SLT SECURITIESLENDINGTIMES

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ISSUE035 27.09.2011 TUESDAY

European Beneficial Owners' Securities Lending Summit review

LONDON 26.09.2011

IMN's 16th annual European Beneficial Owners' Securities Lending Conference in London saw a bigger and better turnout than in previous years, with the first day providing plenty of material for debate and discussion.

Following a closed door beneficial owner breakfast, the conference proper kicked off with a presentation from SunGard's Timothy D'Arcy, who provided an in-depth overview of the state of the current market.

It was apt, said D'Arcy, that the event is being held in the shadow of the UK Houses of Parliament, as Governments, both in Europe and North America, are going to have a huge part to play in shaping financial services over the coming years. "And it will be interesting to see how that applies to securities lending," he added.

While there have been seasonal spikes in European equity borrowing costs, the key factor over the past year or two has been the increasing intrinsic rates applied to specials, which are much higher in the past – the proportion of specials available at 500 basis points or more is making up 49 per cent of specials revenue, while specials themselves are responsible for as much as 80 per cent of overall revenue within securities lending.

In the US, markets are seeing significant growth in fixed income activity, but while this is an improvement, it is still significantly down on levels seen before the crisis, said D'Arcy.

The morning session continued with a macro economic look at the European market, as described by Data Explorers' David Carruthers, who highlighted how the trends we're seeing in the overall markets are likely to affect the securities lending industry. Carruthers highlighted the data on whether the region is likely to go into a double dip recession, and discussed the attitudes European governments are taking to both dealing with their internal financial problems and improving the sustainability of their financial institutions.

Next up was the beneficial owner panel, with representatives from around the continent discussing the opportunities and issues the market is likely to face in the coming months and years. As always, the discussion centred around regulation, the potential – or lack thereof – of CCPs and where the market is moving.

This led smoothly into the final session of the morning, which focused on the regulatory issues those in the industry are having to deal with. While tax harmonisation across Europe is being broadly welcomed – if with a few reservations about the implementation – there is more concern about the incoming regulation.

The afternoon started with the ongoing debate over cash vs non cash collateral, as the panellists discussed how the markets of Europe and North America are getting closer together. This was followed by a look at the risk and returns of securities lending in emerging markets. The returns, of course, are bigger, but so too are the risks and in the current risk-averse environment many beneficial owners are running scared of operating in markets with which they have little experience – especially with securities lending often playing a relatively minor role in their overall investment programme.

The final session of the day looked at the strategies and methods for maximising the performance of a securities lending programme, while highlighting the different options available for measuring the performance of the business. Once again, the session was well attended, and at its end, the delegates were ready for a well-earned glass of wine...

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BoE warns on securities lending contagion risk

LONDON 23.09.2011

The Bank of England (BoE) has issued a warning on the potential contagion risk associated with securities lending transactions in its latest quarterly bulletin.

As a financial transaction, securities lending results in chains of counterparty exposures which increase interconnections within the financial system, wrote the BoE, adding that during episodes of stress, interconnectedness can cause contagion when problems at one or more institutions are transmitted across networks, impacting counterparties and their customers.

Lehman Brothers, for example, was a large borrower in the securities lending market and often borrowed securities on behalf of clients, such as hedge funds.

"When Lehman failed, most beneficial owners were able to liquidate their collateral and replace their lost securities. But a small number of beneficial owners struggled to liquidate their collateral and made losses," wrote BoE.

Meanwhile, hedge funds that had borrowed securities via Lehman found it difficult to reclaim the collateral that they had pledged to the firm in order to borrow securities. This was partly due to rehypothecation of collateral - a practice that involves using collateral posted by clients as collateral for other purposes.

"Since the onset of the financial crisis, market participants have sought to address some of the concerns around securities lending. New regulation on institutions involved in securities lending may also address some of the risks, particularly counterparty credit risks. New market infrastructure may also help," wrote the BoE.

The advent of CCPs "should lead to more continuous and predictable changes in margin requirements" and reduce the likelihood of sudden collateral calls on borrowers.

read**more** p3

NEWS**IN**BRIEF

Deltix seeks alpha with Data Explorers

Data Explorers has announced that its intraday security level inventory and short interest data will be available as part of the Deltix QuantOffice, which allows users to create, back-test and optimise trading strategies.

Ilya Gorelik, CEO and founder of Deltix said: "The availability of Data Explorers data in Deltix provides another source of alpha for our users. The ability to rapidly create, back-test, optimise and deploy trading strategies in Deltix QuantOffice and QuantServer means that our users can generate immediate value from this data."

Corporate repo market in Azerbaijan by 2012

The Baku Stock Exchange (BSE) will be expanding exchange tools to include corporate bonds in its repo market, according to the Azerbaijan Business Centre.

"We expect to finalise the technical issues of this market before the end of 2011 and since early 2012 to commission the corporate repo market," said BSE chairman Khayal Abdinov.

Currently Azerbaijan's repo market only processes government securities.

INSIDE SECURITIES**LENDING**TIMES

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BoE warns on securities lending contagion risk

continued from p1

"Provided CCPs are highly robust, they can potentially provide benefits to the securities lending market. By acting as a secure node within a network of financial institutions, they can reduce system-wide counterparty credit risk," wrote the BoE.

However, the central bank also noted that the net impact of new regulations on the securities lending market is difficult to estimate but could be significant.

Higher capital requirements in Basel III regulation could result in higher costs to banks for securities lending transactions. In turn, this could increase the cost of services such as market-making or collateral upgrade trading for bank funding purposes.

"Higher capital requirements for banks and insurers should make participants more able to withstand negative shocks and reduce the risks that arise from interconnections. But it could also reduce the supply of — and demand for — securities loans, diminishing some of the benefits to the functioning of the financial system associated with securities lending," wrote the BoE.

Such benefits include increased liquidity which helps markets operate more smoothly and efficiently, in turn leading to better price discovery and reduced volatility.

AFME and ICMA announce new co-operation agreement

The Association for Financial Markets in Europe (AFME) and the International Capital Market Association (ICMA) have signed a Memorandum of Understanding (MoU) which will strengthen their co-operation on matters of mutual interest in European financial markets. The agreement is focused on streamlining communication between the two associations and eliminating any operational inefficiency which could arise through duplication of effort. The aim is to maximise the influence of each association on behalf of its individual members.

AFME and ICMA represent different sectors within the capital markets and different, although partially overlapping, membership bases. Under the new arrangement, each retains its current structure and independence.

Collaborative efforts will be directed towards agreeing a common approach to regulatory developments in Europe which affect both associations' members. Examples would include the sharing of information and responses to consultations and attending each other's relevant committees and councils as observers.

AFME and ICMA will also from time to time organise joint market events and educational courses on topics which would benefit both membership groupings.

Simon Lewis, AFME's chief executive said: "The financial sector is undergoing sweeping structural and regulatory reform. It is more important than ever that its members speak with a consistent voice and work together to ensure this reform achieves the lasting financial stability that legislators, financial firms and their customers all desire. Co-operation between representative bodies is key to achieving an integrated approach across the sector and we believe this agreement between AFME and ICMA will be welcomed by all stakeholders as a more efficient and effective way of working with them."

Martin Scheck, ICMA's chief executive said: "The future well being of the capital markets in Europe and the consequent health of its economy demand that all market participants, both retail and wholesale, have access to coordinated representation as the new framework of market regulation evolves. It is critical that ICMA maintains its constructive relationships with all relevant financial market associations and in this context we are delighted to be making a public commitment to mutual co-operation and enhanced efficiency with our colleagues at AFME."

CCPs provide choice - SIX x-clear

Amid a larger overhaul of opaque financial transactions associated with bilateral markets, CCPs are making the business case for their role in the securities lending industry.

SecFinex, an MTF for cleared securities lending transactions, has made some progress pulling business onto a platform, but there is still work to be done convincing agent lenders of the value proposition, said Tomas Kindler, head of clearing relations at Six Securities Services on the sidelines of the Sibos conference in Toronto.

Drawing a parallel to the OTC derivatives market, Kindler said that though regulations such as Basel III favour cleared transactions, they are not the key component of the industry's business models, which are emerging to meet the anticipated demand.

On a cautionary note, he added that, like OTC derivatives markets, securities lending markets are undercollateralised.

"With a CCP in place, that becomes very transparent, you can't undercollateralise anymore, there are very strict requirements in terms of risk exposure and that is part of the risk mitigation that comes with a CCP," Kindler said.

Moreover, since CCPs behave as a counterparty, the risk profile of existing counterparties is made irrelevant, he adds.

"We are a AA-rated entity and from our perspective we create choice, [market participants] do not need to worry anymore about who they are dealing with because the CCP steps in and [the trading] is anonymous," Kindler said.

The issue being debated within the industry, however, is over the potential repercussions of a CCP default.

Kindler believes that expected requirements to be set by IOSCO, a membership organisation of securities regulators, will go far in ensuring robust risk management and supervision. In SIX

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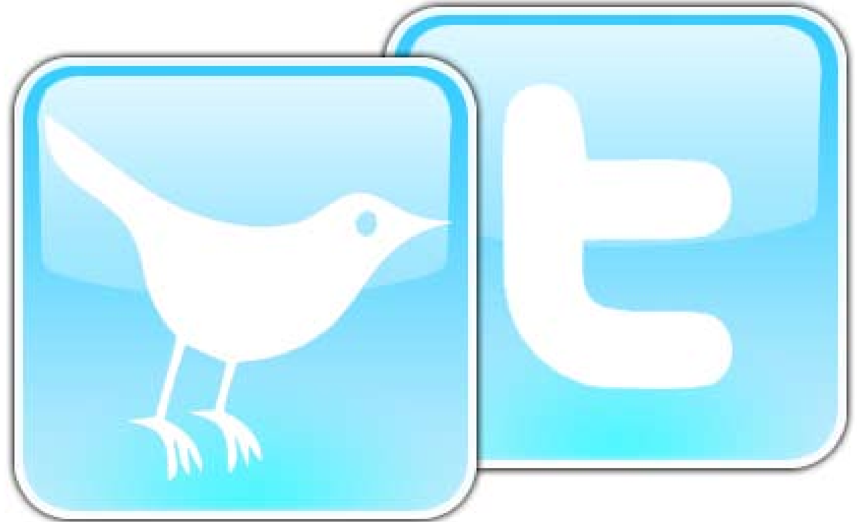
x-clear's case, the Swiss regulator currently demands stress testing in adverse scenarios, such as the default of a CCP's two biggest clients.

However, he acknowledges that more options might be needed in order to bring agent lenders onside.

"Maybe there is a need…to have two offerings to the market…a bilateral offering and a centrally cleared offering at different price levels with a different risk profile associated with each," he said.



Twitter sends "short" messages

Derwent Capital Markets has launched a fund that invests based on twitter posts to gauge sentiment towards the stock market.

To test out the concept, Data Explorers spent a day tracking share focused tweets and then applied securities lending data. It seems to work.

"In short, US names almost exclusively make up the list, which was dominated by retailers and consumer services stocks – a trend we flagged in recent analysis assessing professional investor sentiment following the turmoil in August," wrote Data Explorers.

Derwent Capital Markets is the first European social media-based hedge fund and uses real-time sentiment analysis to provide "what it hopes will be an invaluable insight into the "fear and greed" aspect within the financial markets".

Securities finance industry dynamics changing - SunGard

The securities lending market is punctuated by increased scrutiny from regulators and clients, as well as changing dynamics in hedge fund operation, wrote SunGard in a recent report.

"The securities finance industry continues to transform in the midst of a slow economic recovery and impending new regulations. Customers are demanding greater transparency, consolidating systems to increase efficiency and reduce costs and improving their processes in order to better leverage their securities finance business," said Jane Milner, head of strategy for securities finance and collateral management in SunGard's Capital Markets business.

Of ten identified trends in the industry, one is that hedge funds are sitting long, traditional long-only asset holders are creating hedge funds and proprietary desks are being spun off.

"As a result, market participants are seeking ways to service these 'morphed' entities," it adds.

Meanwhile, the industry is also facing greater scrutiny from regulators around the world resulting in demands for increased transparency, tighter controls over short selling, more visible contingency planning for times of increased stress and higher capital allocations for each business line.

"The increasing emphasis on transparency is leading large global players to demand cross-geography, cross-product and cross-organisational views of key data in order to better manage their risk and leverage assets," wrote SunGard.

These pressures are being felt not just from regulators, but also from clients, which are demanding hard numbers to justify the costs and risks associated with the securities lending business.

Taking centre stage, says SunGard, is the use of collateral management as a tool to mitigate risk and manage liquidity - firms are recognising the additional revenue generation opportunities that this provides for both their organisations and clients.

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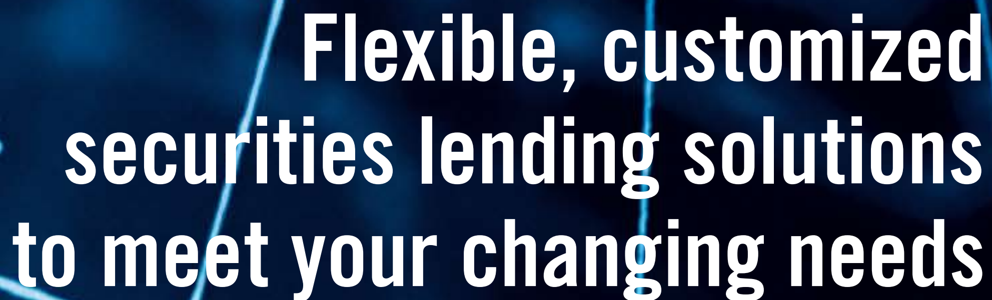

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Oscar Huettner, global product manager for BondLend, commented, "Clearstream has always been a tremendous source of liquidity for the European securities finance market. BondLend's AutoBorrow service will allow them to continue to expand automation and build stronger relationships with their client base. We are very excited to have them join our platform."

Jean-Robert Wilkin, executive director and head of product management for Global Securities Financing, states, "Joining BondLend concurs to our objective for further standardisation and straight-through-processing in our securities lending pool distribution. It aims at optimising revenue for our lenders, giving an easier access to liquidity for borrowers and surely reducing operational risk in securities loan processing. This is a step taken in preparation for the launch of our Equity Lending service in early 2012 and for which we will also link to EquiLend."

Securities lending returns cover fund costs - Finadium

Securities lending income can be a significant offset to fund expenses, according to Finadium's fourth annual survey, Leading Asset Managers on Securities Lending, Collateral Management and Custody.

Out of a sample of 164 mutual funds that were lending securities, the average fund returned 3.14 basis points from their lending activities. Although this is not a substantial amount when compared to investment returns, it was sufficient to cover custody costs by more than four times and to make a nine percent reduction in the total expenses of the funds, wrote Josh Galper, managing principal at Finadium and author of the report.

Other findings show that higher securities lending returns are skewed towards a small group, with greatest returns earned by funds investing in small-cap and global securities.

It was also the first year that asset managers reported an alternative fee arrangement - the most popular being a basis point fee on either the value of assets lent or the value of a portfolio. This means the securities lending agent will receive a flat fee and is then obligated to produce an unexpected return or better, according to Finadium.

"It is our expectation that this type of arrangement will become more popular as the years go on," wrote Galper.

Diamond Hill selects Citi for securities lending

Citi has been appointed by Diamond Hill Capital Management. to provide a range of investor support services for the firm's fund assets totalling $4 billion.

"We selected Citi because it offers a rare combination of global perspective and local on-the-ground presence, as well as the ability to structure and scale solutions to meet our specific needs," said James Laird, chief financial officer, Diamond Hill Capital Management, and president of Diamond Hill Funds. "In making the decision to move our business to Citi, we were impressed by Citi's understanding of our day-to-day challenges and the value they place on fitting seamlessly into our operations with a consolidated service model."

The scope of services Citi is providing to Diamond Hill includes fund administration, accounting, transfer agency, global custody, and securities lending. Citi's fund operations are located in Columbus, Ohio, which is also headquarters for Diamond Hill.

"We are extremely pleased that Diamond Hill chose Citi," added Joseph Rezabek, managing director, Citi's Fund Services, North America. "As a boutique-style service partner, Citi will draw on years of practical experience to deliver solutions focused on the specialised needs and objectives of Diamond Hill, while leveraging the depth and breadth of our global network."

Smaller recovery for securities lending losses says Lehman

In a court filing last week Lehman said it decided that claims against the Lehman parent arising from guarantees of subsidiaries' securities lending agreements do not qualify as Class five senior debt under the Chapter 11 plan, according to Bloomberg Business Week (BW).

Unless the bankruptcy judge in confirming the plan overrules Lehman's opinion about the status of securities lending guarantee claims, holders of the claims will have a smaller recovery because they won't benefit from the subordination of parent-company subordinated debt, noted BW.

Lehman has scheduled an emergency hearing on 14 September for authority to modify the disclosure statement by deleting guarantees of securities-lending claims from the list of parent-company senior debt and, with approval to modify the previously approved disclosure statement, Lehman said it intends to send out disclosure and voting materials to creditors in the last week of September this year, BW added.

Conifer Group upgrades

The Conifer Group has selected Empaxis as its Advent application and automation support provider to help maintain its legacy Advent environment. Conifer has selected Empaxis which offers services ranging from reconciliation to application services because of its flexible support model and it will provide Conifer access to highly trained personnel on Advent's products.

"In today's environment where Conifer is investing heavily in re-tooling its service delivery platform, it was critical that we find a solution that allows us to actually increase the reliability of our existing application infrastructure while enabling safe, transparent transition to our future state Conifer iCon platform (powered by Advent Geneva World Investor)" said Jack McDonald, president and CEO of The Conifer Group. "Empaxis more than met our requirements by delivering a top notch team that can step in and assist us with special projects as needed."

"We're delighted that Conifer has chosen us to help support Conifer's technology infrastructure," said Stephen Van de Wetering, CEO of

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Empaxis. "With outsourcing back office operations becoming such a vital resource for the investment advisory industry, developing this relationship with Conifer, who is currently launching one of the industry's most exciting Cloud-based outsourcing platforms, will play a pivotal role in driving growth for both of our companies."

ISITC updates tri-party repo guidelines

In response to guidelines issued by the New York Fed, the International Securities Association for Institutional Trade Communication (ISITC) released an updated Market Practice for tri-party reverse repurchase agreement settlement and confirmation.

"Part of our mission at ISITC is to respond to industry regulation and develop best practices for all market constituents," said Erica Choinski, executive sponsor of the ISITC Settlements Working Group.

The reforms, some of which were implemented by August this year, introduce and strongly recommend the netting of tri-party reverse repo trades to reduce the number of intraday cash wires.

In a separate statement, J.P. Morgan announced that volumes and business have not been affected by reforms such as the move of the daily unwind to 3:30pm, which was mandated for 22 August by the New York Fed's Task Force.

"When we first learned of the [New York Fed] guidelines, we teamed up with the [Asset Managers Forum] to really understand how we could comply with the new reforms and bring a greater degree of automation to the netting process," said Choinski.

The Market Practice addresses the various netting scenarios presented by these guidelines, including single deal netting scenarios, multiple deal single broker netting scenarios, and multiple deal multiple broker netting scenarios.

The scope of the Market Practice document defines tri-party reverse repos and the business practices between the investment manager, custodian bank, and/or accounting agent. ISITC is also currently developing best practices for matching which will provide further direction for tri-party repo matching.

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What single change could improve the returns from securities lending?

There are some simple answers to this question: more demand, less regulation, more M&A activity. But the industry is a complex one, with multiple constituents, each of which has their own motivations. The beneficial owner is seeking to maximise their return on the lending of their securities. The agent lender wants to ensure that they can finance their significant overhead from the fees from activity undertaken on behalf of their clients, custodial or third parties. A broker dealer wants to make the most on their securities lending (borrowing) activity. Finally, a hedge fund is interested in lending their long positions instead of simply minimising the cost of their shorts and may want more transparency on effective rates.

As a consequence of the above, greater emphasis might be placed on a different factor by each stakeholder. However, maybe it would be more appropriate to turn the question on its head and ask what single change would make participants feel that their returns have improved. The answer would be modified expectations. Now perhaps it is time to recognise that the mega-returns of the years gone by are not likely to return in the near term and that more modest goals need to be established taking into account market activity, risk and the regulatory environment.

Tim Smith, executive vice president, SunGard Astec Analytics

We are facing the next wave of the financial market crisis thanks to the european dept woes. In such a scenario there are a lot of opportunities to make some money. But the major question is how much risk do I want to take? And can I afford the risk in terms of capital costs or trading limits who could stop me out?

Instead of increasing outright risk it's more the efficient management and optimisation of the collateral which reduce my costs and therefore improve my returns. For me the single change is to adjust my business model and implement the right infrastructure and processes like ATP, CCP and STP.

Arne Theia, managing director, head of repo and collateral trading markets, UniCredit Bank

The single change that will improve the returns from securities lending is the increase development of "re-use of collateral" strategies - Example: negative or positive basis trading.

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Conference preview

In the run up to the RMA's annual conference in Florida, the organisation's director of securities lending and market risk speaks to SLT about the hot topics during the week

BEN WILKIE REPORTS

SLT: From an RMA perspective, how would you describe 2011?

Christopher Kunkle: 2011 can be summed up in two words: "Regulatory Communication". Never in my two years as a staff member or my 15 years as a RMA committee/subcommittee member have I seen our efforts as busy on the regulatory side. We are communicating both in outreach programmes and direct meetings with the SEC, FRB New York, OCC and other regulators consistently through the first half of the year. Additionally we've made positive comment to the US Treasury tied into issues that could have arisen from the Cost Basis Reporting scheme that was not meant to cover securities lending transactions. I think the next year or two will continue at this pace, but I don't see it as a negative. It's just another thing that has to be executed on behalf of the membership.

SLT: This year has seen a lot less demand from borrowers but are the pension funds back lending?

Kunkle: I think the two are not inter-twined. There is less demand due to (i) a move by borrowers to borrow only what they need for their regulatory requirements and proprietary efforts and (ii) US Government lending is way down given low interest rates and the difficulty differentiating in that market. We also have the NY Fed SOMA programme lending its portfolio into the market and while it's a temporary supply, it affects supply/demand/rate.

SLT: Who do you feel could have done a better job to grow the industry (regulators, associations, investment banks)?

Kunkle: I don't think it's the regulators' job to grow the industry. Associations can enable their memberships to network, and have a common platform to discuss how the business can improve. I think this question should be not "Who do you feel could have done a better job to grow the business?" but "What do you feel could be done to continue to make the business better?"

SLT: What has been the biggest hurdle or ongoing challenge facing the industry?

Kunkle: I don't think we've encountered a "tremendous" hurdle yet, but the regulatory communication takes continued and proactive effort on myself, the Executive Committee, the Legal Tax Regulatory Subcommittee and the Operations and Technology Managers Subcommittee. As I stated above, we may have a couple more years of this.

SLT: Changing dividend laws have some people confused, with some being qualified and unqualified from a tax perspective, how has this affected the securities lending industry?

Kunkle: QDI in the United States is not a confusing concept. It applies to taxable lenders such as Mutual Fund companies. Those clients have sophisticated processes to know how lending securities versus receiving in-lieu of dividends payments affects their expenses incurred. The JGGTRA act of 2003 made it more of a concern for taxable securities lenders. If that were to be sunset-ed at some point, it would become a moot point putting mutual funds on even ground with pension plans when lending dividend paying equities. If JGGTRA stays in place, then the algorithms used by the mutual fund companies and their agents will continue to successfully measure a fund's ability to lend assets throughout the year.

SLT: What is the RMA's view on all the changing short selling rules which have been implemented over the course of 2011 and do you feel they have harmed rather than protected the market?

Kunkle: The RMA defers to ISLA's and PASLA's membership and outside counsels for their comments to the global short selling restrictions outside of the United States. In the US, it was pretty clear from both academic studies and prior regulators involved in the short selling restrictions (during the liquidity crisis) that they didn't work as planned (or well). But that's another conversation for SLT with an academic or two.

SLT: And finally what is your prediction as to which will be the hottest and best attended session at the RMA securities lending conference this year?

Kunkle: Personally, I'm looking forward to the Tuesday events, not to take away from all the hard work being done by our moderators/panelist throughout the Tuesday – Thursday format. All of the events are timely, accurately paneled and led and I look forward to the actual event. **SLT**

Christopher Kunkle
Director of securities lending and market risk
Risk Managers' Association

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Direct markets

Following his return to Deutsche two years ago, Tim Smollen has overseen fundamental changes in the bank's strategy regarding securities lending

ANNA REITMAN REPORTS

Despite the 2008 crisis, the vast majority of investors continue to participate in securities lending - albeit with an especially keen eye on risk management. Tim Smollen, global head of agency lending at Deutsche Bank, speaks about the European firm's space in the securities lending market and shares insights on emerging trends.

SLT: Could you talk a little about Deutsche Bank's position in the market?

Tim Smollen: Deutsche Bank securities lending delivers customised lending solutions to a select group of sophisticated global clients where the underlying tenet is superior risk management and client service. We sometimes describe ourselves as the "anti-black box" provider because we start with a blank sheet of paper and create a customised securities lending programme for each client.

> There's a strong trending in cash reinvestment indemnification, collateral flexibility and moving cash reinvestment in-house

Clients hire us because we are able to differentiate ourselves from other providers such as third party programmes or custodial agents. We are unique in many ways. To begin with, we have an integrated business model where all functional teams sit together as a cohesive unit with one agenda, the client. Additionally, we have the advantage of being a premier European bank with a global footprint and a strong balance sheet and capital base. Indemnities in our industry are only as good as the balance sheet that backs them up. Therefore, we have the best of all combinations - the nimbleness and client focus of a small specialist firm backed by one of the world's strongest financial institutions.

SLT: Have you made any major changes since arriving back at Deutsche?

Smollen: We've accomplished a lot over the past two years in terms of taking advantage of Deutsche Bank's resources. We've insourced term reinvestments to Deutsche Asset Management, which entailed transferring a couple of our securities lending portfolio managers to the Deutsche Asset Management investment teams in New York and London. As a result, our clients have unfettered access to one of the largest liquidity managers in the world, replete with multi-currency reinvestment expertise. This positions us to manage legacy reinvestment assets that transition to us with new mandates, which is an important capability given recent market events. Investors with problematic reinvestments can count on tremendous support and attention when they hire us. Lastly, our business leverages a number of the bank's global markets risk management applications, which we believe give us significant competitive advantages.

SLT: Have you encountered any surprises since you returned?

Smollen: We did not anticipate that clients would be mandating us for both custody and lending. As you know, Deutsche Bank is not a global custodian but instead offers domestic custody in many markets in Europe and Asia, which is called Direct Securities Services. Institutions like sovereign wealth funds and central banks are awarding us specific markets for both services. We did not expect to be back in the custody lending business, but it certainly fits into Deutsche Bank's larger strategy and we are pleased to provide these clients with our unique approach to third-party lending. We interface seamlessly with 35 custodians, so this dovetails well with our business model.

SLT: What are you seeing in the market?

Smollen: Coming out of the crisis, the vast majority of investors continue to participate in securities lending. However, many are formally, or even informally, re-evaluating their lending strategy and service providers. As part of that updated strategy, policies and guidelines that are now outdated are being retooled for "intrinsic value" lending. There's a strong trending or interest in cash reinvestment indemnification, collateral flexibility (eg, non-cash collateral) and moving cash reinvestment responsibilities in-house. We also speak with many prospects with "legacy" reinvestment holdings that require expertise and monitoring.

Decoupling securities lending from custody can be considered "best practice" these days. This is encouraging to clients that have historically lent via their custodian exploring non-custodial or multi-provider strategies for the first time. Many clients are realising that their relationship pricing is outdated and that they need to explore options for fiduciary reasons, as well as strategy optimisation.

SLT: Is your clients' attitude to risk changing in response to the events over the past couple of years?

Smollen: Our clients tend to have extremely conservative programmes. That being said, we currently have a contained client base, which helps us to head off any mounting concerns. We're all about access to the management team and transparency, so we issue market commentary specific to ongoing events and back that up with frequent regular contact. Our client service teams are experts in securities lending rather than custody administrators, which means anyone who answers the phone knows the client and can respond to complex securities lending enquires. This gives our clients a sense of confidence in how we manage the business.

SLT: Are your clients focusing on any particular markets or sectors?

Smollen: Our client base is domiciled throughout the world, so it's extremely important that we be able to service every asset type in both mature and emerging markets, from global equities to all fixed income instruments. A universal theme is our clients want to extract "intrinsic value" in the assets they own, wherever they are invested. In particular, access to our management team is important to our clients who tend to be sophisticated lenders who want a detailed understanding of how Deutsche Bank optimises returns and manages risk in the markets in which they invest. **SLT**

Tim Smollen
Global head of agency lending
Deutsche Bank

I need to see credit limit breaches when I book a trade – I don't have truly real-time global position management – I have to provide locate authorization codes to my day traders – I have to maintain the correct level of debit/margin balance all the time – I am unable to benefit from hot stocks tied up in my margin/debit balances – Many of my operational activities are highly labor intensive - I only have time to sort out the large billing discrepancies

Managing multiple technology vendors takes too much of my time

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Canada

While staying on course, the Canadian securities lending market is trying to seize opportunities and improve the legislative landscape for the future

ANNA REITMAN REPORTS

Slow and steady are the two words that Reeve Serman, head of securities lending trading and market execution at RBC Dexia, uses to describe the Canadian securities lending market.

The Bank of Canada's prudent fiscal policies and the country's comparatively functional majority conservative government has sparked investor confidence resulting in strong demand for the country's debt, and high levels of interest in the equity markets have held up "remarkably well", says Serman.

"There is huge global demand for purchasing high quality government debt right now from the investment community" says Serman, adding that this same intensifying demand is being translated into multiple opportunities across RBC Dexia's global lending desks for high quality Canadian and European government debt.

And while a myriad of inconsistent and unpredictable short selling regulations across the world are adding an administrative burden to stock lending and dampening the demand side of the non-Canadian equity book, Canadian equity balances have, in contrast, held strong he notes.

The global custodian bank has four trading desks covering North America, Europe, Spain and Asia-Pacific and is active in 28 markets. The securities lending trading arm headed by Serman has a globally diversified book of business, with high concentrations in North America and Europe and a significant contribution from the Far East.

August was a particularly volatile month from a risk perspective as both the eurozone debt crisis and US political dysfunction in addressing its debt burdens rattled markets causing a global sell-off in equities and, simultaneously, flight-to-safety investing.

"In Canada, from a risk perspective, we are not overly concerned as the major securities lending participants are the major banks, which are some of the best banks globally with solid balance sheets. That brings an element of comfort from a credit risk perspective and allows us to trade up with high balances with less concerns from risk departments, lenders and borrowers," Serman says.

Though there has been a rebound since the summer, there are still significant market jitters and all eyes have turned to eurozone developments in Greece and to a lesser extent in Spain and Italy, while increasing concerns around French Banks' exposure to these countries is mounting.

"The eurozone does not seem to have an aligned vision, there are divergent views on how to fix [the sovereign debt crisis] and no real consensus. Italy seems to have a vision of raising taxes, and France is facing an election next year, the expectation on Germany to carry the eurozone is not sustainable and everyone is looking to the US for an economic rebound, there is an

election there next year...I think ugly politics are a major hurdle in resolving this global economic downturn," says Serman.

Moreover, the US' persistent high unemployment rate, high debt levels, low rates of consumption, among other macroeconomic and internal political dynamics are causing concerns over the potential impact on Canada if the situation continues. Still, the country's economy is proving to be highly resilient.

Ferguson: I am not saying that a CCP model is more risky, it just might not result in the particular risk profile that clients would have chosen under a non-CCP model

In terms of global securities lending, Canada is RBC Dexia's home market and where it has depth and strength, and while it remains a major focus, in terms of growth, Serman says higher incremental returns are expected from its European desk. "We are seeing opportunity in the eurozone specific to securities lending as we bring more supply into our programme as a result of [the joint venture between RBC and Dexia]. Dexia has lots of clients and has successfully brought in new participants," Serman adds.

At the same time, risk management functions are taking up more and more of his time. There is a lot of focus on reducing concentration risk on both the loan and collateral side, focusing on liquidity risk for both loans and collateral as well as looking at the correlation risk between the collateral and lending portfolios. For equity loans verse equity collateral, explains Serman, the correlation risk of a portfolio is significantly reduced – if the market moves sharply in either direction, both the loan portfolio and collateral portfolio drop or rise in a more correlated manner.

The same is not true for an equity loan portfolio versus a fixed income collateral portfolio, where one would observe a higher correlation risk between the portfolios as markets move.

"Risk is not something to be afraid of. One needs to understand it and be able to partner with one's risk group and clients to strategically manage it," Serman says.

"We would like to see more clients understand how [using equities as collateral] can help them reduce their risk profile in the market. Historically, everyone thought the best kind of collateral is government debt but if one factors in correlation risk during periods of high volatility...equities on equities clearly reduces risk. Many models and research papers published by credible sources demonstrate this dynamic," Serman says.

Through CASLA, the Canadian Securities Lending Association, an industry representative body where he is a member of the board, Serman would like to engage industry participants, including Canadian regulators, in meaningful discussions to increase awareness and benefits of collateral alternatives, including equities, from a risk reward perspective. In addition, borrowers are receptive to paying higher margin levels for equity collateral at a time when restrictions are many and collateral costs are high for good quality government debt collateral.

"I am finding a new dynamic in the securities lending world, where there is a disjoint between the demand and supply side of the market," says Serman. "Borrowers want lenders to be more flexible on not just collateral, but also term structures, which provide certain financial institutions balance sheet advantages as a result of certain term structures specific to high quality government debt. If lenders were open to [this], there is a huge opportunity which is not really being capitalised on as lenders struggle to get these opportunities approved internally," he adds. "While securities lending may not be a core product of lenders, these opportunities can result in significant incremental revenue streams in a risk adjusted manner."

It might be too much to ask for flexibility at a time when playing it safe is on most agendas. One area that Serman has seen a significant shift towards this attitude is in the specials market. Although the slowing of this activity is indicative of less mergers and acquisitions activity, it is also a reflection of a diversified risk adjusted return approach, meaning less capital being allocated to highly concentrated one-off trading opportunities as caution is being applied to decisions on how to best allocate that capital.

But just as lenders are cautious in flexibility and big risks, they are not shying away from new "rules of engagement" in terms of demanding transparency, benchmarking, reporting and analytics.

"It is a bitter sweet dynamic, we are encouraged that [lenders] are getting more sophisticated, however, with that comes a lot of extra management with the clients," Serman notes.

For now, participants in the Canadian securities lending market are focused on operational efficiency, risk management automation and managing the underlying client. While an initiative to start a CCP for Canada, though getting some attention in the market, is not a priority for the immediate future, he adds.

Paving the way

Still, CCPs are an expected requirement for certain transactions under the US Dodd-Frank Act and participants in Canada are moving in this direction, as are many other markets. In general, CCPs offer benefits around efficiency, transparency and risk-reduction, but CCPs only make sense if they can achieve these goals without unduly driving up costs, says Rob Ferguson, head of global securities lending at CIBC Mellon.

"Conceptually, CCPs are an interesting idea and certainly worth discussing – so long as benefits outweigh costs. To date, however, it has been difficult to identify the benefits for our underlying securities lending and borrowing clients," he says.

That is, in part, because borrowers and lenders can create a bespoke model and make choices on collateral, counterparties and design a risk profile. Ferguson notes that CCP models could take away some of that flexibility, while also not making it clear who the counterparties are.

"I am not saying that a CCP model is more risky, it just might not result in the particular risk profile that clients would have chosen under a non-CCP model," he says. "[CCPs] could take away the clients' ability to control the composition of their risk balance."

He also thinks that a CCP for Canada's securities lending market is far from being a done deal.

"I am not sure that we could just be an island. If other jurisdictions move to CCP models and become comfortable with their operation, I could see participants becoming more comfortable with the various risk profile, cost and revenue implications of a CCP model. So if the rest of world moves in this direction, maybe we would see it happen here in Canada, but I certainly don't see this as a slam dunk," he notes.

Serman: Risk is not something to be afraid of. One needs to understand it and be able to partner with one's risk group and clients

This is particularly true as any increased costs are anathema in an environment of global economic challenges. Though 2011 has been stronger than 2010 for CIBC Mellon's securities lending business, uncertainty and negativity as a result of macroeconomic concerns may impact business volumes, says Ferguson, adding that

low interest rates and a flat yield curve are also making cash reinvestment more challenging.

One of the areas gaining traction is the use of equity collateral in the post-credit crisis landscape. Though non-cash collateral tends to be predominantly government sovereign debt – accounting for some 90 per cent – participants are showing increased interest in broadening what is acceptable as collateral in securities lending transactions.

Ali-Dabydeen: Canadian rules lack a cohesive scheme, different bits and pieces of the Income Tax Act need to be tied together

More than three-quarters of Canadian agent lending is done versus non-cash collateral - that has dropped off somewhat from just over a decade ago, when the figure was above 90 per cent. At the same time, barriers to using non-cash collateral are relatively small if a security is deemed qualified under Canada's Income Tax Act, Ferguson says.

Mutual funds, a relatively new player in Canadian securities lending, are prohibited from accepting equity collateral.

"These rules do disadvantage mutual funds, putting them on unequal footing with pension funds, for example," Ferguson says.

He is supportive of the efforts to broaden collateral being undertaken by CASLA and its president Rob Chiuch.

"A smaller part of broadening collateral is about improving a client's risk profile. We would never tell a client to take 100 per cent equity collateral, but we would say a small percentage of equities would improve your risk profile. If regulations were amended to broaden collateral acceptability, mutual funds might then be able to accept equity collateral, which in turn could mean new revenue opportunities," Ferguson says.

But in the here and now in the securities lending industry, despite challenges, the uncertainty cloud hanging over markets does have a silver lining; uncertainty often lends itself to some securities lending optimism.

Ferguson points to solar energy company stocks as an example, where a combination of short-term downward price pressure, but good longer term prospects is creating revenue opportunities for both borrowers and lenders.

"From CIBC Mellon's perspective, our lending program continues to grow as we add new clients and earn additional business from our existing partners. I remain cautiously optimistic about the market in 2012," says Ferguson.

Simply tax

From a tax perspective, Canada is mired in layers of draft legislation as part of the Income Tax Act, impacting the efficiency of the market, says Reya Ali-Dabydeen, tax partner in the Financial Services Group at Ernst & Young.

"We need to have more clarity. Today, we rely on the draft legislation to perform transactions on the assumption that the Department of Finance would provide us certainty," Ali-Dabydeen says. Currently, analysis of trade requires that tax advisers look at draft legislation from 2002 and 2006, which often shows a variance between the two, making the process inefficient, he adds.

But withholding taxes are the biggest issue for Ernst & Young clients, he notes, as Canadians borrowing, for example, European equities are charged withholding tax on the compensation payments.

"Canada needs to start thinking about how it applies withholding taxes on non-Canadian source dividends…at the moment the process is market inefficient," Ali-Dabydeen says.

Clients are using derivatives instruments to deal with this inefficiency in order to synthesise desired returns, but this is also an area without a clear set of rules.

"Canadian rules lack a cohesive scheme, different bits and pieces of [the Income Tax Act] need to be tied together. This is not a bad thing as some of those rules are intended to prevent tax avoidance but where other jurisdictions have comprehensive securities lending rules, Canada does not. [The government] should at the very least be passing current legislation but at the same time begin thinking about rules in a comprehensive fashion," he says. "Right now, there are always bigger legislative issues and the size of Canada's market may not attract Finance's attention, and so it is one of those areas that is not a priority of the Department of Finance as one might hope."

In general, Ali-Dabydeen positions Canada somewhere between the US and UK in terms of development. Canada could do more to follow the example set by the City of London, which lobbies aggressively for clear guidance on capital markets, but without going as far as the US in terms of the complexity of burdensome rules.

"The risk [of not having a clear framework] is that transactions are more expensive partly because of the lack of clarity, but also it may impede the development of the Canadian securities lending market," he says. **SLT**

Next issue:
The Chinese market

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Canadian affair

State Street's Canadian securities lending specialist speaks to SLT about how the market is developing

ANNA REITMAN REPORTS

Warren Maynard is vice president of account management & sales for State Street's Securities Finance division in Canada and is also responsible for collaborating with the trading, legal and product development teams to help create products specifically for Canadian lenders.

In addition, Maynard serves on the board of the Canadian Securities Lending Association (CASLA) as vice president.

SLT: What is State Street's role in the market?

Warren Maynard: State Street acts as an agent for its lending programme in Canada. We offer our clients the options of both a non-cash collateral program and a cash collateral programme with a customised solution to meet their program goals and risk parameters.

The Canadian market, which is approximately $700 billion as of mid-September according to Data Explorers, continues to be a primarily non-cash lending environment with 90 per cent of the lending negotiated versus securities as collateral. The cash collateral market in Canada is approximately 10 per cent of the current market. Lenders have been doing deeper dives into their lending programmes and customising lending solutions based upon their risk and reward tolerances. Canadian lending clients are generally risk adverse and have been rolling back the risk profiles of their lending programmes over the past couple of years.

The trends that we are seeing in Canada on the non-cash collateral side are an expansion of non-traditional non-cash collateral types like equities as collateral and widely-traded debt instruments. On the cash side, clients are customising investment portfolios towards their own internal risk parameters and looking to participate in segregated cash collateral investment programs to allow this customisation and portability for future market changes. This customisation includes not only the credit parameters around the cash collateral re-investment guidelines but also the weighted-average maturities of the investment portfolios with most being brought in.

The securities lending industry in Canada has been and continues to be dominated by the custodial lenders. There are only a few lenders who lend directly and only a handful of lenders that lend on a third party basis through another provider other than their custodian. This dominating custody lending model is vastly different than the lending models of other regions that have a great deal of more lenders that lend through third party arrangements.

SLT: What is the current state of the market?

Maynard: Today, from the standpoint of beneficial owners and lenders the environment is much better as opposed to the post-crisis period of 2008. Beneficial owners in general have gained a better understanding of their overall programmes and taken action on their programmes, altering aspects so they are better set for the future.

We're seeing clients that are more engaged and having more regular discussions with our lenders. The theme of customisation is now popular with lenders as they look to tailor their lending programme to their own internal risk parameters. Increasingly, we are having conversations along the lines of, "Is there anything that my counterparties are doing that we should look at?"

SLT: What are the most important macroeconomic factors from your point of view?

Maynard: Interest rates in Canada are low currently but they are higher than interest rates currently in the US. In Canada, this does allow us the flexibility on the cash collateral side to undertake more business to pick up some investment spreads. While recent comments from the central bank have indicated that it was positioning for higher near-term rates, recent commitments by the Fed to keep rates unchanged until 2013 and softer economic data have changed the Bank of Canada's rhetoric leaning to a more dovish tone in its statements over the short term. Over the longer-term there will likely be higher revenues as the central bank begins a tightening cycle to normalised rates. When we do eventually enter into an increasing rate environment we will experience the same type of challenges we have seen before in managing the short-term duration of the funds around the Bank of Canada reset dates for overnight interest rates.

SLT: In a recent Finadium survey, asset managers noted that they expect increased revenues in securities lending over the next few years due to greater AUM in their programmes and higher interest rates - do you see this as well?

Maynard: We cannot predict when we are going to enter an increasing rate environment as that may take longer than what we initially anticipated at the beginning of 2011. However, we are seeing growth opportunities in the market with lenders coming from expansion into non-traditional type non-cash collateral programmes allowing the borrowers greater opportunities to finance their long inventories as collateral. We also continue to see some growth on the cash collateral side of the business as clients segregate and customise their investment programs.

SLT: What are some of the advantages of and barriers in the Canadian securities lending market?

Maynard: The advantages that the Canadian lending market has enjoyed is that on an industry-wide basis there was not as much impact as other markets experienced during the global crisis. Our regulations in Canada provide lending clients with a wide variation of options available to them in their lending programs and there is less intervention by regulators in terms of restrictions on lending programmes such as short selling rules.

We have increasingly moved into the global forefront with regards to lending markets that Canadian lenders can participate in and we have enjoyed relief of some of the cross-border tax burdens that our market has had in years prior. Canadian lenders have several choices and considerable opportunities for customisation of their programmes.

The barriers in the securities lending market in Canada would, in some cases, be similar to those experienced by other global lenders. Supply continues to grow at a faster rate than demand for loans. The demand side of the business has not grown back to where it was pre-crisis. Another challenge that the industry faces in Canada is that we have a relatively small short-term money market in Canada which limits our cash collateral re-investment options as we look to grow this side of the business. There are also fewer borrowing counterparties in Canada compared to other markets. SLT

Warren Maynard
VP Canadian account management
State Street Securities Finance

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Riding the rollercoaster

There's a need to apply a real-time focus to existing risk management practices and consider other risks inherent in financial markets operations, writes Dedication Group's Greg Pritchard

EXCLUSIVE

The financial media is currently awash with the news that instead of periods of high volatility constituting exceptional market conditions; high volatility is becoming the new normal. Thus, rather than organisations applying extra attention and oversight to risk management in the short-term due to volatility spikes, we are starting to see a change in the risk management paradigm itself.

During periods of lower volatility participants are able to augment automated market and credit risk systems with manual oversight and exceptions-based investigations. However, unsurprising to any head of trading or desk manager, highly volatile markets mean that the time between checking and resolving risk management exceptions shortens to daily or intra-day intervals, thereby making manual investigations too time intensive.

These manual investigations are at the mercy of specialist resource availability to work through large volumes of data, requiring additional oversight to ensure all checks and balances have been undertaken. Incurring further losses as the time taken to investigate and manage exceptions, increases.

Traditionally spikes in volatility have forced us to:

- closely track market risk; undertaking Value-at-Risk (VAR) and other market-shock calculations to establish the sensitivity of position valuations from price and rate movements
- re-mark trades with counterparties to reduce position exposures
- recalculate capital adequacy to ensure regulatory compliance.

In most organisations, the risk management teams are effectively applying these techniques, and more, to identify sources of risk and to enact strategies to limit exposures and losses. Regardless of volatility levels; these measures are stemming the preventable or expected losses inherent in normal trading activity.

However the combination of higher volatility with fraudulent and unauthorised trading activity, presents almost insurmountable losses as seen in the cases of UBS, Societe Generale, and Barings. In these situations, real-time market risk management was calculated on what was assumed to be the correct position.

In hindsight, utilising market risk calculations on fictitious trades runs the risk of creating a false negative indicator on loss potential. That is, market risk in this instance did not contribute to identifying sources of loss before they occurred. These examples show market and counterparty risk calculations can prove invalid when based on flawed assumptions in the integrity of the underlying trades. The learning from this is market

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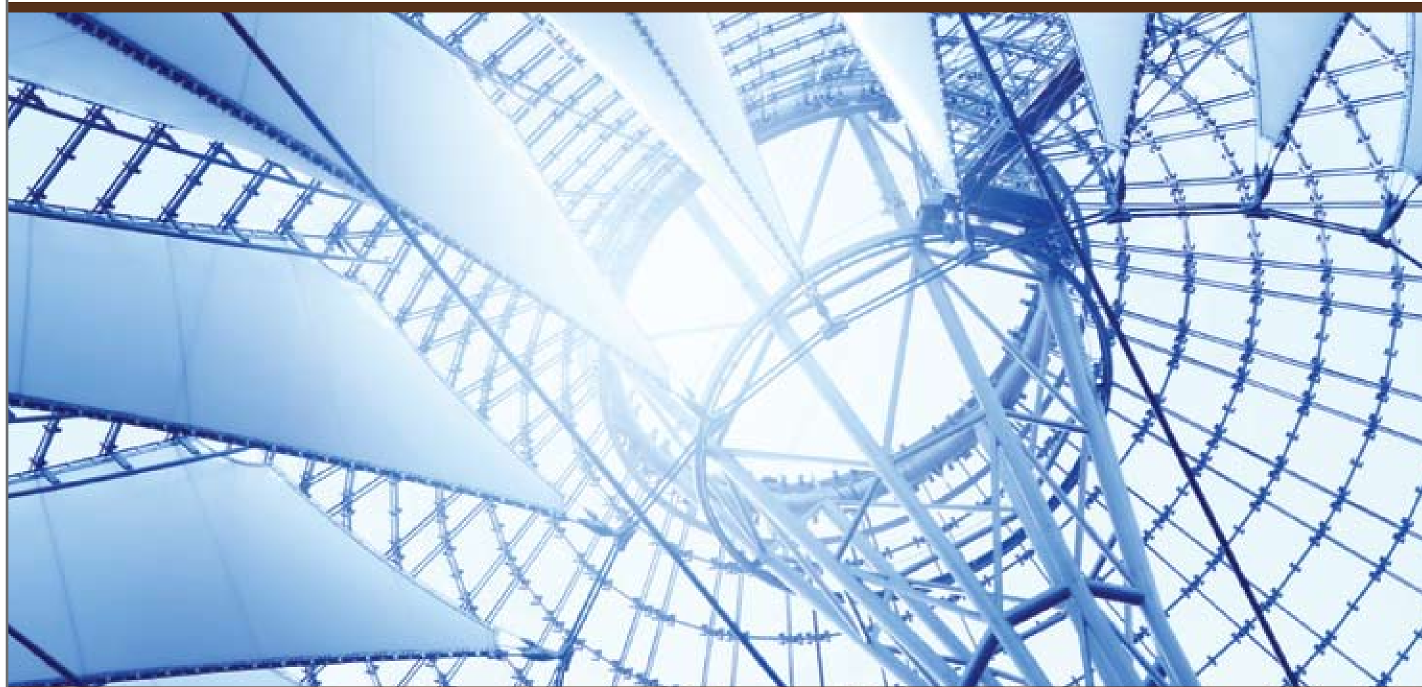

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risk can be calculated correctly on a fictitious position as much as it can be correctly calculated on a valid trading position.

In a volatile environment the importance of timely identification and reporting of operational exceptions may mean the difference between business survival and ruin.

Fighting volatility – head on

While exceptional events such as fraudulent and unauthorised trading, may be generating negative sentiment for some institutions at present, these system failures provide a useful reference point for highlighting where risk management needs improvement. The tools, systems and measures used to identify and report on these events are the very structural elements we should be incorporating to responsibly manage risk in trading operations.

In a volatile environment the importance of timely identification and reporting of operational exceptions may mean the difference between business survival and ruin

In raw terms, whatever you're manually analysing after the fact - you should be doing in real-time, consistently and repeatedly as part of normal trading operations and risk management.

To understand what it would take to systematically identify and manage these exposures in real-time; we first look at the steps undertaken during a forensic analysis of trading operations after a significant fraud or unauthorised trading event:

- every trade (in question) is confirmed with each respective counterparty
- cash flows and internal funding is reconciled against deals
- trade modifications post-booking, especially by front office, are scrutinised
- every position feeding into market risk is re-marked
- every trade is verified as actually feeding into the market risk calculation
- trend correlations of P&L, VAR and funding requirements.

There are many, varied investigative paths, but with each of these the core verification steps remain. These include; counterparty confirmation, internal funding or external cash settlement, reconciliation, calculation and reporting of P&L.

In order to bring all risk management functions into real-time modelling across the individual risk classes of market, credit, operational and regulatory risk, teams must:

- baseline the trade flows and official position repositories across the systems' topology within the trading environment – this will provide a model against which gaps and further sources of risk can be analysed
- identify the areas of risk in the trading environment i.e. manual handling touch points, gaps in system functionality relative to trading sophistication, access to systems and controls by users outside of the intended operating model
- establish quantitative measures and normal operating ranges for each of those risk areas
- automate collection of the data to support these measures
- algorithmically verify the source data against pre-defined quantitative levels
- present the information in a manner consistent with the reporting levels and frequency of other risk measures
- prove the measurement and reporting model at high volumes as well as at high volatilities.

To give an example, every OTC deal needs to be independently confirmed with counterparties. The sending or receipt, and acceptance, of the confirmation needs to be tracked and measured centrally with confirmed failures reported through the same reporting mechanisms used for market and credit risk. Where a trade has not been confirmed within pre-defined "normal" timeframes, the risk and desk managers' dashboard should highlight the discrepancy and instigate an investigation.

In addition, trades will either require internal funding from the organisation's central treasury, and/or be cash settled with external counterparties. These cash movements need to be tied back to every single trade in the ledger. Generally speaking fictitious trades don't require funding. Therefore, attention should be drawn to mismatches between expected, benchmark funding levels and actual funding requirements. Positions which aren't actually funded according to their theoretical requirements should be red flags for investigation and followed-up. Often we see organisations manage funding at such an aggregate level; that deal-by-deal funding discrepancies can go unnoticed.

Trading activity should generally show a correlation between the three variables of; P&L, funding and VAR. That is, positions with a high P&L should carry large funding requirements and/or be exhibiting changes to VAR. While combining and calculating correlation between the three variables can highlight trade recording errors, either accidental or fraudulent - many organisations measure these values independently across the finance, treasury and risk functions respectively. Measuring these values in organisational silos misses the opportunity to identify problems that can only be seen in the context of other factors. For example, a significantly large arbitrage position may be generating modest P&L, with limited funding, but have VAR measures not in-line with expectations. . Systematically collecting this data, calculating correlations in real-time and comparing against historical trends can allow you to view deviations from expected norms and identify risks with positions or valuations.

What the future holds

To achieve real-time risk management to cope with volatile markets requires organisational vision and co-ordination across the firm. There are numerous barriers to adopting a successful real-time risk management program; however the potential for significant loss remains when accurate and timely information is not readily available.

Some of the barriers faced by organisations include:

- achieving a consistent definition of operational risk metrics
- out of date or inflexible systems inhibiting access to core data in real-time
- not having the expertise to design the required technical and operating topology, and
- lack of political clout to drive solutions spanning divisions and lines of responsibility

By incorporating operational risk factors quantitatively into established risk management processes, and evolving risk management oversight to an automated, consolidated and real-time model; organisations are better able to protect themselves from risk exposures in highly volatile environments. In the end this is what will differentiate the firms that will survive from those that will not. **SLT**

Greg Pritchard
Managing director
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The new breed

The founder of All American Technologies is driving real change in the securities lending industry. But, he says, there's still a long way to go

ANNA REITMAN REPORTS

John Tabacco is a big personality representing the "little guy". All American Technologies (aka Locatestock.com), founded by Tabacco, is one of very few companies that allows users to execute securities lending transactions aside from providing pricing data.

Since its inception, Locatestock.com has processed 82 million short sale locate transactions and 380 billion shares for short sale approval without any failed client audits as a result of using its Matador platform.

In this interview with SLT, Tabacco talks about the state of the market, what needs to change and where he sees it going.

SLT: How did you get started in securities lending?

John Tabacco: My goal in life from a young age was to be involved in the world of global finance and after almost 20 years of participating in US capital markets in many different roles, I found myself introduced to the world of securities lending by a great friend and mentor, Anthony Venditti. I joined the securities lending community as an outsider and became a "finder", in every other area of the capital markets, a finder is called a broker, but for some reason in securities lending the term finder became a dirty word. And, while finders provide an important service to the settlement community, in 2003 regulators decided that they were going to declare war on finders and eliminate the opportunity for intermediaries to participate in the lending markets. I saw that potentially my livelihood might be gone.

Regulators had found a few individuals who were breaking the law and brought them to justice. But afterwards, I think they used a sledgehammer instead of a scalpel. Finders are like independents or individuals, smaller companies and, at least in the US, it seems that when regulators go after small companies they go in with a very big hammer and when they go after big companies they use a wrist-slap, it is a disproportionate regulatory enforcement policy.

Either way, I asked myself how is it that securities lending is not automated - it is the backbone of every transaction, both long and short. In an era of black box, high frequency, nano second trading, how are people approving short sales when a human being could not possibly act at the speed that these transactions are coming in these days?

I recognised that there will still be a need for a broker, but the regulatory landscape seemed to point towards automation amid calls for transparency. I am an entrepreneur, I have been in different businesses and, though I don't have a background in technology, I know a heck of a lot about securities lending.

Securities lending at that time was one of the last bastions of opacity, so why not be the first guy to build technology to meet that demand?

In 2005, RegSHO, which was a fantastic short sale regulation which set some clear guidelines on how broker-dealers and trading firms should allocate and document an audit trail on where securities were located to support the settlement on the short sale transaction, came into effect and we built the technology to match the requirements of that regulation. Locatestock.com was born.

As the landscape continues to grow with electronic securities lending products, which are great, only we can claim to be first to market, we will always have that.

SLT: What surprises you most about what people don't understand about the securities lending market?

Tabacco: It's that most people don't know that pension plans and retirement systems are some of the biggest lenders of securities in the world, and retirees have no idea that the securities that are purchased by their pension plan are also being lent out to short sellers who are betting and applying pressure to stock that they are invested in to go down.

At the end of the day, I don't think people realise that if you are long stock and your custodian or clearing firm lends it out under an agreement which was signed unknowingly, they are facilitating short sellers to put pressure on that investment

In other words, the pension plan is lending out shares to facilitate short sales in the very stock

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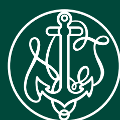

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it bought with hopes of higher returns and in turn applying selling pressure to a long investment. And the bulk of the revenue that is generated from custodial lending programmes is generated from hard to borrow securities.

So I think retail investors need to be made aware that securities in their portfolio that they purchased on margin can be lent out to short sellers. The tricky part is how. Every person who opens a brokerage account signs a customer agreement and tucked away somewhere is a hypothecation clause which allows custodians to lend out from the portfolio to short sellers.

It is overlooked in most customer agreements and I don't think most investors know they are agreeing to that.

SLT: What do you think needs to happen on this front?

Tabacco: The regulation that I think needs to come down the pike is single stock best execution for securities lending transactions. The whole issue brings up the question of fiduciary responsibility: what is the risk-reward ratio? Meaning, how much money are we making from short sellers who are applying downward pressure on our stocks, might it be better to not lend the stock?

SLT: What regulations do you see coming down the wire that the securities lending community should be paying attention to?

Tabacco: Patrick Byrne, the CEO of Overstock.com, has been a one-man wrecking crew to push Washington and regulators to protect investors and eliminate naked short selling. The one thing he is pushing hard on right now, that could clean up the entire problem for pension plans, investors and public issuers, is a mandatory pre-borrower requirement on all short sales. Simple. That would mean, prior to short selling a stock, it would have to be borrowed. Not just a contract entered into with reasonable grounds.

SLT: What are some of the reasons behind this push to eliminate naked short-selling?

Tabacco: Every time a naked short sale happens, shareholder value is diminished. Some retirement system or pension plan, which should have been paid has instead been fleeced, because there is no borrow and there is no securities lend transaction documented.

On July 25 this year, President Barack Obama issued an executive order and declared a national emergency because "significant transnational criminal organisations have reached such scope and gravity that they threaten the stability of international economic systems" were his words. And this is directly related to naked short selling.

So, the President of the United States has recognised that foreign transnational criminal organisations have figured out that our settlement system is broken and the place that it is broken is naked short selling. It can be used to destroy US public companies, like our banks and our financial institutions. I think people need to know that our whole economy could be jeopardised by not acting strenuously enough in taking naked short selling seriously.

SLT: What changes to the settlement system would address this?

Tabacco: Our settlement system needs to go in the direction of share-for-share securities lending allocations to short sales. For example, a clearing firm or custody firm has 150,000 shares of a company they want to lend out or can lend out, there are instances where that firm can approve four or five times the amount of short sales than they have securities in the box. Although RegSHO mandates against this, there are still existing loopholes. I think a national defence approach to cleaning up the cracks in our settlement system is important. It isn't just a regulatory issue any more, according to our own President it is a national emergency.

SLT: What are some of the positive developments you see in the industry?

Tabacco: Beneficial owners have overall done a great job of demanding more transparency and price discovery from their custodians. Some regulation that ties a beneficial owner's fiduciary responsibility to ensuring transactional best execution pricing on securities lending transactions would give beneficial owners another leg up in making sure that they are getting full value for the securities they are lending

There are also companies like my own and Quadriserv that are bringing transparent, real-time securities lending pricing. The bigger firms can get pricing because they generate a large amount of commission business, so they can get some degree of transparency, but nobody really seems to care about the little guys. The smaller firms and investors do not have access.

We created an electronic solution that gives small to mid-sized firms the tools they need to succeed in the securities lending markets . In my mind, sunlight kills germs. The more transparency, the more daylight, the better. This is especially true for retail investors.

Most people think Quadriserv is competitor because we are both in the business of electronic securities lending. I have a tremendous amount of respect for Quadriserv's Pasquale Cestaro, and I like to think of us more as compatriots because we both have vested interests in bringing transparency to the securities lending markets. According to Quadriserv's most recent press release, It seems like the company is gearing up in the direction of facilitating bigger firms with a new block transaction platform, that's "a little cleaner" than their current offering for smaller brokers.

My hope is that we can create products to fill the void for small to mid-sized firms.

SLT: Where is the market headed?

Tabacco: I think every day companies like ours are innovating in the area of electronic tools and platforms to put the power of securities lending in the hands of the actual securities owner. I see it in the US – retail investors are waking up to the fact that their shares are being lent out and they are not receiving a share of the collected fees.

If there is a fiduciary responsibility on securities lending transactions to get the highest price in the market place, it would deliver higher returns to beneficial owners. There is a tremendous disparity between the split fee that winds up to the lender and the prevailing market rate that an end user paid to borrow those shares. I mean a tremendous gap between those two. I think the tools that our company and others are coming out with are continuing to push regulators and the bulge bracket firms in the direction of narrowing the gap between fees paid to lenders and fees charged to short sellers, and there is a huge spread there. I think we are getting closer to the end user meeting the organic lender.

I also think the future of securities lending is in a fully electronic central counterparty environment.

SLT: What kind of new innovations is All American Technologies working on?

Tabacco: We are introducing a custodial lending programme to help public issuers prevent their stock from being naked short sold. I think it will be a revolutionary way for public companies to take control over what many of them feel is a problem that can't be solved - which is fighting short sellers.

Our arena, which was fairly empty a few years ago is becoming more crowded and, for a company that has been engaged in providing electronic securities lending platforms for as long as the regulation has been around, every competitor is welcome and every competitor makes us a better company.

We are the only company with executable electronic securities lending technology that has been profitable since its inception. I think that shows that there is clearly a need for these products, even when it's introduced to the market place by a smaller firm which isn't affiliated with an institution. We aren't some developmental think tank that loses money, we are making a profit. **SLT**

John Tabacco
Founder
All American Technologies

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Magical mystery market value

SunGard Astec Analytics's Andrew Shinn takes a look at an Indian ISP

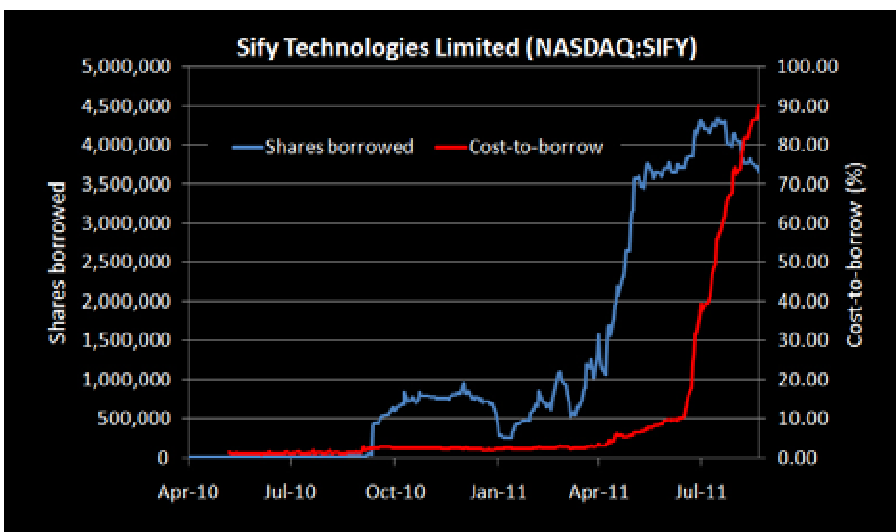
MARKET PERSPECTIVE

Sify, not to be confused with NBC Universal's science fiction television channel Syfy, is an internet service provider in India. Incorporated in 1995 in Chennai to connect corporations' different offices together via the internet, Sify (NASDAQ:SIFY) was also one of the first private dial-up internet service providers in India. While it was certainly a vanguard in the late 1990s, its tie to Satyam Computer Services and its recent dilutive share offering have attracted the attention of short sellers.

Sify's original name was Satyam Infoway Private Limited, and until 2002, it was a subsidiary of Satyam. Satyam, now known as India's Enron, was once one of India's largest information technology companies with a $7 billion market cap. In 2009, however, the CEO of Satyam confessed that the company had falsified revenue over several years and overstated cash balances by $1 billion. Billions of dollars in market value evaporated, and Satyam's assets were eventually auctioned off to Tech Mahindra, a joint venture between Mahindra & Mahindra and British Telecom.

Even though Sify has been an independent company for several years, it is a generally held view that Sify, is still linked to Satyam, and there is the perception that Sify's corporate governance structure is not strong.

Sify earned 80 per cent of its $148 million revenue in 2010 by providing corporations with internet and data services. In addition, Sify provides internet to 300,000 retail subscribers and operates 1,227 internet cafes, all but six of which are franchised. According to web traffic report Alexa, Sify.com is currently the 83rd most-visited website in India, and it generated two per cent of Sify's revenue in 2010. Internet cafes and retail subscribers generated 11 per cent of revenue.



Investors who are bullish on Sify point to the rapid growth in demand for internet that will take place in India over the next several years. Currently there are 100 million internet users in India, 40 million of whom access the internet exclusively from their mobile devices. According to the Telecom Regulatory Authority of India, as of June 2011, there were just over 12 million broadband subscribers in India. Sify claims that its broadband business unit "has emerged as the most unique and cost-efficient model for scaling up broadband across the country," but it also admits that it will have a difficult time competing against the large telecom firms that own the last mile of connectivity to consumers' homes and can bundle internet and telephone services together. Indeed, Sify lost $18 million in 2009. And if not for a $12.4 million undefined legal settlement in 2010, Sify's net income would have been negative $12 million last year.

Sify's corporate governance also merits attention. On October 21, 2010, Sify had 53.35 million shares outstanding and a market capitalization of $105 million. The next day, Sify's board of directors entered into an agreement to issue another 125 million shares to Raju Vegesna, the CEO of Sify. According to Schedule 13D filed with the US Securities and Exchange Commission, "the purpose of the Transaction [was] to obtain funding for the Issuer's ongoing capital expenditures, business expansion and general business operations," yet the company was issuing the shares to Raju Vegesna at a 64 per cent discount to the then-current market price.

The number of shares outstanding tripled to 178 million, yet Sify only received $86 million. And Sify did not even receive all $86 million at once. Instead, 5 per cent of the $86 million was due from Raju Vegesna by October 30, 2010, and another $17.2 million was due before December 19, 2010. Even though the board stated that the new equity capital was needed to fund general business operations, 75 per cent of the $86 million was "payable in such installments as may be decided by the Board of Directors of the Company."

This sale of 125 million new shares at such a steep discount is contradictory to how Sify's board of directors behaved on March 17, 2008 when Sify issued 12.8 million new shares to Raju Vegesna for $4.46 per share, a premium of $0.46 over the current trading price of $4 per share. However, in 2008, Raju Vegesna only controlled 40 per cent of Sify's 40.5 million shares outstanding, so paying a premium to the market price may have been required to get other shareholders to approve the deal. In 2010, Raju Vegesna controlled 54 per cent of Sify., and evidently it was no longer necessary to pay a premium.

Short sellers first started borrowing shares of Sify on October 7, 2010. Shares borrowed in SunGard's Lending Pit averaged 20,000 for several months in 2010, but on October 7, shares borrowed increased from 44,000 to 417,000 in one day. The reason for borrowing these hundreds of thousands of shares may have been due to the rise in Sify's share price from a low of $1.24 on August 27, 2010, to $2.81 on October 1, 2010. After reaching almost one million shares borrowed in December 2010, short sellers covered 75 per cent of their positions and shares borrowed dropped to 250,000 in early February 2011.

The more important point is that since December 21, 2010, when Sify filed its 13D regarding the new share issuance, investors have not priced in the dilutive effect of those new shares. Perhaps investors did not read the 13D, because instead of falling, Sify's share price increased more than 250 per cent over the next four months. Even on July 22, 2011, when the Wall Street Journal's Heard on the Street column highlighted the confusion surrounding exactly how many Sify shares were outstanding, Sify's share price refused to budge. In fact, it increased by 8 per cent to today. Moreover, Google Finance still lists Sify's shares outstanding as 53.35 million rather than 178.35 million. Similarly, Google Finance calculates the market value of Sify as $269 million versus Yahoo! Finance's (as provided by Capital IQ) calculation of $900 million.

Astoundingly, Sify managed to triple the value of its company by doing nothing more than issuing 125 million new shares at a steep discount. Investors who are shorting the company certainly agree that a company cannot raise its market value simply by issuing new discounted shares. It will be interesting to see how long it takes for the rest of the market to figure that out. **SLT**

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Industry appointments

Mrugank Paranjape, managing director, has been appointed head of Direct Securities Services (DSS) for Asia-Pacific where he has overall responsibility for business strategy and growth for the bank's subcustody, clearing, and fund administration business across 14 countries in the region, as well as expanding the Bank's footprint in the onshore fund administration space. Mrugank Paranjape is a veteran banker with over 20 years capital markets experience, including nine years in securities services. Prior to joining Deutsche Bank, he had held senior management roles in international organisations including Prudential ICICI Asset Management India and Citibank.

Joseph Barnes, managing director at Deutsche Bank, has been appointed head of Direct Securities Services sales & relationship management for Asia-Pacific. In addition to business development and deepening relationships with domestic and cross-border clients, Barnes is responsible for growing the bank's third party agency securities lending business in the region and realising synergies within the corporate and investment bank to deliver greater value to the bank's clients. Barnes has been with the bank for 13 years, and has held various sales management and relationship management roles within Deutsche Bank, The Bank of New York and State Street.

Lisa Robins, Deutsche Bank's head of Global Transaction Banking (GTB) business for the Asia Pacific, commented, "GTB intends to rapidly ramp up its already substantial Asian DSS franchise and is putting in place the key people to accomplish this objective. The relocation of two key Managing Directors, Mrugank and Joe, to Singapore underscores our focus on growing our transaction banking franchise in Asia as well as our depth of talent and bench strength across the board in GTB within the Bank."

State Street has announced the appointment of **Douglas Brown** in the role of managing director and sales manager on the Securities Finance Americas team. Brown is based in Boston and responsible for all securities finance sales and new business development efforts for the US, Canada and Latin America.

Brown joins State Street from Credit Suisse, where he was director of Americas sales for the Prime Services division. He will report to Christopher Holzwarth, senior managing director and head of global sales for State Street's Securities Finance business.

Earlier in his career, Brown spent six years at State Street as a senior relationship manager in Securities Finance and three years with Mellon Trust, most recently in a relationship management role.

Societe Generale Securities Services (SGSS) has appointed **Jean-Louis Bernardo** as deputy head of Securities Services and head of business development for SGSS in Russia, where it operates within Societe Generale group's subsidiary, Rosbank, one of the largest privately owned banks in the country. He replaces Mathieu Maurier, who became SGSS' global head of sales and relationship management in January this year.

Based in Moscow, Jean-Louis Bernardo reports locally to Mikhail Bratanov, head of SGSS Russia (Rosbank) and to Philippe Huerre, head of emerging markets for SGSS, in Paris. He will contribute towards developing the offering and growing SGSS' activities in Russia, where it is now the largest international fund services provider, with already one of the widest offerings in the country. It provides local clearing and custody capabilities both to Russian and international corporates, financial institutions and institutional investors and also acts as fund depositary and registrar for a broad clientele of local asset management companies.

SGSS Russia (Rosbank), has had a long-term commitment to Russia, where it is actively involved in the development of the country's financial market infrastructures.

Jean-Louis Bernardo has a masters in Economics and a post-graduate degree in Banking Finance and International Trade from Bordeaux University. He started his career in 1995 with Citibank Capital Markets in Paris, where he occupied various positions in operations. In 2000, he joined SGSS' global sales and relationship management team as product manager and then in 2007 became deputy head and head of operations of SGSS Spain. From August 2009, Jean-Louis Bernardo managed the implementation of a complete securities services platform for SGSS in Egypt to cope with the rapid expansion of the securities services activity in that market.

Credit Suisse has appointed **Michael Mollemans** head of AES for Japan. Mollemans will be responsible for building on the position AES (Advanced Execution Services) has achieved in Japanese electronic trading, and for extending its reputation for innovating with algorithms, crossing engines and smart order routing.

Based in Tokyo, Mollemans will report functionally to Hani Shalabi, head of AES for Asia Pacific, and locally to Martin Keeble, head of equities for Japan. He joins Credit Suisse as a Director.

Mollemans was previously head of electronic trading sales at Daiwa Capital Markets in New York. He has previous experience in Japan, having worked in Tokyo for Crédit Lyonnais Securities between 2000 and 2002 before moving to New York.

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Published by Black Knight Media Ltd
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Avg. Debit Cash Balance	10%	5%	15%	15%	12%
% Longs Hard to Borrow	10%	5%	7%	7%	5%
% Shorts Hard to Borrow	30%	30%	25%	20%	15%
Typical Treasury Impact on a Fund					
Cash Management	$125,000	$125,000	$375,000	$750,000	$750,000
Stock Loan Management	$900,000	$1,000,000	$2,100,000	$3,990,000	$19,800,000
Stock Borrow Management	$1,180,000	$2,212,500	$4,331,250	$6,900,000	$8,415,000
Total Performance Increase	$2,205,000	$3,337,500	$6,806,250	$11,640,000	$28,965,000
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