing". A pre-borrowing regulation would therefore damage the efficiency of financial markets, reduce liquidity and raise the cost of financial services to both issuers and investors.

The costs of a pre-borrowing requirement need to be considered against the likely scale and frequency of the practice it is supposed to be eliminating. There is no evidence that intentional uncovered short-selling is a significant activity. While it is not possible to specifically measure intentional uncovered short selling, we can fix an upper limit to the scale of the problem by looking at the statistics on settlement failures, given that intentional uncovered short-selling will always result in a failure to deliver.

Consider the efficiency of cross-border settlement between the International Central Securities Depositories (ICSDs), Euroclear and Clearstream, who tend to be the settlement agents for international market users, and national CSDs, who tend to be the settlement agents for domestic market users. ICSD-CSD links have traditionally been the weakest links in European settlement. Settlement between a client of Euroclear on the one hand and clients of the CSDs in France, Germany and the UK on the other hand, as measured by the number of successfully settled instructions per month over the turbulent period from January 2008 to May 2010, averaged 97.6 per cent (97.3 per cent for France, 98.7 per cent for Germany and 96.8 per cent for the UK), varying between 96.2 per cent and 99.3 per cent. These are high rates of settlement. Given that many of the failed settlements would have been unintentional, ie caused by operational errors or market illiquidity, the likely rate of intentional uncovered short-selling must be very low. Nor did settlement efficiency between Euroclear and these CSDs deteriorate over this period. There is a case to be made that intentional uncovered short-selling is more a hypothetical than a real problem.

Given that intentional uncovered short-selling is not a substantial activity and that serious collateral damage is likely to be caused to the market by the imposition of a pre-borrowing requirement, such a blunt regulation would be a disproportionate response. Instead, as intentional uncovered short-selling is a form of market abuse, it should be treated as such and dealt with by applying existing market abuse regulations. The amendment of those regulations to specifically cover short-selling is not appropriate. Although short-selling can be used by marker abusers, so can any other financial instrument. As a matter of principle, market abuse regulations should focus on the misuse of instruments, not the instruments themselves, particularly given that intentional uncovered short-selling is likely to be just one element in a more general pattern of abusive market behaviour.

However, perhaps the most important point to make is that prohibitions on uncovered short-selling of fixed income securities are generally unnecessary, because there are already market mechanisms in place that, in normal circumstances, are very effective in deterring intentional uncovered short-selling and in reducing unintentional uncovered short-selling.

Failure to deliver in the repo market

While intentional uncovered short-selling, by definition, results in delivery failure, the problem of delivery failures in Europe is not a reflection of short selling. It has already been noted that there are more routine reasons:

Operational errors originated by personnel within the front or back offices of counterparties, such as incorrect, incomplete or late settlement instructions. The vast bulk of settlement failures are believed to originate in such operational errors. The ability to correct these errors can be constrained by the poor technical design of settlement systems and the rigid business practices of CSD.

Operational failures in systems and communications, eg power outages.

A scarcity of a particular issue in the market, particularly in hectic market conditions, frustrat-

ing attempts by short-sellers to borrow in order to cover their short positions.

Barriers to interconnectivity between CSDs and ICSDs which obstruct the efficient transfer of securities cross-border.

Failures occur in the settlement of both the cash and repo transactions. They may take the form of permanent, late or partial delivery. Late delivery may include delivery on the scheduled settlement date, but too late for an agreed processing cycle within the settlement system.

Factors reducing delivery failures

Parties involved in chains of transactions who fail to receive securities on one side can avoid failing on the other side by borrowing. The problem of delivery failures can therefore be reduced by providing access to liquid repo and securities lending markets. All European countries have repo markets, but not all have securities lending markets. While repo performs an analogous function to securities lending, the overlap is not total. Securities lending is the preferred market for equity, and some lenders prefer securities lending to repo, for reasons such as the impact of cash on their balance sheets and the expense of signing another legal agreement in order to transact repo. The lack of liquid securities lending markets is particularly noticeable in countries such as Greece, Italy and Spain, where international market users have expressed concern about the difficulties of cross-border settlement into local CSDs.

The automatic agency securities lending facilities offered by the ICSDs play a particularly useful role in reducing delivery failures in the cross-border market (contributing in the region of five per cent to settlement efficiency). Users who sign up to these facilities are able to demonstrate to regulators that they intend to deliver and are not engaging in unintentional short-selling. Moreover, because the ICSDs charge fixed borrowing fees, users cap the risk of borrowing at reasonable levels.

The scope for delivery failures is being continuously reduced by the adoption of new market technologies in the form of:

Electronic repo trading --- which centralises trading and therefore tends to avoid the formation of chains of transactions. The matching function intrinsic to electronic trading also assists in reducing the scope for delivery failures by precluding mismatched settlement instructions. Electronic trading currently accounts for about 28 per cent of the value of outstanding European repo contracts.

CCPs (usually attached to electronic trading systems) - which can eliminate the operational sources of delivery failures by matching transaction details and identifying errors before settlement, as well as cutting chains through multilateral netting (eg if A sells to B, who sells to C, who sells to D, a CCP would limit the effect of a delivery failure to A and D by netting out B and C). CCPs handle about 19 per cent of the value of outstanding European repo contracts, mostly electronic trades (ICMA survey, December 2009).

Tri-party repo --- which eliminates delivery failures entirely, as collateral is selected on behalf of repo sellers by tri-party agents only if it is available in the account of the seller. Tri-party repo also allows more effective and flexible use of collateral resources. It accounts for about eight per cent of the value of outstanding European repo contracts, although it has been as high as 12 per cent.

Most cash and repo markets in Europe have well-established and generally accepted conventions, actively promoted by the ICMA's European Repo Council (ERC), the International Capital Market Association (ICMA) and the Association for Financial Markets in Europe (AFME), which, in normal market conditions, successfully contain delivery failures by creating compelling economic incentives for market users to avoid or cure such failures. To understand these conventions, consider the following scenarios:

- A seller fails to deliver in a cash transaction.
- A repo seller fails to deliver at the start of a repo.
- A repo buyer fails to deliver at the end of a repo.

Failure to deliver in a cash transaction

In the cash market, if an outright seller fails to deliver a security to an outright buyer:

The buyer should withhold or recover his cash payment.

As the buyer has contractually become the legal owner of the security, he holds a long position in that security, which means that he will start to accrue coupon interest on the security.

The position of the seller will be a mirror image of that of the buyer. He holds a short position in the security. As the seller will, at some stage, have to buy the security in order to fulfil delivery (or make an equivalent settlement of claims), the daily accrual of coupon interest on the security will add to his eventual cost of purchase.

While the failure to receive a particular security may be inconvenient to the buyer, the immediate financial consequences are positive for him, providing compensation, which should cover or at least reduce the cost of borrowing the security, if he wished to do so.

At the same time, the accrual of coupon interest on the security represents an accrual of loss to the seller. This provides an incentive for him to cure the delivery failure by borrowing the security from the repo or securities lending markets and paying a borrowing fee up to the equivalent of the accrued coupon interest.

Failure to deliver by a repo seller at the start of a repo

In the repo market, in the case of a failure by a repo seller to deliver collateral securities at the start of a repo, the generally-accepted market convention operates as follows:

Despite the delivery failure, the repo is not automatically cancelled.

The repo buyer will withhold his cash from the repo seller or, if he has made payment, he will immediately recover it.

The repo seller is able to deliver the collateral securities to the repo buyer at any time during the contract period. If and when the repo seller delivers, he will be entitled to receive the original cash amount of the contract for the remainder of the original contract period.

Whether or not the repo seller makes a late delivery of the collateral securities, and even though he does not receive or cannot keep the corresponding cash payment unless or until he delivers, the agreed repo rate will accrue to the repo buyer each day of the full contract period, as if the repo seller had actually received and had the use of the cash for the whole of the contract period.

While the failure to receive collateral securities may be inconvenient to the repo buyer, the immediate financial consequences are positive for him and provide compensation which should cover or at least reduce the cost of borrowing the security, if he wished to do so.

When interest rates are reasonably positive, the repo seller's unchanged obligation to pay the repo rate to the repo buyer (whether or not he ever actually had the use of the cash and regardless for how long he may have had its use) is a strong incentive on the repo seller to borrow the collateral securities and cure his failure to deliver. He will be better off borrowing the collateral securities from the repo market or securities lending market in order to cure the delivery failure and paying a borrowing fee up to the equivalent of the repo rate.

Failure to deliver by a repo buyer at the end of a repo

In the repo market, in the case of a failure by the repo buyer to return collateral at the end of a repo, the repo seller will not repay the repo cash and will cease to pay the repo rate to the repo buyer. Instead, the repo seller will reinvest the cash for his own benefit. Accordingly, the repo buyer has an incentive to cure the delivery failure by borrowing the security from the repo market or securities lending market and paying a borrowing fee up to the equivalent of the repo rate that he is foregoing. The repo seller is compensated for the delivery failure by the reinvestment return on the repo cash and could use that compensation towards the cost of borrowing the security himself. **SLT**

The full paper is available to view at www.icmagroup.org

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Making the switch

Many clients are anxious about any potential risk surrounding moving providers but, says Joshua Lavender, executive director at J.P. Morgan, a considered approach can reap the benefits

EXCLUSIVE

For beneficial owners contemplating changing securities lending agents the potential fear, concern and in some cases the potential for realising losses, can often influence the decision as to whether to change lending agents or not. Such decisions to make a change of lending agent may be driven by service issues, poor revenue performance (and risk management), a desire for a different approach driven by change in parameters and risk appetite or historical issues relating back to the market crisis period.

Whilst there are challenges relating to changing providers, the greater concern comes from beneficial owners who may have issues relating to their cash collateral investment portfolio, and whether it's in a separate account or commingled fund. Those in this position fear that switching securities lending agents may cause them to realise investment losses and may require a great deal of staff effort and time.

When reviewing the possibility of changing securities lending agents, beneficial owners should primarily focus on four areas:

- Level of liquidity in their cash collateral investment portfolio;
- Ability to execute loan novations where necessary;
- Type of cash collateral investment account (eg, separate account vs. commingled funds); and
- Condition of their cash collateral investment portfolio and any in-kind distributions.

However with some careful thought, detailed planning and a partner with experience in undertaking large and complex transitions, these concerns can be overcome and should not prevent beneficial owners from working with a new securities lending agent.

Liquidity

Market participants were reminded during the 2008/09 financial crisis that liquidity plays a key role in the ability to sell securities at appropriate prices. Poor liquidity can lead to forced selling of collateral investments, which increases the likelihood for realised losses. Therefore, the collateral investment portfolio's duration and liquidity ladder (or essentially when the securities will mature) play a key role in determining the appropriate timing or feasibility of transitioning to a new securities lending agent.

Loan novations

Liquidity concerns can be overcome if the beneficial owners' current and future lending agents, with co-operation from the borrowers, are receptive to loan novations.

Loan novations allow existing loans to remain outstanding with the same borrowers by transferring the loan from the books of the legacy agent to the new agent, without the need to recall loans and return the borrowers' collateral.

For beneficial owners that have cash collateral, the ability to novate outstanding loans is critical because if they are unable to do so, loans will be terminated and borrowers will expect to receive back the cash collateral.

Therefore, more loan novations will lead to fewer programme interruptions, have a smaller impact on revenue, and reduce the potential for forced selling of the cash collateral portfolio.

It's important for beneficial owners to work closely with their new lending agent to determine borrowing demand for their securities

Sometimes beneficial owners may need to remind their existing agent, that loans belong to the beneficial owner and not the agent!!

When and if loan novations are not possible and cash collateral is involved, the current lending agent may need to sell these re-investment securities and if done so below cost, a realised loss will occur. This loss will have to be funded by the beneficial owner. However, this can be avoided if the amount of cash collateral associated with the loan novations is at least equal to the illiquid portion of the invested cash collateral. Ideally, the new lending agent will look to execute new loans on the transition day sufficient to cover the liquidity needs of the collateral portfolio. It's important for beneficial owners to work closely with their new lending agent to determine borrowing demand for their securities around the transition date as this will be the source for liquidity.

Types of cash collateral investment account

Additional concerns may be warranted depending on the type of investment account (eg, commingled fund or separate account) a beneficial owner has with their current lending agent. Separate accounts generally pose fewer issues since the beneficial owner has the choice of how the existing collateral investments will be distributed (eg, cash, securities, or both), and the timing of the withdrawal. This type of fund structure reduces the chance for partial par amounts or "odd" distributions. The receipt of such non-marketable lots is more likely the case with distributions from commingled funds, where the beneficial owner owns a proportional share of the fund's investments. Moreover, commingled funds could have withdrawal restrictions in place that dictate when and how a distribution can occur. With either fund structure, a cash only distribution allows a beneficial owner to commence the new securities lending programme at their discretion and eliminates any liquidity or funding concerns since all loans are terminated and cash collateral is returned to the borrowers prior to the transition date. Conversely, an in-kind distribution could lead to the need to fund a shortfall in the amount of cash collateral due back to the borrowers. In this instance and absent any loan novations, either the in-kind securities would need to be sold or the beneficial owner would be required to use their own cash (not collateral from loans) or reach an arrangement with the new lending agent, in order to return the cash collateral to the borrowers.

J.P. Morgan's Approach

The concerns associated with switching securities lending agents are not insurmountable. Using a comprehensive and risk-controlled approach, J.P. Morgan has successfully completed multiple complex transitions including mutual fund firms with significant numbers of separate accounts, and large public pension funds.

J.P. Morgan's conversion process entails specific actions that are designed to minimise the realisation of losses on beneficial owners' legacy cash collateral investments that are illiquid or have unrealised losses.

The process begins with J.P. Morgan conducting an asset/liability analysis to determine the optimal composition of existing loans and cash collateral investments for a staged transition. During this process, J.P. Morgan works closely with the beneficial owner to assess:

- the existing loan and collateral portfolio;
- current rebate levels;
- the market environment;
- borrowing demand;
- loan duration;
- the borrowers' willingness to novate loans; and
- target securities for loans to generate minimum funding on the transition date.

Based on its findings, J.P. Morgan works with the beneficial owner and current lending agent to formulate a specific strategy to govern the conversion and asset transition.

Throughout this process, J.P. Morgan leverages relationships in the borrower community to provide ample liquidity in order to determine the minimum number of transition date loans and/or novations that would have to be made in order to ensure that an appropriate level of liquidity is maintained in the existing securities lending account.

Additionally, J.P. Morgan coordinates a recall/return process with the terminated lending agent to ensure a smooth loan balance reduction process leading up to transition date, while making certain that minimum funding requirements are maintained.

J.P. Morgan establishes a separate account structure to receive the transitioned investments from the current cash collateral investment portfolio. This type of structure is ideal for a beneficial owner who will be transitioning assets resulting from a pro-rata share distribution from a commingled fund. The beneficial owner's pro-rata share of assets will be transferred to J.P. Morgan and these assets will be isolated and established in a "hold to maturity pool." As these investments mature, the cash will be transferred to a newly formed separate account which will also hold any cash received in connection with the beneficial owner's new securities lending programme. Moreover, the investment guidelines for this separate account will be based on the beneficial owner's specific requirements and will therefore be consistent with their risk/return profile.

The aftermath of the 2008/09 financial crisis created fears in beneficial owners' minds

Throughout this transition process, J.P. Morgan provides each beneficial owner with a detailed project plan, frequent status tracking calls, and fully transparent and customised reporting.

The aftermath of the 2008/09 financial crisis created fears in beneficial owners' minds that switching securities lending agents could be too costly and time consuming for them to change. However, beneficial owners are becoming more aware that these fears or concerns can be overcome and that their desire to change securities lending agents can be supported. Today, options abound for beneficial owners that work with an experienced securities lending agent that has a proven track record of migrating beneficial owners from their current provider into a new programme that is designed to meet their specific requirements. **SLT**

Joshua M Lavender
Executive director, securities lending
J.P. Morgan

Securities lending activities in Japan are booming at the moment. Data Explorers' Will Duff Gordon examines why

SLT EXCLUSIVE

Investors seem active in Japan all of a sudden with a strong recent pickup in demand to borrow Japanese equities. Of course, some of this activity relates to some large companies paying dividends at the end of September. However, there are definitely some interesting directional shorts to observe in names like Trend Micro, Kintetsu, Eisai, Sanrio, Keiyo and Don Quixote.

Ahead of the Asian Securities Financing Forum in Hong Kong on 7th October (www.dataexplorers.com/hongkong), it is interesting to note that Asia contributes 17 per cent of the total income from securities lending in equities – up from 14 per cent a year ago. In Japan, the value on loan has suddenly spiked.

The ratio of inventory to stock on loan has swung in the direction of more loans and in the process it has set a new 52 week high. Prime brokers increased their borrows by 12 per cent over the last week alone. In contrast, there has not been much change in the US and Europe although they are seeing a small increase in demand to borrow.

In fact, the number of Japanese names with an increase in lending compared to a decrease over the week is 74 per cent versus only 26 per cent seeing a reduction in loans. Anti-virus firm Trend Micro (4704) has seen a massive increase in lending. This looks, in part, in relation to a corporate action but some of the four per cent of the company that is on loan looks to be directional. One wonders why given the recent takeovers in this arena with Intel buying Mcafee recently.

Conglomerate Kintetsu (9041) has been a profitable short for some time although the shares are rebounding. There has been a recent spike in demand taking it to seven per cent of the company on loan.

Sanrio Company (8136) is a multi faceted company known for selling gift products. Trading volume has hugely increased in the last three months alongside a big increase in short selling to 1.8 per cent of the company, which is a large proportion of the shortable supply. It is not clear whether this is in relation to a special dividend or a directional view on the prospects for the maker of Hello Kitty.

With the strong yen, there have been reports that people from Japan are increasingly buying their luxury goods online from US websites for the discounts available when transacting in USD. This could affect the profitability of high end Japanese retailers over time.

Women's clothing retailer Daiei (8263) has seen a recent pick up in shorting with 10 per cent of its shares on loan. Household and DIY retailers like Keiyo (8168) and Don Quixote (7532) have seen recent increases in shorting to 2.7 per cent and 10 per centrespectively.

Eisai (4523) makes and researches pharmaceutical products and has seen a very big recent increase in short selling to six per cent of its shares.

This is may be due to its involvement with Arena Pharmaceuticals in the development of anti obesity drug - Lorcaserin - that was rejected by the FDA (in America) very recently. **SLT**

Will Duff Gordon
Media director
Data Explorers

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4th Annual Collateral Management Conference

Date: 5-6 October
Location: Amsterdam
Website: www.jacobfleming.com

A number of high-profile defaults, volatility in the financial markets and heightened concerns over counterparty credit risk have placed great strain on many banks' collateral programmes and have highlighted the need for a new approach.

Hong Kong Securities Financing Forum

Date: 7 October 2010
Location: Hong Kong
Website: www.dataexplorers.com

Data Explorers' Securities Financing Forum in Hong Kong is taking place on Thursday, 7th October 2010. Our Global Securities Financing Forums are known throughout the industry as THE event to attend for insightful analysis that highlights specific challenges and opportunities facing the securities financing market.

27th Annual RMA Conference on Securities Lending

Date: 12-14 October 2010
Location: Boca Raton Resort & Spa in Boca Raton, Florida
Website: www.rmahq.org

The Boca Raton Resort has always been one of our premier conference locations. It was the site of the very first RMA Conference and continues to be the foremost favorite venue. We know you'll enjoy the newly renovated Boca Beach Club. It is quite a dramatic transformation!

SunGard Toronto City Day

Date: 14 October 2010
Location: Toronto
Website: http://events.tenfor2010.com/citydays/toronto/register.aspx

This event highlights best practices and emerging trends in the prime brokerage, securities finance and asset servicing industries.

Finadium 2010 Conference

Date: 19 October 2010
Location: New York
Website: www.finadium.com/site/conference_1010.php

This event highlights best practices and emerging trends in the prime brokerage, securities finance and asset servicing industries.

Dubai Securities Financing Forum

Date: 11 November 2010
Location: Dubai
Website: www.dataexplorers.com

Data Explorers' Securities Financing Forum in Dubai is taking place on Thursday, 11th November 2010. Our Global Securities Financing Forums are known throughout the industry as THE event to attend for insightful analysis that highlights specific challenges and opportunities facing the securities financing market.

Amsterdam Securities Financing and Buyside Breakfast

Date: 17 November 2010
Location: Amsterdam
Website: www.dataexplorers.com

Data Explorers' Securities Financing Forum in Dubai is taking place on Thursday, 11th November 2010. Our Global Securities Financing Forums are known throughout the industry as THE event to attend for insightful analysis that highlights specific challenges and opportunities facing the securities financing market.

Industry Appointments

Sven Weinhold will join UniCredit Bank Germany in Munich on 1st October in a move that the bank says will strengthen its repo and collateral trading in fixed-income assets.

Weinhold's main focus will be on funding and collateral solutions for the bank's clients. He will report to Arne Theia, head of repo and collateral trading.

Theia commented: "We are very much looking forward to Sven joining the team. His profound knowledge of interest rate products will help us to significantly enhance our customer services."

Weinhold has worked in the German repo market for a number of years. He has held various positions, including roles at Hamburger Sparkasse, HSH Nordbank and Bayerische Landesbank.

Barclays Capital has made a series of appointments in its prime services as part of a drive to build up the servicing and financing business to hedge funds.

10 new managing directors have been appointed, made up of internal promotions and new hires. The roles will be split between London and New York.

Appointments include **Thomas Chippas** as head of quantitative prime brokerage, **David Gaynes** as head of prime services origination sales for multi-strategy hedge funds and **Penry Jackson** as head of synthetic product management.

Jack Inglis was appointed in June as head of prime services distribution, Europe.

Northern Trust has appointed **Annika Larsson** and **Erik Norland** as senior relationship managers in its Stockholm office, in line with the company's strategy of serving clients as close to their home market as possible.

Larsson, who has over 20 years experience working in the asset servicing industry in the Nordics, will look after key Northern Trust clients across the region, with a focus on Finland and Sweden. Larsson joins from Handelsbanken Nordic Custody Services, where she was head of the relationship management and sales group. During her career, she has also worked for Brown Brothers Harriman in London and Stockholm, most recently as relationship and sales manager, Nordics.

In his new role, Norland will focus on Northern Trust's institutional clients and banking relationships in the Nordics. He joins Northern Trust from Fondsfinans, where he was in equity sales. During his career, he has also worked for Credit Agricole Cheuvreux and at Nordnet, both in Stockholm.

John P. Sisterson has recently started with Macquarie Securities in Hong Kong. Sisterson will be responsible for the stock lending and equity finance business in Asia, including Japan, reporting into Greg McCafferty, global head of stock lending and synthetics.

Sisterson has been based in Asia for 14 years and previously held head of desk roles at Credit Suisse and Nomura. More recently he was working with EquiLend to successfully establish their presence in Asia.

Following the arrival of Lieve Mostrey from BNP Paribas Fortis on 1 October as chief technology and services officer and a member of the Euroclear Management Committee, the allocation of responsibilities among Euroclear Management Committee members has been reviewed.

The duties of chief administrative officer, currently performed by Tim May, will be re-allocated, thereby reducing the number of management committee members to five. It will be proposed at the next Euroclear Board meeting at the end of September that Tim May leave Euroclear with effect from 31 October 2010.

Replacing Tim May as chairman of Euroclear UK & Ireland, **Frederic Hannequart** will take on this role in addition to his responsibilities as chairman of Euroclear Bank, Euroclear Finland, Euroclear Sweden, and as a member of the Euroclear Management Committee. Bernard Frenay, managing director and head of the Euroclear Financial Division, will replace Tim May as chairman of Xtrakter Ltd, which Euroclear acquired in May 2009.

Tim Howell, Euroclear's chief executive officer, said: "We look forward to reinforcing Euroclear's reputation as the pre-eminent post-trade service provider under the leaner, reorganised management committee's leadership. Combining the extraordinary pool of skills and experience within the Euroclear group with external market talents, will further strengthen the organisation. We thank Tim May for his contributions to the Euroclear group and to our operations in the UK specifically. We wish him success in the future."

Omnium has announced the appointment of **Alexis Fosler** as head of international sales. With more than 18 years of industry experience, Fosler will drive Omnium's international expansion focusing on the Asian and European markets. Fosler will be based in Hong Kong.

"Alexis has an outstanding track record of partnering with clients to help them build their businesses," said Peter Sanchez, global head of business development and client service for Omnium. "She will be an incredible asset to our firm."

Previously, Fosler was the head of prime brokerage sales in Singapore for Citigroup. Prior to joining Citigroup, Fosler was in equity research sales with Credit Suisse First Boston.

The Bank of New York Mellon has promoted four executives to the position of vice chairman of the corporation:

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Published by Black Knight Media Ltd

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Thomas (Todd) Gibbons, CFO, **Timothy Keaney**, CEO of asset servicing **Karen Peetz**, CEO of financial markets and treasury services **Brian Rogan**, vice chairman

In addition, vice chairman **James Palermo** will assume new responsibilities as CEO of Global Client Management and will also oversee Global Markets, Liquidity Services and Corporate Marketing. Palermo was previously co-CEO of Asset Servicing with Keaney.

Rogan's responsibilities will expand to include global operations and technology. The company's Pershing subsidiary will join the broad group of businesses reporting to Peetz.

"Each of these talented leaders has played a key role in growing our company and distinguishing our performance through turbulent markets," said Robert P. Kelly, chairman and chief executive officer of BNY Mellon. "These promotions and expanded responsibilities reflect our success in developing senior executives known for their commitment to outperforming for clients and for leading extraordinary teams around the world." **SLT**

60 Second Resumé

Rob Primiano

Meet Rob Primiano, a 32 year old industry professional who is looking to return

Contact Rob Primiano
email: Primo314@verizon.net
mobile: 917-656-0680

Tell me a little about yourself

I am a SI resident who was recently married in May. I currently live in New Dorp with my wife and we were just about to start house hunting before my lay off from Barclays in August due to headcount cuts across the board.

What industry qualifications or relevant certification do you hold?

I've been in the financial business operations industry for 14 years.

I hold a certification in Margin Operations and Advanced Margin Operations with Options. I've been with five different well known companies and I'm looking for my sixth - hopefully my home for a long time.

What was your last position in the industry and what did you enjoy most about it?

I held a senior operations analyst position at Barclays Capital in the equity finance division for securities lending settlements. I was absorbed with the Lehman bankruptcy teams and held that position for two years before I was laid off last month.

I loved everything about it, the high intensity of the deadlines of returns, rates, and pts loans at the end of the day. I loved being counted on to get the pressure cooker time sensitive loans and returns out the door so we didn't sit on anything overnight. I loved (for the most part) the people I worked with on a daily basis.

I was a team player, always looking for more and strived to be the best and do the best of my ability.

What area are you looking to get back into?

I'd like to return to securities lending, third party lending (agency lending), operations or middle office, in a supervisor AVP type role.

What do you feel you could bring to a future role?

I have experience, product knowledge, system knowledge and seniority. I'm well liked by many in the industry, and a force to be reckoned with as a team leader for an operations/mid office team!

What do you feel the industry needs most?

More business! Everyone I speak to is telling me the same thing, they are slow, rates are tough, hard stocks, needs and fills are all scarce, companies need business and volume and ever since the mortgage crisis, they are very skeptical about bringing on business and the urgency of risk are probably at the all time high.

We need more of the Mom and Pop shops to come back and turn things around, this business is now being driven by all of the major banks and it's not the way it used to be. It became very very very corporate over the last few years and that I can tell you is what is most missed in this industry.

We all need the big banks, yes, without them we would struggle but the smaller family type places are the ones that had the great relationships and high volume. You're just a number at these bigger institutions rather then a voice heard in the office like the old days.

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