SLT
SECURITIES**LENDING**TIMES

www.securitieslendingtimes.com

ISSUE008
07.09.2010 TUESDAY

EU to crack down on abusive short selling

BRUSSELS 02.09.2010

European Union regulators are set to bring in new laws that will ban the abusive short selling of shares and naked selling of credit default swaps and sovereign debt for three months or more.

The draft law is expected to be published on September 15.

Following the collapse of Lehman Brothers two years ago, a number of EU countries brought in temporary bans on naked short selling, and there have been calls for EU-wide regulation on the matter.

Greece in particular has criticised speculators for pushing it to the brink of default.

"The regulation aims at addressing the identified risks without unduly detracting from the benefits that short selling provides to the quality and efficiency of markets," said the draft law, which has been seen by Reuters.

The measure will cover all financial instruments and will give the new European Securities and Markets Authority, which will be in place from January, the powers to introduce emergency measures, such as three-month renewable bans.

But while the need for more regulation is understood by most within the industry, there are some who feel that this goes too far. The UK Government, for example, has said that it does not want to introduce laws that will affect the workings of the City. And some industry associations have also expressed reservations.

"We would not wish to see short selling banned even in extreme market circumstances," said Andrew Baker, chief executive of Aima. "The crisis experience has shown that imposing such bans does little to calm a market panic."

NEWS**IN**BRIEF

New tax rules for securities lending in Japan

The Financial Services Agency in Japan has announced that it will introduce a tax exemption regime for securities lending transactions.

The exemption forms part of the FSA's 2011 tax reform plan, which will also have an impact on the preferential tax regime for dividends.

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LCH. Clearnet offers free equity clearing

LCH.Clearnet is to introduce free equity clearing for average daily member volumes of over 150,000 trades a day. The new tariff will be implemented from 1 October.

Kevin Milne, director of post trade, London Stock Exchange said: "We are very supportive of these tariff amendments. In combination with our own ongoing tariff cuts, this move will further reduce the overall cost of trading for our major clients and make the service more compelling. We will continue to work collaboratively with LCH.Clearnet and others to ensure that the users of our markets receive the most competitive offerings possible."

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INSIDE SECURITIES**LENDING**TIMES

New tax rules for securities lending in Japan

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At the moment, interest and lending fees for cross border securities lending transactions are taxable within the Japanese market, unless double taxation avoidance treaties are in place. The new proposals mean that there would be a tax exemption on cash collateral and lending fees received by foreign firms.

Non-resident investors are subject to a preferential dividend withholding tax rate of seven per cent, while domestic investors face a rate of 10 per cent, which includes a three per cent local tax. This rule expires at the end of 2011, but the FSA has proposed extending it for another three years, until the end of 2014.

The plan is expected to be finalised later this year, then submitted to the Japanese Diet in January 2011. If approved, the proposals will come into effect in April 2011.

LCH. Clearnet offers free equity clearing

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Wayne Eagle, director of equities, LCH.Clearnet said: "This supports our exchange clients, rewards customer loyalty and incentivises growth. Customers get economies of scale, without having to choose between cost and the quality of clearing."

Reduced fees will also be introduced for members with average daily volumes above 50,000.

Eurex quiet but repo grows

At the international derivatives markets of Eurex, an average daily volume of 7.8 million contracts was traded in August (August 2009: 9.1 million).

5.4 million contracts were traded at Eurex (August 2009: 5.4 million) and 2.4 million contracts were traded at the International Securities Exchange (August 2009: 3.7 million). In total, 171.2 million contracts were traded on both exchanges compared with 191.5 million contracts in August 2009.

At Eurex, the equity index derivatives segment was the most active segment, totaling 55.5 million contracts, compared with 55.7 million contracts in August 2009. Futures on the EURO STOXX 50 reached 24.8 million contracts and options recorded another 21.2 million contracts. The futures and options on the DAX index reached a combined turnover of 7.9 million contracts.

The Eurex segment of equity-based derivatives (equity options and single stock futures) recorded 25.0 million contracts (August 2009: 25.1 million).

Eurex's interest rate derivatives segment reached 38.5 million contracts, compared with 32.0 million in August 2009. Approximately 16.7 million contracts were traded in the Euro-Bund-Future, 8.6 million contracts in the Euro-Schatz Future, 8.5 million contracts in the Euro-Bobl-Future and nearly 69,000 contracts in the Euro-BTP-Future.

Dividend derivatives traded roughly 320,000 contracts, an increase of more than 40 per cent y-o-y. ETF derivatives recorded more than 67,000 contracts.

Eurex Repo, which operates CHF repo, EUR repo and GC Pooling markets, grew by 29 percent y-o-y and all markets combined reached an average outstanding volume of 237.5 billion euros (August 2009: 183.7 billion euros). The secured money market GC Pooling achieved the strongest growth with 38 percent, totaling an average outstanding volume of 91.6 billion euros (August 2009: 66.5 billion euros).

The electronic trading platform Eurex Bonds, which rounds out Eurex's fixed-income product range, saw volume of 6.4 billion euros (single counting) in August. In July 2010, the figure was 6.8 billion euros, and in August 2009 volume was 6.4 billion euros.

BNY Mellon picks Standard Bank for custody in Africa

Bank of New York Mellon has selected Standard Bank to provide custody services in sub-Saharan Africa.

Standard Bank has custody operations in 12 sub-Saharan countries: South Africa, Nigeria, kenya, Zambia, Ghana, Swaziland, Zimbabwe, Botswana, Namibia, Malawi, Mauritius and Uganda.

It will provide custody services to BNY Mellon in all these countries. To this point, Standard Bank was the custodian in Nigeria, Namibia, Swaziland and South Africa, while Barclays serviced BNY Mellon in Botswana, Ghana, Kenya, Zambia and Zimbabwe.

Head of custody at Standard Bank in Ghana, William Sowah said: "Standard Bank will persistently focus on the development of custody capabilities in new markets and the development of new products, as well as extending existing product capability to new markets.

"As growth increases among the range of products and value-added services with respect to custody, investment and securities lending services to both our clients and the Standard Bank Group, we will keep investing heavily in these core business functions to maintain our leadership position in the respective sub-Saharan African markets**".**

Northern Trust gets approved in China

Northern Trust announced that its application for a branch license in Beijing has been approved by the China Banking Regulatory Commission (CBRC). The authorisation by the CBRC marks a milestone for Northern Trust, which has had a representative office in Beijing since 2005.

"Institutional investors in China and the Asia-Pacific region have turned to Northern Trust as a strong, stable financial partner with a commitment to the development of domestic financial institutions as sophisticated global investors," said Northern Trust chairman and CEO Frederick H. Waddell. "With its dynamic economy and emerging opportunities for overseas investment, China is a strategic focus for Northern Trust. Authorisation of the Beijing branch will allow us to help our clients pursue their goals and bring the full Northern Trust client experience to the Chinese marketplace."

The Northern Trust Company Beijing Branch will support institutional clients in China with global custody, accounting, performance measurement and investment mandate compliance monitoring services. The branch licence allows Northern Trust to provide client services directly from the Beijing office, rather than from Singapore or Hong Kong, as is required with a representative office. The Beijing branch will play a key role in Northern Trust's continuing growth in the Asia-Pacific region, where assets under custody grew by 80 percent in 2009. Over the past three years, Northern Trust has grown its staff in the region to more than 2,000 employees at its offices in Beijing, Hong Kong, Singapore, Tokyo, Melbourne and Bangalore.

"Our strong track record of providing customised service to Chinese clients reflects Northern Trust's commitment to our clients and our desire to serve as a long-term partner to support growth of the Chinese financial industry," said Teresa A. Parker, chief executive officer of the Asia Pacific region for Northern Trust. "With the approval of a banking branch license, we can build Northern Trust's local infrastructure, strengthen our service capabilities and enhance opportunities for sales and business development in China."

Northern Trust's presence in China dates to 1999, when it began a cooperative relationship with the Bank of Communications. In 2002, Northern Trust began consultation with China's National Council for Social Security Fund (NCSSF) in preparation for its investment in overseas equities markets. After receiving approval to open a Representative Office in 2005, Northern Trust was appointed as global custodian for both the NCSSF and Bank of Communications, and has continued to develop its custody and asset servicing business in China.

Northern Trust has provided global custody portfolio reporting in Chinese to institutional clients since 2005, including Chinese-language web pages for investment reporting - an innovation that dramatically improved accessibility and transparency for institutional Chinese clients. Northern Trust is also a leader in developing solutions to support IFRS7 financial reporting for global investors in Asia.

"This is an exciting moment for Northern Trust and a significant achievement in our strategy to grow our business in China," said Michael Wu, chief representative for Northern Trust in Beijing. "Over the past decade, Northern Trust has worked with Chinese companies and institutions to develop the financial infrastructure to support overseas investment programs. With this branch license, we can expand the service solutions we provide to current clients and further strengthen Northern Trust in the Chinese asset servicing market."

Volumes flat at OCC, but securities lending grows

The Options Clearing Corporation (OCC) has announced that total OCC cleared volume in August reached 285,128,314 contracts, representing a one per cent decrease over the August 2009 volume of 287,627,998 contracts.

OCC's year-to-date average daily volume is up seven per cent compared to 2009 with 15,440,615 and year-to-date total volume is up seven per cent with 2,578,582,756 contracts.

Activity in OCC's securities lending programme has continued to grow with an 88 per cent increase over last August.

Securities Lending: In addition to the 88 per cent increase from August 2009, OCC's stock loan programme, including OTC and AQS, saw a nine per cent increase in new loan activity over July with 59,778 new loan transactions in August. Year-to-date securities lending activity is up 62 per cent from 2009 with 400,204 new loan transactions in 2010. OCC's stock loan program had an average daily notional value of $13,171,478,824 in August.

Options: Exchange-listed options trading volume reached 283,487,110 contracts in August, a one per cent decrease from August 2009. Index options trading rose 10 per cent from the previous August.

Futures: Futures cleared by OCC in August rose to 1,641,204 contracts with a year-to-date average daily contract volume of 100,888. Equity futures volume reached 407,036 contracts, a 53 per cent increase over the same month last year when 266,891 were traded.

OneChicago reports August rises

OneChicago, LLC reported that 407,036 security futures contracts traded at the Exchange in August 2010, an increase of 53 per cent from August 2009. Year to date volume was 3,598,342, up 128 per cent from 2009.

Open interest stood at 629,735 contracts at the end of August 2010, a 21 per cent increase over August 2009.

The top five August volume OneChicago contracts are:

- Exxon Mobil Corporation
- Chevron Corporation
- Avon Products, Inc.
- Pepsico, Inc.
- BCE, Inc.

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UK

The UK financial services industry is bruised and battered, but its core capabilities remain strong, and securities lending is leading the way

BEN WILKIE REPORTS

As the centre of Europe's financial services industry, and a global leader in the securities lending market, the UK has been hit hard by the downturn. Several of the country's leading banks have required state support, job losses run into the tens of thousands, and market activity has fallen sharply.

The market has been further hit because of the make-up of the British markets. In the UK, some of the biggest players are banks, who have seen their values plummet and in some cases their credit ratings dissipate; and oil firms, where BP has seen tens of billions wiped of its capitalisation following the notorious oil spill in the Spring. Famous names such as Woolworths have also fallen victim to the downturn, leaving investors reducing their risks wherever they can.

And that's not all. There has been a real public and political backlash against the banks. It's felt that it was the financial institutions who drove the country - and the world - into the financial turmoil, thanks to reckless investment strategies and shady bookkeeping. While there's not a huge amount of truth to this, the public perception of the financial industry is not helped by some banks who still admit they are unsure of how much trouble they are in, and RBS' figures for 2009, which showed a loss that was in the top 10 of all time globally.

"It's not been a lot of fun being a banker in the past couple of years," says Charlotte Anning, who worked for Lehman Brothers until its collapse and is now taking time out to be with her family. "We're on about the same sort of level as journalists and politicians in the estimation of the public.

"When I told someone at a party that I worked for a bank but had just lost my job, their response was that the best kind of banker was an unemployed banker. There is a real anger out there, but I think this was mostly down to ignorance of what most banks actually do."

So that's the bad news. The good news is that London is simply too big a financial centre to be destroyed by something as small as the worst recession since the 1920s. It's the home of every bank that wants to be a player, along with a huge number of hedge funds, and other investment vehicles. The strength of the market is down to its size, and the quality of the businesses that operate within it.

"There's no doubt that we've had a difficult couple of years," says a spokesperson for one of the world's largest banks. "But in a way it's been good for us. The good times couldn't go on for ever, and we've strengthened our internal systems and cut our costs, which means that going forward the business we do is likely to be more profitable."

And while the industry has certainly been in the spotlight, securities lending has been able to fly under the radar in most cases. "There certainly were sharp practices going on, including within my own organisation," says a representative of another major player. "But because of the controls already in place - like CCPs - no-one really made a loss and nothing bad has really come out. There was a much greater focus on derivatives and MBS, where the losses were tangible."

With the obvious exception of Lehman Brothers and a couple of Icelandic Banks, all the major institutions have maintained a strong presence

in the UK, and those that offered securities lending in the past still do so. In fact, the downturn has been good for some organisations - as clients looked for stability, many of them turned away from some of the established names - especially the major US banks - and looked at firms that didn't have major internal problems. The likes of BNP Paribas and other European institutions have seen their client base grow in the past couple of years, while the well-known 'stable' banks such as Northern Trust and State Street have also done well.

The money

As is common with most major financial centres, assets pour in from all over the world. US firms are major investors, as are those from continental Europe. There is also increased activity from Asia, particularly China, and the Middle East.

Domestically there is a mature and liquid investment market. Hedge funds are here in force, but this is mixed with the popular tax-efficient ISA schemes, as well as pension funds.

Pension funds in the UK can generally be divided into two strands. Private schemes (which do sometimes apply to public sector employees) are run by investment companies - the likes of Aviva and L&G are major players here. They tend to be more knowledgeable about the market, and happier with involving themselves in securities lending activities. Virtually anyone can join one of these private schemes.

Then there are the employer schemes, which are usually for public sector workers (although not necessarily - often they include companies that at one stage were nationalised and have since been sold off). These are run by the employer itself, and are there to provide benefits only to eligible people. In many cases, these are huge funds, but often it's found that they are happier to stay out of complex interactions. Before the downturn, though, this was changing, with more employer schemes looking to become more active.

However, many of these funds, particularly public sector schemes, remain cautious. "The problem is that we don't really understand securities lending," says the head of one mid-size local government scheme. "And if nothing else, what the last couple of years has taught us is that we shouldn't get involved in things we don't know enough about." This head, who asked for anonymity, is currently in the process of choosing a provider to carry out securities lending activity - amongst other services - on its behalf, and act as an adviser on more complex financial instruments.

Regulation

The financial crisis led to calls for a raft of new regulations on the banking sector in the UK, and there are still a number of issues left undecided - chief amongst them, the option of breaking up the banks into retail and institutional, which is favoured by the smaller partner of the current coalition government.

But, whether it likes it or not (and many don't), the UK is part of the EU, and the government seem to accept that a multinational regulatory structure will be a more effective mechanism. The EU is due to publish draft guidelines that will limit short selling activities, in particular naked short selling. It's likely that restrictions will be put in place to reduce the amount of naked short selling that can be carried out during times of market turmoil, while at all times those institutions involved in the practice must make their activities public.

Generally speaking, the UK has always had a more laissez faire attitude to regulation than its nearest neighbours, but the past couple of years has seen a greater move towards tighter rules. However, the current UK government is wary of seeing the UK lose its place as Europe's major financial centre, and has publicised its concern that the proposed regulations may be too restrictive.

And this thought has been echoed by associations: "We would not wish to see short selling banned even in extreme market circumstances," says Andrew Baker, chief executive of Aima. "The crisis experience has shown that imposing such bans does little to calm a market panic."

So as the jurisdiction and its neighbours wait to see how they will be governed in the future, the securities lending industry is getting back on its feet. Volumes are rising, and confidence is slowly coming back. We're unlikely to see the levels of 2007 in the near future, but current activity is a good barometer. **SLT**

> "It's not been a lot of fun being a banker in the past couple of years"
>
> Charlotte Anning

Security rankings by total daily return

1	Liberty International Plc
2	HSBC Holdings Plc
3	British Land Co Plc
4	Royal Dutch Shell Plc
5	Heritage Oil Ltd
6	HMV Group Plc
7	Hammerson Plc
8	Standard Chartered Plc
9	Land Securities Group Plc
10	Prudential Plc

Source: Data Explorers

The ‘special’ repo market

In the second part of our series on the ICMA White Paper looking at the European Repo Market, we look at the role of the ‘special’ repo market

MARKET RESEARCH

The repo market performs both money market and capital market functions. On the one hand, it is a market for the short-term borrowing and lending of cash. On the other hand, it is a market for the borrowing and lending of securities (in this respect, performing the same function as the securities lending market).

The same repo transaction can perform both functions simultaneously, with one party motivated by the need to borrow cash and the counterparty by the need to borrow securities. However, money market and capital market repos are generally distinguished by price differences.

The terms of a repo performing a primarily money market function will be driven by the supply of and demand for secured cash. The precise identity of the collateral securities will be a secondary consideration. There is a tacit list of securities (the so-called “GC basket”) between which the majority of repo dealers are more or less indifferent when collateral is offered for cash-driven repos. The focus on cash rather than the identity of the collateral in such repo transactions means that the cash will be priced at a broadly uniform rate of return for each maturity called the “GC” or “general collateral” repo rate. This is a money market rate of return and is accordingly closely correlated with unsecured money market rates.

In contrast, the terms of a repo performing a primarily capital market function (analogous to securities lending) will be driven by the supply of and demand for a particular security. If demand is strong enough relative to supply, such a transaction will be distinguished by a repo rate significantly below the prevailing GC repo rate for the same maturity, as potential buyers compete to borrow this security by offering cheaper cash to potential sellers. Such securities are said to have gone “on special” in the repo market. Special repo rates are a normal market-clearing price mechanism which helps to rebalance supply and demand. The offer of cheap cash represented by a special repo rate serves to attract an additional supply of securities into the market, and at the same time makes it more expensive to borrow, thereby cooling the demand.

The cheap cash that has to be offered for a security which is on special in the repo market means that a party borrowing that security is incurring an implicit cost. The more special the security, the greater the implicit cost.

The differential between the prevailing GC repo rate and the special repo rate on a particular security represents an implicit borrowing fee for that security. The size of an implicit borrowing fee in the special repo market should be equivalent to the explicit fee being charged for the same security in the parallel securities lending market.

If the level of the GC repo rate is low enough and the demand to borrow a particular security is high enough, special repo rates can go negative. For example, a GC repo rate of 1.00 per cent and a borrowing fee for a particular security of 200 basis points implies a special rate for that security of -1.00 per cent. The repo market is unique in offering natural negative rates. Negative repo rates can occur frequently in low interest rate environments (as the GC repo rate will be closer to zero) and can be routine for government securities which are “on the run” or “cheapest to deliver” in the bond futures market.

An "on-the-run" security is one that is used by the market to benchmark the cost of borrowing for an issuer for a particular term to maturity. They tend to be the latest issue of securities close to terms such as five and 10 years, and will typically be the largest and most liquid issues. The bulk of trading in the cash and repo markets takes place in on-the-run issues and the level of demand often forces them on special in the repo market. The "cheapest-to-deliver" or CTD is the security which, for reasons of relative cost, is the one which the sellers of bond futures contracts prefer to use to fulfil their delivery commitments in the futures market.

Sellers have a choice of securities which they can deliver to settle bond futures contracts - a so-called "basket of deliverables" specified by the futures clearing house - but rigidities in the contractual method of determining how many of each deliverable security is required to settle one futures contract means that the required amount of some issues cost less to buy than the required amount of others: the cheapest-to-deliver is the deliverable issue for which the required amount costs the least to buy.

Negative repo rates are not the manifestation of a dysfunctional market. They simply reflect the size of implicit borrowing fees for particular securities. If such fees are acceptable in explicit form in the securities lending market, they should be equally acceptable in implicit form in the repo market. The fact that borrowing fees sometimes translate into negative repo rates is simply a function of arithmetic and generally low interest rates, which are in turn a product of monetary policy. It is not the absolute level of a negative repo rate that is important, but the implicit borrowing fee represented by the spread between the special repo rate on a particular security and the GC repo rate.

Of course, if the borrowing fee implicit in a special repo rate is exceptionally high, this may indicate severe imbalances between supply and demand for a particular security. Such imbalances may reflect lack of supply of a particular security, possibly due to market instability, and/or the intensity of demand. In many markets, these problems are relieved by issuers increasing the supply of scarce securities by means of:

- permanent issuance and sale of additional securities (re-openings or taps);
- temporary issuance and lending of additional securities ("synthetic" or "phantom" bonds --- see box);
- releasing supply reserved for this purpose at issuance.

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"Synthetic" or "phantom" bonds

Such bonds are the product of the temporary issuance of government securities by an official debt manager, to be used in lending (through a repo facility, therefore against cash) to primary dealers or designated market-makers in order to allow these firms to cover short positions arising from their market-making operations and avoid delivery failures to investors.

The ability of official debt managers to repo out specific issues to the market is designed to dissuade manipulation of the market in those issues, by reducing the prospect of excessive returns and to address instances of market disruption or dislocation, when a particular issue is temporarily in extremely short supply.

Such repo facilities are offered in Belgium, Portugal, the Netherlands and the UK. The charge for lending can be a fixed penalty rate (Belgium and Netherlands) or decided on a case by case basis (Portugal).

In the UK, the official debt manager (DMO) offers a Standing Repo Facility to Gilt- Edged Market-Makers (GEMMs). GEMMs may request that the DMO repos any liquid gilt issue to them for re-use in the interdealer repo market. This may involve the temporary creation of the relevant gilt. The counterparties involved remain anonymous to the market. The facility is available from 12:30pm London time on the previous day up until 11:30am on the day of settlement. Use of the facility may be rolled over daily, but the DMO is unlikely to allow use to continue for more than two weeks. The DMO charges a penal overnight rate equivalent to 300bp below the Bank of England's Bank Rate, subject to a floor of 0.10 per cent pa.

At the same time as repoing out a gilt through the Standing Repo Facility, the DMO will normally insist on a back-to-back reverse repo of other gilt collateral, at Bank Rate, in order to neutralise the effect of the standing repo on government funding requirements and its own cash management operations.

If there is sufficient evidence of severe market-wide disruption or dislocation, the DMO may vary the terms of the Standing Repo Facility, including the repo rate, which may or may not be penal (eg, in May 2009, the DMO offered a special one-week repo facility in two issues at a repo rate of 0.15 per cent pa).

In the Netherlands, the official debt manager (DSTA) offers a repo facility to Primary Dealers to borrow government securities at any time, up to an outstanding volume of EUR 10 billion. Primary Dealers pay a premium of 25 basis points for this facility. In Portugal, the debt management agency offers a repo facility to marketmakers on a case by case basis.

The White Paper was written by Richard Comotto for the International Capital Markets Association. The full paper is available to view at www.icmagroup.org

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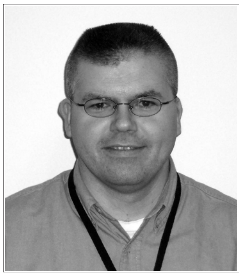
View from the top

Securities lending participants are increasingly moving to central counterparty usage. So is this the future? Our panel of industry experts debate the issues

Ben Wilke, editor



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Ohio Public Employees Retirement System
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Yvonne Wyllie
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Head, securities lending market products & services

Harold Bimpong
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Head of securities finance - operations

Mat Gagné
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Abel Aronovitz
OneChicago
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Allen Postlethwaite
SecFinex
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Thomas Little
Quadriserv
Head of product development and strategy

Future issues

As *Securities Lending Times* moves forward we are always looking for suggestions on future topics and panel discussions. Let us know your thoughts at news@securitieslendingtimes.com

Steven Lafferty, marketing and communications

SLT: With many participants moving towards bringing OTC markets into a central clearinghouse, why should the securities lending industry use a CCP and how would they benefit?

Harold Bimpong: Good question. There are clear potential benefits to borrowers/broker dealers, however little if any benefit to lenders/beneficial owners. From an industry and regulatory perspective there is a greater focus on CCP usage in higher risk products (eg, OTC derivatives). Given the operational robustness and low risk of the current OTC securities lending business model, I am not sure what the problem is for which a CCP is the solution.

Abel Aronovitz: There are many inherent advantages to a CCP for all market participants.

A CCP exposes lenders to additional borrowers without the associated counterparty risk and without the need for multiple ISDA agreements.

- Removes the need for unnecessary fees such as indemnification.
- Provides valuable anonymity.
- Allows the lenders and borrowers to act independently of each other after the transaction as the CCP provides for novation.
- Provides pricing and informational transparency and accurate pricing data.
- Pricing transparency will ensure that lenders and borrowers receive the best current market price. It also allows for market forces to be at work as both parties can exact the price they desire compared to the current opaque pricing process in traditional lending.

Informational transparency will allow regulators to facilitate the failure of financial institutions without producing contagion and systemic risk for market participants. To the best of my knowledge, there has never been a market event that has caused the client of a clearing member of the Options Clearing Corporation (as of 2010, the world's largest derivatives clearing organisation) to experience a loss as a result of the failure of a clearing member. When a clearing member has failed in the past, all underlying client positions were transferred smoothly to other clearing members. Clients didn't lose a penny.

In the end, a CCP will restore public confidence in the securities lending market, which benefits all market participants. Because of this, the question should be "why shouldn't we use a CCP?"

Thomas Little: History provides a useful starting point in this regard: CCPs in other financial markets have helped to reduce counterparty risk and increase liquidity and volumes.

There is little doubt that the securities lending market is also moving in this direction, as evidenced by the broad regulatory endorsement of the use of centralised clearing, particularly in relation to OTC products. But the overlooked fact is that, increasingly, commercial interests are driving the movement towards a CCP model as they seek competitive advantages and risk mitigation. These include: increased attention to counterparty risk, the appeal of a complementary route to market, tougher regulatory requirements in terms of capital allocation and balance sheet usage, new awareness of the costs to end users inherent in securities lending, and regulatory concern over systemic risk and market supervision.

CCPs also directly support market transparency and price discovery through broadened market participation and post-trade anonymity.

Allen Postlethwaite: Utilising an exchange model incorporating central clearing and straight through processing provides a number of advantages. Reduction in capital allocation, increased supply and distribution point, centralised daily mark to market, real time risk management and margining, and netting efficiencies across all instruments, including OTC markets, traded with that individual clearing house. Clearly a CCP model has benefits for all participants in securities lending.

Yvonne Wyllie: In the current environment, where regulators are looking at securities lending with greater scrutiny, the relative transparency and counterparty risk reduction of a CCP can be considered attractive attributes of the model. However, until there is broader acceptance across all market participants the adoption of the CCP model is not likely to occur anytime soon. To some extent the industry is still at a formative stage in this regard. The high level benefits are clear and understood from their use in other financial markets; what isn't clear yet is how exactly it can work in a securities lending environment, which markets or asset classes will lend themselves more easily to the model, and which providers will have the depth to create the liquidity needed.

Mat Gagné: If a CCP can adequately address the risk, transparency, and structural needs of a securities lending transaction with the added feature of increased market or operational efficiency, the benefit of an additional route to market and broader distribution network would create a strong case for the use of a CCP for securities lending. The benefits of broader distribution would potentially have a positive impact on income and there should be a clear benefit in the reduction of counterparty risk via consolidation under a highly rated counterparty designed to "eliminate" systemic risk.

But the overlooked fact is that, increasingly, commercial interests are driving the movement towards a CCP model

Thomas Little

Kevin McNulty: Whilst there's a general push to have OTC transactions centrally cleared, where this makes sense it's important to consider why this is happening.

Regulators want to prevent build up of systemic risk and worry that without some form of central clearing we could see the development of otherwise undetectable problems. The securities lending business, despite being an OTC market is generally conducted with sound management practices - full collateral, and daily marking to market. It's not as clear-cut that systemic risks would be better controlled in a CCP environment for securities lending. From a lender's perspective, the impetus to consider using a CCP will be driven by whether there is likely to be an improvement in overall risk adjusted returns - either through a perceived reduction in risk or through increased returns. For agents that offer indemnified programmes it's possible that using a CCP may reduce the capital costs associated with the indemnity (although I'm not sure that this is certain at this stage).

One issue that needs to be considered is whether the lender can be a direct member. If not (as may be the case for non-financial firms or those acting as agents) access to the CCP may be through a clearing house member firm. In such cases it may be that the lender's risk is concentrated in the clearing house member and this is unlikely to be attractive. For borrowers, decisions will be driven by whether the available supply of securities is improved or most likely, whether the reduced capital costs expected to be associated with trading with a CCP outweigh any additional costs of doing business.

SLT: In the securities lending context, central counterparties (CCPs) guarantee both the return of the loaned securities and borrower collateral. As a result, CCPs impose margin requirements on both the lender and borrower of a securities lending transaction – a vast departure from OTC conventions of 102 per cent/105 per cent overcollateralisation from the borrower. How does an operating environment that calls for additional collateralisation impact your decision to participate in a CCP?

Jerry May: From my perspective, there may be ways for CCPs to mitigate this requirement of collateral from the lender. Large pension funds or other types of beneficial owners may very well have better credit metrics than typical borrowers, who could be categorised as more risk-taking organisations. That said, there may not be an insurmountable hurdle for lenders to post collateral, as many lenders will be familiar with the process with more traditional derivative instruments.

Aronovitz: The posting of collateral or a performance bond should not be a deterrent for a lender or borrower when using an Exchange of Future for Physical (EFP) transaction as an equity-financing tool to synthetically lend or borrow a security.

For beneficial owners, while the posting of collateral is a change from what many are accustomed to, they have multiple options at their disposal to meet their collateral requirements. A performance bond can be posted with cash, bonds, or marginable equities. Because they never lend their entire portfolio anyway, they can post their idle equities as collateral thus enabling them to still free up close to 100 per cent of their own cash. If bonds are posted, they can continue to earn interest on them. Therefore in essence the lender can execute the trade for close to no money down, but would be subject to variation pay and collects.

By using an EFP to synthetically borrow a security, borrowers are reducing their collateral requirements from 102 per cent to approximately 20 per cent. Therefore they experience dramatic cost savings.

This is very important; the EFP transaction frees up cash for both sides and allows them to act much more efficiently and independently. In a traditional lending/borrowing relationship, a lender and borrower enter a bilateral swap and are dependent upon their custodians and brokers to facilitate, maintain, and exit the swap. In an EFP, lenders and borrowers have the control to reduce or exit their position whenever they want (during market hours) based on market price. In effect, EFP transactions allow lenders and borrowers to self-fund themselves at market-determined rates.

Little: Additional margin requirements must be considered within the overall benefits of a CCP; in this case, margin protocols help ensure investors do not take on excessive risk. This amounts to a mutualisation of risk, including credit assessment and collateral management. The increased movement towards a CCP model suggests that market participants are eager to comply with margin requirements to reduce uncertainty while accessing the clearinghouse to close open positions and secure the failed party's collateral.

> It will be difficult to persuade beneficial owners to pay away a haircut
>
> Harold Bimpong

McNulty: I'm not clear about the precise margin requirements for securities lending CCPs but one reason that regulators afford special capital treatment for their counterparties is that they tend to require minimum margin payments from both sides of the transaction and I would expect these may well be higher than those common in the OTC market.

A borrower that currently provides collateral to a lender will need to consider whether the costs of placing margin with a CCP are greater than the collateral and capital costs in the OTC market. I believe that some CCP providers are constructing models where lenders may not need to post margin but in situations where they do, they will need to consider how they or their agent will actually do this.

Bimpong: It will be difficult to persuade beneficial owners to pay away a haircut when they're used to receiving one in their favour. CCP usage also implies standardisation of collateral criteria, which won't suit beneficial owners either - the standardised collateral profile will either be too risky for conservative clients or too conservative for the more entrepreneurial clients who currently use collateral flexibility as a positive differentiator. Question marks also remain regarding tax and operational issues.

Wyllie: For the borrower, this is nothing new. Whether they post margin to a lender or to a CCP makes little difference. For the lenders, there is a direct cost to raise the collateral in posting the margin required. This is a completely different structure with new costs that must be clearly understood and this could be a deal breaker for some agent lenders. Risk management is of key of course, but we're trying to cut costs in this environment, not necessary create new ones.

Gagné: The collateral requirement from the long asset holder, when seen in the context of the options and futures market, is a well-established market practice. The margin that will be placed on securities lending transactions could be a hurdle when viewed in light of traditional bilateral lending. However, a full understanding of the need for margin in a CCP structure and inclusion into and any cost-benefit analysis of a CCP model may ease initial scepticism of the lender's margin requirement. CCP models that do not require margin from the lender offer various alternatives that also have to be considered on a case by case basis relative to a lender's ability to lend under these models.

SLT: Beneficial owners and plan sponsors continue to focus on generating returns from the securities loans themselves (rather than the cash reinvestment). How is this focus on efficient pricing and performance impacting the network of lenders/borrowers with whom you transact?

Little: With the current low interest rate environment and closer scrutiny of risk-adjusted returns from securities lending, large lenders and their clients are focusing more closely on the 'intrinsic value model', which secures the best fee for every loan.

As far as impact going forward, it is certainly possible that custodial and agent lenders will move more of their business to exchange-like, CCP-based systems as one of a variety of service

offering to their clients. This would allow lenders to find the best rate on every transaction by connecting them to end borrowers. That notion of market-based transparency and competitive price discovery is a well understood principle within the broader fiduciary community.

May: Even though risk is being reduced in many owners' securities lending programmes, there will always be some amount of risk involved if a return is to be generated. The question then arises at to where one may allocate that risk budget in an efficient way to generate the greatest return on the activity. To the degree that CCPs may reduce risk, and generate a reasonable return, the utility should be evident to participants in the marketplace.

> It's a meaningless question. Our programme has always been driven by price and performance
>
> Harold Bimpong

Aranovitz: The demand to focus on intrinsic value based lending is creating a demand for enhanced pricing transparency. The EFP allows the lender to focus solely on the intrinsic value and capture 100 per cent of the return minus transaction costs. The cash that is freed up can be reinvested any way they would like (or even used for operational expenses) as the pressure to create yield has been removed.

Beneficial owners are also now able to dictate their utilisation rate by market dynamics. EFPs allow the beneficial owner the control to get their position on loan and not have to wait in the custodial lenders queue. Free market dynamics of price determined by supply and demand will determine a lender's ability to lend its security.

Bimpong: It's a meaningless question. Our programme has always been driven by price and performance, the industry landscape is constantly changing in any case.

Wyllie: This does not change the way we operate as RBC Dexia has always maximised risk-adjusted returns by lending assets on their intrinsic value rather than through aggressive cash reinvestment.

SLT: Broker-dealers continue to operate under pressure to reduce capital and balance sheet usage. How has the ability to reduce balance sheet and capital usage influenced your firm's decision to participate (or not) in a CCP?

Little: Transacting through a CCP provides broker-dealers opportunities to reduce capital usage and funding requirements as a function of the efficiency afforded by access to the CCP. Broadly speaking, the capital benefits can be classified as regulatory capital relief and reduced clearinghouse margin requirements. Additionally, there is the potential to apply balance sheet offsets for centrally cleared securities loans and borrows.

In the United States, on the regulatory capital side broker-dealers see benefits from a CCP model via the reduction to any 15c3-1 haircuts to net capital that result from mismatched loan/borrow exposure OTC versus a balanced book at the CCP. The ability to centralise activity with an AAA-rated CCP allows for this type of credit exposure optimisation. For example, a broker-dealer that transacts equal amounts of OTC loans with one party and borrows with another could reduce their net exposure to nearly zero by clearing these transactions at a CCP. The reduction in capital charges would be a function of the percentage of this type of OTC activity that is migrated to the clearinghouse.

Furthermore, for banks and bank holding companies, the ability to apply reduced risk weights against centrally cleared transactions frees up capital that would otherwise be reserved against OTC credit exposure. For example, firms will typically apply risk weights to each of the credit exposures in their trading books. These amounts vary, but could be anywhere from 10-20 per cent of the asset side of the credit exposure. The risk weights are then multiplied by the asset base to establish what is known as the Risk Weighted Asset (RWA) level. Firms will then reserve Tier 1 capital against their RWA amount in accordance with internal capital reserve targets (i.e. 10-11 per cent Tier 1 capital target). Therefore, as it relates to the CCP model, any reduction to the risk weight applied to the asset would reduce the amount of capital required by the firm to support the transaction.

The CCP model also provides benefits by potentially reducing the broker-dealer's clearinghouse margin requirement – another form of capital relief. By definition, a clearinghouse manages the net risk of the transactions submitted for clearance by its members. In the case where uncorrelated positions are cleared in the same account, the net risk to the clearinghouse is reduced as a function of diversification. Thus the margin requirement to the clearing firm is correspondingly reduced. For example, if the firm is net long the SPX through the options market, any short exposure gained through centrally cleared stock loan transactions would have the impact of reducing the overall firm margin requirement proportional to the amount of the offsetting transactions.

In our opinion, CCP models also provide the potential for balance sheet netting where centrally cleared stock loan transactions are cleared in the same way that derivative transactions that already receive netting are transacted.

Wyllie: On the borrower side, CCPs equalises the playing field and allows smaller, less capitalised firms to participate with their larger peer group. At the moment, the benefits aren't clear enough for an agent lender to be seriously interested. Our risk model is fairly sophisticated and our capital usage is low anyway, so this isn't a deciding factor for us currently. In fact, having to post margin may have a detrimental effect on balance sheet usage.

Aronovitz: OneChicago does not participate in a CCP, but rather serves as a conduit for buyers and sellers to take advantage of the CCP. The SSF listed on the exchange used as part of an EFP transaction are a financing tool that serves as an alternative for OTC equity swaps, the stock loan/borrow process, cash management, and combination and reversal/conversion trades.

Because market participants can meet each other in our market and transfer relatively costly long and short delta positions into substantially similar synthetic future positions at more favourable financing rates to both without counterparty exposure, SSF are a logical substitute process for all participants in the equity finance markets.

Bimpong: Regulatory capital/balance sheet usage is not an issue for us as an agent lender/beneficial owner.

SLT: Do the new Basel III regulatory changes impact your business? Will using a CCP for a portion of your business alleviate some of the impact?

Bimpong: No and no.

Postlethwaite: What will be the effect of Basel III on the business?

· Basel III will increase the amount, transparency and quality of capital need by regulated firms to conduct all businesses – especially OTC business through: the narrowing of allowable capital, the creation of counter-cyclical and capital conservation buffers, the introduction of supplementary leverage ratio and tighter liquidity requirements.

· Basel III will also tighten the counterparty risk rules to be followed by regulated firms while at the same time the valuation of collateral used to mitigate such risks will be reduced.

· The changes agreed to the BIS proposals at the July meeting of governors do not fundamentally affect these measures. The new rules will be ratified in November and enacted by member countries in 2011.

Wyllie: The proposed regulatory capital charges under Basel III could be higher than its predecessor and have a major effect on the capital requirements of some market participants. Institutions with larger trading activities with lower rated counterparties would likely be most affected by Basel III's regulatory capital charge proposals. If implemented in their proposed form, this could create a strong incentive towards utilising a CCP and alleviating some of the capital charge impact.

Would a real time variation margin calculation improve the current risk control systems for securities lending?

Aronovitz: Yes, because it will ensure the prompt and accurate return of securities and collateral for both lenders and borrowers. By the nature of how a CCP functions, everything balances out to the penny.

At the time that a trade matches, the CCP becomes the buyer to the selling clearing member and the seller to the buying clearing member. This removes the need to make a credit assessment of the underlying clients. The performance bond collateral is deposited to guarantee the performance of all clearing members.

Since there are always an equal amount of lenders and borrowers for each security, the CCP collects and passes the variation margin daily. Clearing members receiving variation margin on behalf of their clients complete the process by crediting that variation margin to the individual accounts of clients whose futures contracts increased in value.

Little: In general we think that risk should be managed according to the dynamic risk profile of a particular deal or trading book. From that perspective, as markets change the risk profile of the underlying deals also changes and thus any attempt at risk control should be sensitive to that shift. This view is consistent with the practices at most clearinghouses. For example, in the AQS market, transactions are cleared at the Options Clearing Corp. The OCC employs a dynamic risk model that simulates a distribution of potential risk outcomes based on recent correlations and prices, as well as stress tests. The result of this methodology is a risk model that adapts to the current risk in the market.

While we think risk based margin models make intuitive sense, there are implementation challenges related to standardisation. In OTC markets this approach would require agreement between two counterparties on the model parameters and other inputs. Clearinghouses on the other hand, are well positioned to institute standard risk models given their non-partisan position in the underlying transaction.

Bimpong: Current risk control systems have been demonstrated as adequate, as shown by the orderly liquidation of collateral following the Lehman default. This is an intrinsically low risk activity compared to other OTC markets (eg credit derivatives).

Wyllie: In extremely volatile markets, real time margin calculations are definitely a benefit. In normal markets, the practicalities of managing intra-day margining probably outweigh the benefits. Assuming reasonable correlation between loans and collateral, five per cent margin should be enough to cover intraday market volatility.

With the impact of deleveraging and consolidation of counterparts (due to risk aversion) on revenue streams; would wider distribution via a CCP, with minimal systemic risk, be a preferred route to market?

May: It could certainly be a viable route to market. Diversification of providers, counterparties, and routes to market all lead to an optimisation of a plan sponsor's securities lending programme. This is basic economics - as one route or provider may be struggling another that is thriving can assist in providing more consistent returns for a beneficial owner over a long time frame. There are certainly some intriguing attributes of CCP's theoretically, but the operational details and how efficient those markets will be are variables that will determine their attractiveness and success over the next few years.

Aronovitz: Yes. A CCP has the ability to bring all participants in equity finance into a single, transparent, regulated marketplace. Beneficial owners, hedge funds, and federal regulators amongst others have called for better risk management, transparency, and an improved risk/return in their stock loan programme. A CCP will help facilitate this, reduce the risks involved in the securities lending process, and help restore confidence in the functioning of the markets.

> I would not go as far to say preferred route to market but it is another option
>
> Yvonne Wyllie

Little: Yes. Transacting through a CCP opens distribution to a wider range of counterparties without the bilateral counterparty risk of the OTC market. When you combine the benefits of central clearing with those of an electronic market, the benefits are even greater as a broader network of market participants are bidding on the same centralised pool of supply to establish the true value of the security.

In addition, funding and securitisation markets critical to pricing and intermediating credit are strengthened due to reducing counterparty risks through a CCP.

Wyllie: I would not go as far to say preferred route to market but it is another option. Under our current structure, the lender has control of limits, collateral and margins but once this is handed over to the CCP; it is out of the lender's regime and this process needs to be clearly understood to minimise risk.

Bimpong: From a lender's perspective the obstacles to CCP participation outweigh any theoretical benefits. Even the borrowers/broker dealers who would in theory benefit from CCP usage are at best ambivalent on the topic. The most enthusiastic CCP advocates are the CCPs themselves, electronic trading platforms and journalists/conference organisers in search of something to write about. **SLT**

Target right

With a changing hedge fund industry, Merlin Securities takes a look at the different types of investors

ANALYSIS

The hedge fund industry is experiencing a period of unprecedented uncertainty. Many existing and established funds are struggling simply to keep moving forward against redemptions and perilous market conditions. Additionally, for many managers who have launched in the past several years, while their initial goals may have been clear – get the fund up and running, build a track record and grow to the target AUM goal – the financial crisis has knocked them off course.

Many investment managers made early infrastructure investments they felt were necessary to reach their goals: they bought advanced trading, reporting and risk technology products; took up expensive space; and hired top-tier talent. They built the foundation for a significant fund platform.

Then came the financial crisis and the ensuing turbulent market. The "ready" capital these managers expected to find early in their development was invested instead with larger, more established funds with better pedigrees and longer operating histories. Additionally, the revenue they anticipated from their "2 and 20" compensation structure never materialiSed: the management fees suffered from smaller AUM, and performance fees suffered because the market has been difficult to navigate. Many of these funds are experiencing low single-digit returns and are still under or near their high-water marks.

For these managers – as well as other existing managers whose revenues are simply not sufficient to support their operating expenses – today's climate necessitates difficult decisions both for the top- and bottom-lines. Critical questions that must be asked include: What expenses should be reduced? How can managers grow AUM in this environment? How can a fund meet its day-to-day obligations and pay top-tier talent when the revenues are not where they need to be?

These questions are – at their core – the most basic questions any business manager must ask. And while little good has come from the financial crisis, one positive development has been the realization among many hedge fund managers that they are not simply managing a fund – they are operating a business.
This concept, while seemingly straightforward, is the key to moving up through the various levels of potential investors.

The spectrum of hedge fund investors

The spectrum of hedge fund investors is arranged, generally, in terms of how "institutional" each type of investor group tends to be. Regardless of whether these investors are in fact "institutions," by "institutional" we are referring to the level of general requirements each investor group places on their hedge fund managers: assets, operational practices, risk management framework, track record, reporting and so forth.

Just as the spectrum goes from risk-tolerant to risk-averse, as a general rule of thumb, hedge funds can assume that if they are ill-equipped to meet the needs of one level of investor, they are unlikely to realistically be able to target any higher, more risk-averse levels further along the spectrum.

Partners, Friends, Family & Angels

Overview: Friends and family members are the inner circle of investors. They have close relationships with the general partner(s) of the fund, including in many instances a prior investment relationship. General partners of a fund traditionally make significant investment of their own net worth into the fund to demonstrate an alignment of interest with their limited partners.

When to access: Prior to Day 1. These investors often comprise a significant portion of a fund's launch capital.

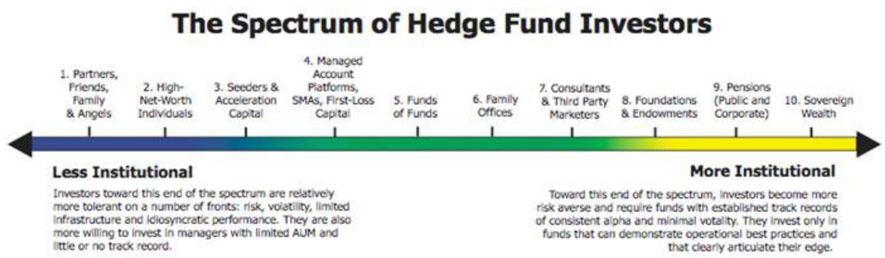
Advantages: The personal relationships that often exist among these investors may enable a manager to find capital without overcoming the institutional hurdle – ie, without having a significantly developed infrastructure, team, track record and AUM. These investors will also likely require minimal due diligence and will stay with the fund through various market cycles as patient investment capital.

Challenges/Limitations: While these investors are helpful as first movers of capital, they typically make small investments. They may get a fund up and running, but they do not help achieve critical AUM – ie, a level of assets that allows investors further up the spectrum to invest without becoming a significant portion of overall AUM.

> Since 2008, FOFs have been less likely to be early investors, preferring instead to look at more established managers

High-Net-Worth Individuals

Overview: As a non-institutional group of investors, high-net-worth (HNW) individuals are accredited investors or qualified purchasers as defined by the US Securities and Exchange Commission. They have the ability to invest based on referrals from personal relationships. Managers may access HNW individuals by net-



working with friends and family, current and past investors, executives of the companies the fund covers, hedge fund databases, consultants and third-party marketers.

When to access: Prior to Day 1 and early in a fund's development.

Advantages: Similar to the friends and family group, these investors are often willing to invest in managers that do not satisfy the rigorous requirements of institutions and who have smaller AUMs. They should be longer term investors, typically.

Challenges/Limitations: Smaller check sizes, harder to source investors, potentially difficult to perform background and due diligence checks. Many HNW investors will require access to the portfolio management team, which can become a strain on PMs.

Seeders & Acceleration Capital

Overview: Investors who provide seed or acceleration capital receive compensation for their investment, often in the form of a revenue sharing agreement or equity ownership. These investors can provide Day 1 funding from $5 to $100+ million, and that capital is typically provided by one of the 20 traditional seed capital providers, other hedge fund managers, HNW individuals or private equity firms.

SMAs provide liquidity and transparency and thereby enable investors to gain comfort at any stage of the funds lifecycle

This capital is also often used to help spinout funds that are seeking to replicate their previous funds. Once a fund is able to secure this level of capital, they typically are at the first level of critical AUM for marketing to other investors. Acceleration capital is provided to managers who have already launched but are willing to enter into a partnership with an investor to quickly ramp up their AUM level.

When to access: Prior to Day 1, or anytime for acceleration capital.

Advantages: These investments, typically larger in size, enable a manager to reach critical AUM, which in turn opens the door to the first levels of institutional investors, especially those with lower AUM requirements.

Challenges/Limitations: While seeders are willing to invest early with managers, typically they require a revenue sharing agreement or an equity stake in the fund. Given their unique ability to invest significant capital with unproven managers, seeders are extremely sought after. They see many opportunities, but invest in few.

Managed Account Platforms, Separately Managed Accounts, First-Loss Capital

Overview: This group of investors requires that their investment be placed in an investor-owned account segregated from the commingled fund. The manager will act as the trading advisor to this account, and while most often traded pari passu, in some cases investors will require additional strategy constraints or risk parameters be applied to the SMA. This source of capital has enjoyed a major surge in popularity by investors and acceptance by managers following the broad market redemptions and gating of 2008. Their popularity is due to the benefits they offer to investors, including transparency, ownership of the account and liquidity through control of assets. Other investors take these benefits one step further and require managers to put up capital into a separately managed account to serve as first-loss capital, thereby creating a principal-protected account.

When to access: SMAs provide liquidity and transparency and thereby enable investors to gain comfort at any stage of the fund's life cycle.

Advantages: SMAs provide an additional revenue stream to support the business and help build out infrastructure. Taking capital into an SMA shows AUM growth and fundraising momentum.

Challenges/Limitations: SMAs increase the operational complexity for a manager. The assets are not invested with the commingled funds and therefore do not assist in targeting larger investors who, because of their minimum investment size, are limited by the total fund size.

Funds of Funds

Overview: As the name suggests, FOFs invest capital across a range of hedge funds. Given today's competitive capital raising environment, and the fact that FOFs typically have a sophisticated investment team that conducts multiple layers of manager due diligence, FOFs can take 6 to 18 months to make an initial investment. Before engaging with a FOF, be sure that a true partnership relationship is possible.

When to access: Once a good source for Day 1 capital, since 2008 FOFs have been less likely to be early investors, preferring instead to look at more established managers with track records of producing alpha and a proven ability to manage their business. Newer managers will be monitored until an investment strategy can be verified by their performance metrics.

Advantages: FOFs are active allocators of capital and are most likely to invest if the fund's strategy is of current interest and the fund is performing well. However, this active allocation practice cuts both ways: underperforming managers or those managing out-of-favor strategies may suffer redemptions. FOFs have a general reputation of having higher turnover rates than institutional investors further up the spectrum, but this must be taken on a case-by-case basis.

FOFs are active allocators of capital and are most likely to invest if the fund's strategy is of current interest and the fund is performing well

Challenges/Limitations: Managers need to perform due diligence on the FOF to understand who are their underlying investors. FOFs may have an unstable capital base and therefore be subject to underlying redemptions. That means they may be "hot money" – ie, having to redeem capital from managers.

Family Offices

Overview: A family office is an organisation built to manage a family's wealth and can be administered by the family itself or by a team of investment professionals. Often incorrectly lumped into one bucket, family offices can vary significantly in terms of their level of investment expertise, sophistication, strategy interest and risk tolerance. Smaller family offices allow for closer access to the money, but allocations may be smaller ($1–$5 million) to start. Larger family offices often require as much due diligence as institutional investors and tend to allocate in larger sizes ($5–$25 million). This is particularly true of multifamily offices, which manage assets for a number of HNW individuals and families. The sophistication and expertise of multifamily offices is often at a level more consistent with larger institutions.

When to access: As family offices have varying mandates that enable them to be opportunistic, they can be accessed throughout a fund's lifecycle.

Advantages: Family offices typically have flatter structures that allow managers to get closer to the decision makers and may lead to a shorter due diligence process.

Challenges/Limitations: Unsophisticated family offices may overweight AUM and name brand recognition in their due diligence process and therefore only allocate to the largest, most pedigreed hedge fund managers. Managers with smaller AUMs may find this unsophisticated group quite challenging to access.

Consultants & Third-Party Marketers

Overview: Putting together these two groups is more a function of the outsourced service they provide rather than the similarity of that service. Consultants often work in an advisory capacity to investors, while third-party marketers work as an extension of a fund's marketing efforts. Fundamentally, what each group provides is "access."

Many consultant relationships are set up in an advisory capacity for investors who have decided to outsource a portion of their investment process. Therefore, while consultants do not have discretion to invest capital, they do provide investment options to their underlying investor.

Third-party marketers act as an extension of a fund's marketing efforts and enable the fund to reach a broader universe of investors. Some third-party marketers might focus on HNW individuals, others may provide access to institutions and some may have regional and global reach.

Understanding to whom consultants and third-party marketers are speaking enables managers to determine whether this relationship will be appropriate. Approval on one of these platforms can lead to rapid asset flows, so capacity and AUM targets must be clearly defined.

When to access: There is no set timeframe to begin reaching out to consultants and third-party marketers, but typically only after a fund has reached out to the previous levels of investors can these groups be accessed.

Advantages: These groups provide easy access to a broad and diverse investor base.

> There is no set time-frame to begin reaching out to consultants and third party marketers

Challenges/Limitations: The biggest challenge with these groups is that the fund strategy must have capacity. Once approved, a fund may receive a steady flow of assets. While it may be costly to use a third-party marketer, especially if they are simply leveraging performance numbers, they can be of great benefit if they have real investor relationships.

Foundations & Endowments

Overview: Endowments and foundations are institutional investors that manage the assets of schools and nonprofit organizations. Because the organisations they represent are permanent, these groups invest with exceptionally long-term time horizons.

The longer time horizons translate into sticky capital – i.e., a lower turnover rate in the portfolio. However, that also means that there are fewer opportunities to be added to the portfolio and that the chances of receiving an allocation are proportionately decreased.

When to access: Foundations and endowments are essentially untouchable until a fund can demonstrate true institutional quality. There is no value in approaching these investors before the firm's infrastructure has been built out and the fund has demonstrated staying power and a track record of producing alpha. Only funds in Stage 4 (see below for an explanation of the Stages of a Hedge Fund's Development) of their lifecycle need focus on these and subsequent investors.

Advantages: These groups can make significant investments of long-term capital.

Challenges/Limitations: The low turnover rates among these investors means less opportunity to be added.

Pensions (Public and Corporate)

Overview: Pension funds are responsible for preserving and growing capital for companies and governments which is used to support their employees upon retirement. There is a wide range of investment expertise represented by pensions. Some are staffed by highly experienced investment professionals, while others are managed by people with little financial experience. The former will invest in a wide range of strategies to produce a diversified portfolio of strategies, whereas the latter may disproportionately invest with blue chip, pedigreed managers or outsource their research process to consultants. Understanding the different types of pensions will help managers effectively navigate these investors.

When to access: Pension funds have the ability to invest with hedge fund managers at any point in their lifecycle, but given the long-term nature of these investments and their size, they typically spend the majority of their due diligence energy on established, blue-chip managers. With that said, many pensions can be opportunistic with their investments.

Advantages: These groups make significant investments and represent sticky capital.

Challenges/Limitations: Pensions vary widely in their sophistication. Pensions have ERISA considerations and need to have transparency into a manager's portfolio to understand leverage levels. They may require a separately managed account for transparency purposes.

Sovereign Wealth

Overview: Sovereign wealth funds are entities set up by governments to manage a country's wealth through long-term diversified investments. Wealth is often generated by capital account surpluses in natural resource rich countries. Because these funds are so large, capacity becomes one of the critical considerations; managers must be able to accept $500 million to $1 billion as a minimum investment size. Therefore sovereign wealth funds usually deal with only the largest hedge fund managers.

> Sovereign wealth funds have the ability to write very large cheques and are fairly stable with their investments

When to access: Managers must have a fully built-out infrastructure and the capacity in the fund to take in a large investment.

Advantages: Sovereign wealth funds have the ability to write very large cheque and are fairly stable with their investments.

Challenges/Limitations: The strategy must have the capacity for large investments, and typically only funds with AUM of at least $5 billion have the necessary infrastructure in place to take on such large allocations. Additionally, such larger investments mean that to maintain a liquid strategy managers will be forced up the market cap curve, which might constrain strategy. These investors are often costly to access and conduct extensive due diligence. **SLT**

Ron Suber is senior partner and global head of sales and marketing; John Quartararo is partner, sales and marketing; and Patrick Mc-Curdy is partner and head of capital development at Merlin Securities

Industry change

Is the return of M&A nothing but a good thing for securities lending, asks Will Duff Gordon, media director at Data Explorers

SLT EXCLUSIVE

In an effort to transform their future prospects, corporates are increasingly reaching for their cheque books. Witness the live deals announced in August – BHP/Potash, Intell/McAfee, Partygaming/Bwin. The credit crisis forced companies to become introspective. During this period they sold non-core assets, lowered their overheads and streamlined everything they could. Such action improves profitability by lowering costs but it doesn’t address the holy grail - new sales growth. For this they need more radical action and it is this that makes today’s chief executives suddenly such extroverts. Surely this is unqualified good news for the securities lending market?

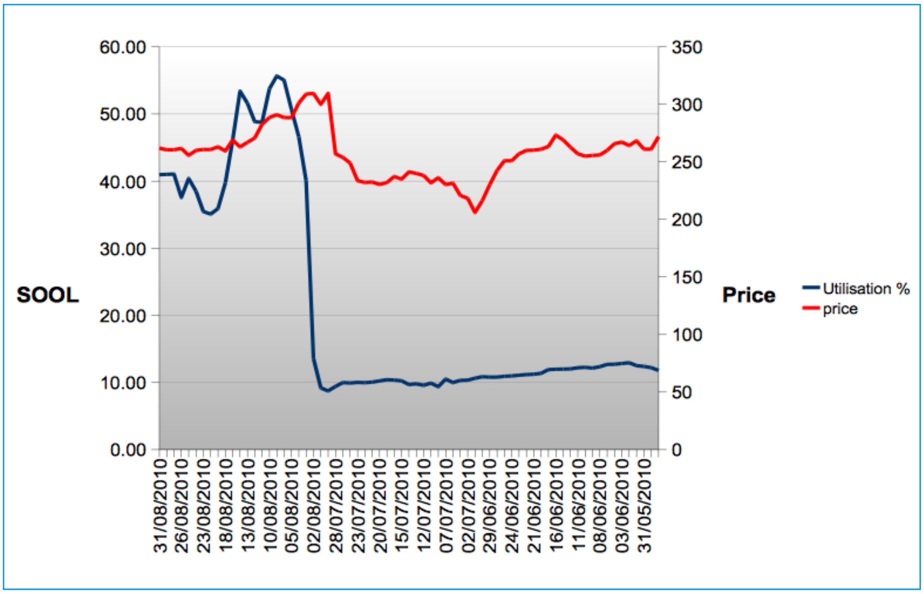
More deal flow is good news for most areas of the capital markets and securities lending is no different. It should herald a return to action for so called “Event Driven” hedge fund strategies that trade the spread between the share prices of the acquirer and target. Such funds were rampant pre credit crisis, forming an almost umbilical cord between the buy side and the prime brokers in an effort to ensure they could profitably trade their way through the deal cycle. When M&A dried up from mid 2008 onwards most hedge funds shrank their allocation of money to this strategy and this removed a core plank of the borrowing demand. With so many live takeovers in play, we expect the situation to reverse.

This will not take place overnight. It takes time for the buy side to move money between strategies. This could explain the difference between what the CEO of BHP Billiton thinks has happened to the Potash share register and what has actually happened. Marius Kloppers has said that he thinks lots of “fast money” investors (ie, event driven hedge funds) have bought shares in Potash whereas others close to the situation disagree. We also can’t see evidence of institutional owners selling their shares when looking at shares held in custody through our database. This could be due to there being fewer people trading this type of deal today than there would have been a couple of years ago.

In early August, Partygaming announced a merger with Austrian listed Bwin. This prompted strong interest from the buy side showing that some people are still keen to trade these types of deal. Stock on loan in Partygaming went from 10 per cent of gross supply pre announcement to over 50 per cent and remains quite expensive to borrow. The same happened with Bwin, albeit to a smaller scale and has since reduced.

Not only are there suddenly plenty of takeovers going on but two of them are hostile (BHP/Potash and KNOOC/Dana Petroleum). This will inevitably lead to a shareholder vote and this will bring securities lending sharply into focus. If any institution is found guilty of leaving their shares on loan at the voting cut off date, heaven help them!

It is not only companies who are putting deals together; private equity companies also have money to spend. US PE group Apollo has tabled an offer for UK listed Brit Insurance and today there is even a rumour that upmarket clothing retailer Saks is in talks with a private equity consortium. This leads me to finish with a word of caution. In 2005/6 people used to justify the continually rising equity markets by saying it was due to the “private equity put option”. With a potential bid round the corner for any company given the money swilling around the likes of Blackstone and TPG it was dangerous to be short any share. Could this uptick in M&A deter short selling even further for those funds still looking to find over valued companies? **SLT**



Will Duff Gordon

Will Duff Gordon is media director at Data Explorers

11th Annual Collateral Management

Date: 8-10 September 2010
Location: London
Website: www.marcusevans.com

For this 11th annual marcus evans conference we both pick up on the changes to the collateral landscape as well as return to the great debates within the field to offer practical solutions for meeting these challenges.

IMN's 15th Anniversary European Securities Lending Summit

Date: 20-21 September 2010
Location: London
Website: www.imn.org

In September 2009, more than 250 attendees and 60 beneficial owners participated in IMN's 14th Annual Beneficial Owner Securities Lending Summit. Leading European decision-makers discussed important issues confronting beneficial owners and the securities lending industry at large.

SunGard London City Day

Date: 23 September 2010
Location: London
Website: http://events.tenfor2010.com/citydays/london.aspx

SunGard is engaging with key customers and industry players to determine how best to meet immediate challenges and help prepare you for the new business priorities which lie ahead.

4th Annual Collateral Management Conference

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

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

Hong Kong Securities Financing Forum

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

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

27th Annual RMA Conference on Securities Lending

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

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

Finadium 2010 Conference

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

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

Industry Appointments

Lieve Mostrey will join Euroclear as executive director, chief technology and services officer of the Euroclear group. Mostrey will also become a member of the Euroclear Group Management Committee and an executive director of the Board. Mostrey's appointment will be effective as of 1 October, following receipt of the necessary regulatory approvals.

Mostrey is currently a member of the Executive Committee of BNP Paribas Fortis in Brussels, where she is responsible for IT technology, operations (including securities, payments, credit cards, mortgages, clients and accounts), property and purchasing. She began her career in 1983 within the IT department of Generale Bank in Brussels, moving to operations in 1997 and, upon its merger with Fortis in 2006, became country manager for Fortis Bank Belgium. She became chief operating officer of Fortis Bank in 2008, which was acquired by BNP Paribas in 2009. Mostrey was also a non-executive director of the Boards of Euroclear PLC and Euroclear SA/NV between 2006 and May 2010.

At Euroclear, Mostrey will oversee all technological and operational aspects of the business. Approximately half of all staff employed within the Euroclear group is directly involved in these functions.

Northern Trust has has appointed **Wim van Ooijen** as country head of Northern Trust The Netherlands, succeeding Eric Pouwels, who has been named director of strategic development for Europe, Middle East and Africa (EMEA).

In his role as country head, Van Ooijen is responsible for all asset servicing business development, sales and client activities across The Netherlands and will also serve as the primary contact for the regulators. Van Ooijen, who joined Northern Trust in 2004, was previously head of Northern Trust's Dutch relationship management team.

"The Netherlands continues to be a key market for Northern Trust and one in which we have been increasingly successful as a corporation for many years," said Penelope Biggs, head of Northern Trust's Institutional Investor Group, EMEA. "Wim has a wealth of experience in supporting the sophisticated needs of our business in the region and we are delighted to promote him to lead our Dutch operations as we drive future growth."

Pouwels, who joined Northern Trust in 2005 as head of asset servicing and business development for The Netherlands, will now focus on Northern Trust's business strategy for growth across EMEA.

"We are seeing an increasing demand from institutional investors and asset managers for solutions that can support their diverse and changing requirements, not least those driven by impending regulations such as UCITS and the AIFM directive," said Biggs. "Eric's role is to focus on expanding our end-to-end asset servicing and asset management solutions to support these clients, as we build our business across the EMEA region."

BNP Paribas Corporate and Investment Banking has added **Lincoln Shepherd** and **Jin Park** to the foreign exchange (FX) sales team. Shepherd and Park will be based in New York and report to George Nunn, head of FX and local market sales, NY.

Lincoln spent the past 10 years with Barclays in Boston and NY covering Real Money accounts for their FX products and was instrumental in helping grow their business. He has an MBA from the McDonough School of Business at Georgetown University, and also three years of experience with American Express Financial Advisors. He will focus on growing BNP Paribas' FX franchise in the Americas.

Jin spent the last five years covering hedge funds and real money accounts for Barclays. He holds an MBA from Columbia Business School, and prior to Barclays worked for Bank of America as a credit analyst. Jin will also focus on bolstering BNP Paribas' FX platform.

The International Capital Market Association (ICMA) has announced that **Simon White**, head of senior issuance at Lloyds Banking Group in London will chair its UK, Ireland and Americas Region.

White will work with ICMA to co-ordinate its activities in the City of London, and more broadly in the region, in support of its members. His initial priorities include building on relationships between members and ensuring optimal contacts and information flow between members and ICMA at a time when there is still much uncertainty about the new regulatory structure of the market at both UK and European level.

Martin Scheck, ICMA chief executive said: "Simon is admirably qualified to take on the chairman's role at this critical juncture, where actions under consideration by governments and regulators will define the financial markets for years to come. I have no doubt that he will drive forward our understanding and focus on our members' needs in the region."

BNY Mellon Broker-Dealer Services has appointed **John Vinci** as its head of global product management and strategy and **Andrew Demko** as business manager for Europe, Middle East and Africa (EMEA), both newly-created senior management roles in the Broker-Dealer Services business.

In his new role, Vinci will oversee the development of product management and strategy for BNY Mellon Broker-Dealer Services, focused on tri-party, derivatives and exchange collateral management, and clearance product sets. Demko, who will relocate to London, will serve as the senior business manager for the EMEA region while continuing in his current role as head of global sales. Both Vinci and Demko will report to James Malgieri, chief executive officer of BNY Mellon Broker-Dealer Services.

Vinci was most recently head of the New York Relationship Management group within BNY Mellon Broker-Dealer Services, where he was responsible for the overall implementation of higher service levels and client satisfaction. Before that, he was a client executive within the company's Financial Institutions Group. Prior to joining the company in 1996, he was a relationship manager at J.P. Morgan Chase.

Demko, who joined BNY Mellon in 1985, has held a variety of management roles in operations, client management and sales, the majority of which have been focused on building the company's relationships in the broker-dealer industry. In his most recent role as head of global sales for BNY Mellon Broker-Dealer Services, a position he still holds, he was responsible for creating a team to market the company's clearing and collateral management services. **SLT**

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60 Second Resumé

Jaclyn Sankovic

Meet Canadian Jaclyn Sankovic, a motivated, outgoing professional with experience on both the trading desk and in operations.

Tell me a little about yourself

I am a highly motivated, energetic, outgoing person and love a challenge.

I value my relationships both personally and professionally; as such I am extremely close with my family and friends.

I am an avid fan of music and can often be found attending as many live shows as I possibly can in my free time.

I have a huge sense of adventure; recently I took a helicopter tour of the Grand Canyon to conquer my fear of heights - it was exhilarating! Next up: white water rafting maybe?

What industry qualifications or relevant certification do you hold?

I have eight years experience in positions both on the trading desk and in operations. At university I studied philosophy, which helps immensely with “seeing the bigger picture” and thinking outside of the box, being creative yet logical.

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

My last position was at Merrill Lynch Canada on the securities lending trading desk. I enjoyed the market analysis aspect of that position most; liasing with various desks around the globe to keep them up to date with the state of the lending market in Canada.

What area are you looking to get back into?

I would love to gain more experience on a trading desk.

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

My vast experience and knowledge of trade flow from beginning to end as well as my relationships management skills.

What do you feel the industry needs most?

Securities lending needs to embrace new technology in order to become more efficient and transparent.

Contact Jaclyn

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