



## Private equity firm buys eSecLending

Securities lending agent eSecLending is under new ownership.

Parthenon Capital Partners, a private equity firm based in Boston and San Francisco with approximately \$2 billion of capital under management, has bought the company for an undisclosed sum.

Craig Starble, who was previously an executive vice president and head of securities finance at State Street as well as CEO of Premier Global Securities Lending, will co-invest in eSecLending.

He will also join the company's management team as CEO.

Starble said: "I am thrilled to partner with Parthenon and eSecLending. The merits of a boutique, independent service provider have become increasingly evident in the current market environment where clients are seeking aligned interests and value-added, tailored solutions. I look forward to joining the team and collaborating with an inno-

vative company to build upon and execute their strategy and goals."

Chris Jaynes, eSecLending's current co-CEO and one of the founding members of the company, will remain as president, responsible for client management, strategy and business development.

He said: "We are excited about the transaction as it further strengthens our business, preserves our independence and maintains continuity of our management team and key personnel."

"In addition, we look forward to leveraging Starble's leadership experience and perspective to further enhance our offering."

Current eSecLending co-CEO Karen O'Connor will retire from the company once the transaction is complete. The most recent addition to its management team is chief risk officer Peter Economou, who joined in August 2012, having previously worked as executive vice president and global head of securities finance and portfolio solutions at State Street.

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## Wells Fargo comments on lawsuit win

A Minnesota jury has cleared Wells Fargo in the lawsuit levelled at the bank by Blue Cross Blue Shield.

In September 2011, Blue Cross Blue Shield of Minnesota, which offer health plans for individuals, businesses and other institutional investors, launched a suit against Wells Fargo in Minnesota federal court, accusing the financial services company of grossly mis-managing investments in its securities lending programme.

Blue Cross Blue Shield's claim stated that securities lending was offered as a conservative option for investors and the bank also represented that the collateral would be safely invested in high-grade money market instruments. Neither of these conditions were satisfied, alleged the firms.

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## New York Federal Bank starts reverse repos

The Federal Reserve Bank of New York has released a statement reiterating that it is ready to support any reserve draining operations that the Federal Open Market Committee might direct.

Its support comes in the form of draining a certain amount of reserves from the banking system using triparty reverse-repo agreements.

On 5 August, the bank announced that at the beginning of that week, it would conduct another series of small-value reverse repurchase transactions using treasury and mortgage-backed securities collateral, with all operations open to all eligible reverse repo counterparties.

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**Private equity firm buys eSecLending**

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"We are thrilled to partner with Starble and the eSecLending executive team to continue to grow the company," commented Brian Golson, managing partner at Parthenon Capital Partners. "[The company] is uniquely positioned to help beneficial owners maximise the risk adjusted return from their securities lending programmes through its unconflicted and differentiated business model."

Zach Sadek, principal at Parthenon Capital Partners, revealed that the private equity firm undertook years of research into securities finance before committing to the deal to buy eSecLending.

He said: "After years of research in the securities lending industry and over a decade of effort in the financial exchange sector, we are attracted to eSecLending's innovative business model as it is well placed to capitalise on the continued changes underway in the market. We are excited to close a transaction with a world-class independent franchise and a talented CEO."

Securities lending agent eSecLending was formed as a subsidiary of Old Mutual in 2000 when it bought United Asset Management.

TA Associates, a private equity firm with a \$16 billion capital base, and eSecLending management recapitalised the company in May 2006.

**Wells Fargo comments on lawsuit win**

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But a Minneosta jury has now cleared Wells Fargo of any liability. A statement from the company said: "The verdict validates that Wells Fargo was focused at all times on serving our clients' interests and that Wells Fargo worked very hard and responsibly to achieve the best results for all participants in the securities lending programme during extremely difficult economic conditions."

"Our conservative approach was effective, as the plaintiffs in Wells Fargo securities lending program had minimal losses averaging approximately three percent at the same time that the markets were down up to 50 percent during the height of the financial crisis."

"The jury's verdict supports our company's firm belief that the investments made on behalf of our clients were in accordance with investment guidelines and were prudent and suitable."

**New York Federal Bank starts reverse repos**

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"Like the earlier operational readiness exercises, this work is a matter of prudent advance planning by the Federal Reserve," said a statement on the central bank's website.

"The operations have been designed to have no material impact on the availability of reserves or on market rates. Specifically, the aggregate amount of outstanding reverse repo transactions will be very small relative to the level of excess reserves, and the transactions will be conducted at current market rates."

"These operations do not represent a change in the stance of monetary policy, and no inference should be drawn about the timing of any change in the stance of monetary policy in the future."

**Clearstream's July GSF creeps up**

Clearstream's global securities financing (GSF) services experienced a monthly average outstanding of €575.1 billion in July.

The combined services, which include triparty repo, securities lending and collateral management, collectively experienced an increase of 2 percent over July 2012 (€563.7 billion).

At €572.0 billion, the year-to-date July 2013 GSF monthly average outstanding was 2 per-

**SLTINBRIEF**



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cent below the same period last year (year-to-date July 2012 was €582.5 billion).

Stefan Lepp, head of GSF and member of the executive board of Clearstream, said: "The European Central Bank's long-term refinancing operation has given the market access to cheap liquidity which is why the GSF monthly average outstandings are slightly lower than at the beginning of the year."

"Despite the monetary policy intervention, which is a temporary phenomenon, our outstandings are 2 percent above July 2012 levels, which shows that we are well on track."

## EquiLend and BNY Mellon chain up their RQV

Anticipating demand for timely settlement of collateral, EquiLend has created a new triparty connectivity service to help expedite the agreement and communication of required value (RQV) figures, while ensuring clients always know the status of their trades.

EquiLend clients can submit values for all of their counterparties in one place. Group instruction functionality enables agent lenders to instruct triparty trades at the underlying principal level and match against a single borrower trade amount.

The service facilitates the pre-matching of trades before they are sent in real time to BNY Mellon. BNY Mellon responds with updates that EquiLend processes, generating individual trade statuses viewable on the EquiLend user interface.

The new service is intended to not only enhance EquiLend's post-trade efficiencies, but also to benefit BNY Mellon's current Auto Deal Matching offering.

Brian Lamb, CEO of EquiLend, said: "Having conducted an extensive build and beta phase with BNY Mellon and our clients, we are confident that EquiLend's offering to communicate and process RQV figures is best in class. We

look forward to continuing our work with BNY Mellon for the benefit of the market."

James Slater, global head of securities financing at BNY Mellon, said: "In today's fast-evolving marketplace, clients are increasingly focused on managing risk, complexity and the need for greater transparency. BNY Mellon has a long history of helping our clients in these areas. This new service is further evidence of our commitment to enhancing the connectivity of BNY Mellon's triparty system for both lenders and borrowers."

## Pension funds bite nails over Dodd-Frank margin demands

Northern Trust has released a paper on capital requirements for pension funds in the wake of the US Dodd-Frank Act that encourages collateral management as a solution to demanding margin requirements.

In an effort to reduce risk and increase transparency, Dodd-Frank imposes mandatory clearing and trade execution of certain derivative products. To help ease the migration of swaps to a central clearinghouse, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have approved a phase-in approach for market participants.

For pension plans subject to the Employee Retirement Income Security Act (ERISA), the mandatory clearing of certain interest rate and credit default swaps begins on 9 September 2013. By mandating interest rate products first, which account for \$489 trillion or 77 percent of outstanding notional, the CFTC has encompassed a majority of the swap activity in the OTC market.

"Many pension funds use interest rate swaps to synthetically increase their portfolios' duration while conserving plan capital. These instruments are widely used in liability-driven investment strategies to hedge long-term pension liabilities," said the report.

But Dodd-Frank's central clearing of swap con-

tracts adds new capital requirements of initial margin and variation margin.

The initial margin is intended to cover the fluctuation in a contract's value over a fixed period. The variation margin functions as a mitigation to credit exposure arising from daily fluctuations of a contract's market value.

Northern Trust has expressed concern about these new requirements, saying that they can be seen as imposing to plan managers. The amount of initial margin required is as yet unknown; with estimates ranging from \$800 billion to \$10 trillion.

A recent report published by the Bank of International Settlements estimated a growth of \$4 trillion in initial margin demand. These figures have begun causing concern that there could be a shortfall in available high quality assets to meet the requirements for plans.

To determine the impact of Dodd-Frank's initial margin requirements on pension funds, the custodian identified the initial margin requirements across hundreds of pension fund accounts, all of which held eligible interest-rate swap products.

Among the accounts in its sample, the average initial margin requirement was \$5.3 million, which is only 1.53 percent of gross notional. Only 18 percent had initial margin requirements larger than \$10 million.

"Our analysis shows that most funds in our sample group with margin requirements of more than \$1 million have ample eligible collateral, in the form of high-grade government or corporate bonds, to meet their initial margin requirements," said the report.

While the clients have sufficient collateral to cover the initial margin required for interest rate swaps, pension funds use other OTC products as well, it added.

Across the sample set of data, 57.4 percent of the trades in the pension accounts were interest rate products. The next most preva-



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lent swap type was credit products, which consisted of 34.5 percent of all trades, leaving 7.9 percent to be distributed across remaining swap categories.

Dodd-Frank imposes initial and variation margin for uncleared swaps.

“Due to the phasing in of product categories under the Dodd-Frank regulations, pension funds may discover they eventually will be required to post collateral to multiple sources for these non-interest-rate products,” said Northern Trust, adding that distributing collateral to counterparties on non-cleared derivatives will require sophisticated collateral management to track and ensure proper collateral is available to cover all margin requirements.

“For the accounts sampled in our data set supplying initial margin should prove no immediate challenge. However, pension plans must also be mindful that margin will also be required for uncleared swaps. Having cash on hand to meet variation margin needs may pose a challenge for some plan managers, especially those with longer duration swaps, which can have large market value swings. The real test will be ensuring that plans are engaging in the more efficient use of their collateral.”

### New prime brokerage mandate for BofA Merrill Lynch

Bank of America Merrill Lynch has secured a new mandate as the main prime broker for CFH Clearing.

The London-based firm will continue to work with UBS as a prime broker, predominantly for precious metals.

BofA Merrill Lynch was selected following a rigorous RFP process. Its strong service model, competitive pricing and speed in which it onboards were particularly impressive, according to CFH Clearing.

Lars Holst, CEO and co-founder of CFH Clear-



ing, said: “Our recent name change from CFH Markets to CFH Clearing now reflects our business model as an interbank prime of prime solutions provider. Our new relationship with Bank of America Merrill Lynch, combined with our open and flexible technology, allows us to give the smaller to medium sized institutional customer excellent and diverse liquidity.”

CFH Clearing rebranded from CFH Markets in June. It connects to banks globally either directly or via FXSpotStream, allowing clients to trade with these banks via their prime broker of choice or via a margin account held at CFH Clearing.

### Asset managers look to secure lending for revenue and liquidity

A “healthy majority” of large asset managers have embraced their securities lending programmes to generate both revenue and liquidity, but challenges remain, according to Finadium’s 2013 survey.

The Massachusetts-based research firm spoke to asset managers for its 2013 securities lending and collateral management survey, and released the results on 6 August.

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Large asset managers embracing their securities lending programmes to generate both revenue and liquidity are in the majority, “but challenges remain”, said Finadium in a release.

US firms assessing cash collateral reinvestment options in the face of changing regulations and a zero interest rate environment “may no longer be as easy as mandating an overnight repo only policy as this repo supply becomes more constrained”.

In Europe, UCITS providers are “working to comply with European Securities and Markets Authority regulations on maintaining a fee split that is fair and reasonable while also assessing new cash and non-cash collateral options”.

It added: “Dividend arbitrage is expected to decline, but asset growth and entries into new markets and types of securities financing activities are expected to propel securities lending into its next phase of business evolution.”

### Short sellers remain sceptical of Herbalife success

Billionaire investor George Soros recently took a large stake in Herbalife—the weight management and nutritional supplement firm—but short sellers aren't buying into the rising share prices, said SunGard.

The firm released its top ten hottest stocks from a securities lending perspective on 7

August, the first of which was Herbalife. The company has recently been in the press, with George Soros facing allegations that his fund management firm engaged in insider trading before purchasing a stake in Herbalife.

The second hottest stock is 3D Systems Corp, which saw some volatile share action recently, as a surge of buying before its earnings announcement left room for a drop when the numbers came in fair, but below expectations, said SunGard.

“The lending data does hint at some increased demand to borrow, although volumes themselves have remained little changed, with the cost of borrowing climbing by half following the results.”

The third and fourth hottest stocks were Cliffs Natural Resources and Carbo Ceramics, respectively. Cliffs Natural Resources is an international mining and natural resources company that focusses on serving the world's largest and fastest growing steel markets.

It saw some interest after it reaching an agreement with the United Steelworkers Union for a three-year contract for workers at its Bloom Lake mine, and SunGard has said that demand to borrow has picked up as its share price made some small gains in a recent session.

Zillow, Vera Bradley, K+S AG, US Airways Group, Outotec OYJ, and United States Steel Corp were the other six hottest stocks.

### Kay's future for lending fees has stalled, says committee

Over a year has passed since Professor John Kay published his report on equity markets—commissioned by the UK government—and the industry has still not changed, say critics.

A House of Commons committee lambasted the government reaction to the report, saying that it is a “huge disappointment” that previous governments have not implemented the recommendations of previous works, “nor have they kept regulation in line with the rapidly changing nature of equity investment”.

One of the key points of Kay's review was that all income from stock lending should be disclosed and rebated to investors.

The government agreed, and said that it would like to see separate disclosure of stock lending costs and income endorsed by the industry in the context of the development of a more comprehensive industry-led disclosure regime. It declined to give further recommendations, putting any decision off until its progress report in 2014.

Panels that discussed this issue spoke of their unease with current fee standards, as well as the practice of securities lending in general.

Simon Wong, a visiting fellow of LSE and partner in

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Governance for Owners, said that he had seen in passive mandates that the fund manager is rewarded only through the securities lending revenues that they generate.

"Imagine the misalignment that creates, because that fund manager has much less interest in the value of the fund going up: rather, that person will be more interested in how much securities lending revenue he can generate through that relationship. There are certain things that I would advise against strongly."

But there were defenders of the sector. BlackRock was asked to respond to the Kay review, and defended stock lending as a well-established and low risk activity that is comprehensively regulated in Europe.

It did not agree that all income should be passed to investors, reasoning that running these activities represents a cost for the lending agents appointed by the funds.

"Stock lending is a resource-intensive activity," said Amra Balic, the director and head of corporate governance and responsible investment, EMEA at BlackRock.

"A high proportion of stock lending trades are executed automatically, which requires significant investment in systems and technology ... in our

view, paying the lending agent a percentage of the gross revenue generated is the most appropriate way of ensuring alignment between the interests of the investors and the lending agent."

### Prime brokerage 'not an option' for CLO financing

New risk retention rules will dramatically shrink the collateralised loan obligation market, and prime brokers will not help the situation, said the Loan Syndications and Trading Association in a letter to US regulators.

The association submitted a comment letter to US regulators responsible for developing and implementing new risk retention regulations.

It featured a survey that showed managers, representing more than two thirds of the US CLO market, estimating the number of CLO's they manage dropping from 500 to approximately 70, if the rules are implemented as currently written.

The rules would require managers to retain 5 percent of the fair value of a CLO.

"The rules—which would require a manager to purchase and retain \$25 million of notes for every

\$500 million CLO—would be devastating for the largest as well as the smallest managers," said Meredith Coffey, executive vice president of the LSTA.

"[Half of] the respondents said they couldn't or wouldn't issue a new CLO. Over 80 percent said the rules would shrink the market by 75 percent or more."

"We only have to look at the experience in Europe, where CLO issuance has collapsed, to see what risk retention does to a market," said Bram Smith, executive director of the LSTA.

The LSTA submitted the survey findings to the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Authority and the Department of Housing and Urban Development.

Findings were compiled from 35 CLO managers that collectively manage \$228 billion in 509 CLOs.

The survey also showed that financing the retention is not a reasonable solution. Of the 35 CLO managers that responded, 20 said they could not raise funding. Of the 12 that said they could raise funding, just two said that they would.



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"Moreover, even if a CLO manager was willing to finance the retention, it does not appear that such financing would be forthcoming," said a statement from the association.

The LSTA spoke with bankers representing over half the prime brokerage market and a number of the term lenders. Neither route appeared to be a realistic alternative for CLO managers to raise financing to retain 5 percent of a new CLO.

Generally, the term lenders said they would lend between 50 percent and 75 percent of the value of the AAA or AA rated notes—and nothing further down the capital structure.

"In turn, this means that—even if the CLO manager could access term financing—it would still have to provide over half the required retention out of its own pocket. Critically, this loan would be recourse to the CLO manager, meaning that their business could be at risk if just one CLO deteriorated," said the statement.

It added that the prime brokerage option is even less feasible, citing results that found prime brokers indicating that they lend short-term against a percentage of highly liquid securities.

"Not only would these securities be subject to the aforementioned haircuts, but they would also face daily margin calls. In addition, there must be a liquid secondary market where these securities can be traded immediately, and the security must be of a type that the prime lender can lend (rehypothecate) overnight. Because CLO securities are not sufficiently liquid and because the risk retention rules themselves would not permit them to be rehypothecated, the prime brokerage option simply is not an option."

"While an occasional large, top-quality, diversified asset manager might be able to access some amount of term financing, it is simply not an option for the typical CLO manager," said Elliot Ganz, general counsel of the LSTA.

"Moreover, the survey indicated that the prime brokerage option was basically a non-starter."

## OneChicago scores July equity futures increase

OneChicago saw its equity futures volume rise in July, beating the previous year by 58 percent. Open interest stood at 611,092 contracts on the equity finance exchange at the end of July, up 36 percent year-over-year.

More than 500,000 exchange futures for physicals (EFPs) and blocks were traded in July, representing \$2.9 billion in notional value. OCX. NoDivRisk products accounted for 60 percent of OneChicago's July month-end open interest.

"The demand from the managed futures community has been very effective in tapping the

enormous liquidity available for these Delta One products and we anticipate this accelerating through the end of the year," said David Downey, CEO of OneChicago.

## All rise for OCC

OCC's clear contract volume increased 6 percent in July as securities lending activity rose 53 percent.

Its total cleared contract volume in July reached 328,899,421 contracts, representing a 6 percent increase from the July 2012 volume of 309,599,417 contracts.

Securities lending central counterparty activities saw a 53 percent increase in new loans from July 2012 with 123,108 transactions last month.

Year-to-date stock loan activity is up 31 percent from 2012 with 761,628 new loan transactions in 2013. The average daily loan value at OCC in July was \$56,104,353,820.

OCC's year-to-date total contract volume is up 3 percent with 2,471,194,347 contracts in 2013.

## Japan fears collateral optimisation will impact on profits

A survey at recent Calypso event in Tokyo highlighted the state of OTC clearing in Japan.

It is expected that OTC client clearing will be mandated within 2014 in Japan. In a survey of attendees, participants shared their concerns and plans to implement an OTC clearing infrastructure and strategy in Japan. Twenty percent of the survey respondents are currently operationally ready for OTC clearing. More than 50 percent of those firms said that they are actively searching for a new system to help them with operational compliance.

In the survey, over 50 percent of respondents revealed concerns that collateral management/collateral optimisation will impact their business profitability once OTC client clearing becomes a reality.

"The urgency of collateral management is felt more gradually than the need to clear trades, as underlying investors and portfolio managers begin to see the direct cost of collateral impacts to their returns," states Josh Galper, managing principal at Finadium.

Conference attendees were also polled on how they would select clearing brokers. The majority of respondents highlighted that breadth of services was the most important attribute when selecting a CCP partner. In terms of the most valuable clearing services, operational support around connectivity and risk and margin management topped the list.



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## Stripped bare

Recent lawsuits around naked shorting prove that the practice still has an army of critics. So who is fighting for it? SLT finds out

GEORGINA LAVERS REPORTS

“Abusive”, “like a form of terrorism” and “funny paper” are three descriptions of naked short selling, given by the Securities and Exchange Committee, a life insurance company CEO, and broker-dealer Jeffrey Wolfson, respectively.

They do not do much to dispel the belief of naked shorting as a practice that is even worse than selling a borrowed security, only to buy it back at a lower price—what we know as covered short selling.

Selling a security that you haven’t even borrowed is an abstract concept, which of course is where most trading strategies get into trouble in the press—and where headlines are made.

“Crackdown on short-selling leaves the city’s robbers in pinstripes facing huge losses” screamed a Daily Mail headline from 2008. The article also quoted Liberal Democrat Treasury spokesman Lord Oakeshott as saying: “They don’t like the exposure. They want to remain anonymous so they are closing, not disclosing. They thrive in the dark and are totally unaccountable.”

CEO Brian Pardo was similarly expansive when lamenting what he called illegal short selling in stock of his life insurance company.

Pardo said: “It is a tragedy to realise that there are well-known financial entities that intentionally try to destroy companies with these abusive tactics, without any regard for the lives of the workers and the investors they ruin.”

“The original purpose of our financial markets was to bring capital to companies so they could grow and, in turn, contribute to the growth of our whole

economy. This small group has hijacked our financial markets for their own gain. I just hope that the SEC will use the clear evidence we have provided to them to bring those who are working against our economy to justice. In my view, naked short selling is a form of financial terrorism.”

Financial Industry Regulatory Authority settlements with UBS and Credit Suisse speak to the enormous magnitude of naked short selling, said Pardo in his complaint. He also pointed to the recent SEC settlement with the Chicago Board Options Exchange as showing: “How an self-regulatory organisation was compromised by those who engage in naked short selling.”

The exchange agreed to pay a \$6 million penalty and implement major remedial measures to settle the SEC’s charges, which were that the firm suffered systemic breakdowns in its regulatory and compliance functions, including a failure to enforce or even fully comprehend rules to prevent abusive short selling.

Another blow to the practice was the case of Jeffrey and Robert Wolson. The brothers allegedly generated more than \$17 million from naked short selling transactions involving stocks such as Chipotle Mexican Grill, Fairfax Financial Holdings, Novastar Financial, and NYSE Group. As Jeffrey Wolfson stated in a recorded telephone conversation: “What I sell them is not guaranteed, it never gets delivered, it’s funny paper.” They agreed to pay more than \$14.5 million to settle the case against them.

The SEC has taken considerable measures to stop naked shorting. Market participants were required to begin complying with Regulation SHO in 2005, which established uniform locate

and close-out requirements in order to address problems associated with failures to deliver, including potentially abusive naked shorting. Though it did not outlaw the practice all-together (and indeed praised it as liquidity-generating, “in certain circumstances), 2008 saw the issue grow cloudier.

As Fannie Mae and Freddie Mac were being tossed around the markets, the SEC announced emergency actions to limit naked shorting of government-sponsored enterprises, and six months later issued more extensive rules, which managed to include market makers.

But where there are detractors, there are also proponents. Three years ago, the German Minister of Finance announced that naked short selling of euro-denominated government bonds, credit default swaps based on those bonds, and shares in Germany’s 10 leading financial institutions were prohibited.

But it didn’t take long for the International Monetary Fund to dismiss the measure, stating in a report that the ban did relatively little to support the targeted institutions’ underlying stock prices, while liquidity dropped and volatility rose substantially. It added that there was no strong evidence that stock prices fell because of shorting.

A new study has backed up statements such as these, in claiming accounting fundamentals, rather than manipulation, to be more significant in explaining naked short sales.

**Naked Short Selling: Is It Information-Based Trading?** is authored by Harrison Liu of the University of Texas San Antonio, and Sean McGuire and Edward Swanson of Texas A&M University.

Its findings show that—contrary to accepted belief—accounting fundamentals are highly significant in explaining naked short sales.

Liu, McGuire and Swanson looked at 2700 firms' fail-to-deliver data from 2005 to 2008, collected by the stock exchanges and provided by the SEC under the Freedom of Information Act, to decompose total short interest into naked and covered components.

It then came up with three main hypotheses: that accounting fundamentals are highly significant in explaining naked short sales; that recent actions by regulators to eliminate naked short sales are likely to impede informed arbitrage and reduce market efficiency; and that naked short sales contain incremental information about future stock prices.

The authors also stated that their results should be of considerable interest to both regulators and defendants in ongoing litigation.

"Citing a widely held belief that naked short selling is not based on company fundamentals, the SEC (2008) has substantially tightened Reg. SHO close-out regulations in an effort to eliminate naked short selling," said the report's foreword.

It went on to state that abnormal returns from a long/short trading strategy that buys (sells short) shares with low (high) short interest are more than seven times larger using naked and covered short interest, compared to returns using only covered short interest (15.2 percent versus 2.1 percent annualised).

"All trading positions carry some incremental information about the value of a stock price, whether that is an upward/buying pressure, or a selling/downward one," says David Lewis, senior vice president at SunGard's Astec Analytics business.

"Naked short sales are no different in this re-

spect and their influence should be included in any trade flow analysis."

Turning to accounting fundamentals, the report cited Diamond and Verrecchia, who predicted that the proportion of uninformed traders increases as the cost of short selling decreases. Naked short sellers have lower costs than covered short sellers because they receive an (involuntary) zero-fee, zero-rebate equity loan from the buyer, and the logic of Diamond and Verrecchia suggests that naked short sellers are potentially less informed than covered short sellers and, thereby, less likely to trade on accounting fundamentals.

In discussion of the report, Lewis adds that the view of naked short sellers as uninformed is a "dramatic oversimplification."

"There have been viewpoints raised that naked short sellers are less informed than those that are covered, partly due to their avoidance of costs associated with covering their short sales."

"This would imply that the naked short sellers could be characterised as, say, an individual day trading from home as opposed to organised regulated banks undertaking proprietary trading. The implication is that the trading desks operated by the banks have a wealth of information available to them and are more likely to make decisions based on more information."

"This is, potentially, a dramatic oversimplification. Whilst I think it is easy (and perhaps accurate in some cases) to liken naked short sellers to a group of people at the bookmakers betting on races as they come up during the day, based simply on a hunch or tips read in the racing post, it is too much of a generalisation to assert that they are all less informed."

"All short sellers, big or small, expose themselves to potentially unlimited losses when

they take out a short position. Unlike a bet on a horse, get it wrong and you lose more than your stake—the share price can keep on rising and your losses can explode. It would follow, therefore, that any trader placing such a 'bet' would do so carefully and with as much investment in research as they could afford in time and money. It could be argued the other way in fact—day traders trade with their own money—bank traders could, theoretically, take less care as it is not their money at stake."

The report examined whether naked short sales are based on company, rather than accounting, fundamentals, by regressing naked short interest on financial statement fundamentals (and a set of control variables) to determine whether naked short sellers use those data.

Findings concluded that naked short interest is significantly negatively associated with Piotroski's F-Score—which simply means that naked short positions are lower for firms with positive accounting fundamentals.

Naked short interest is therefore significantly positively associated with both capital expenditures and sales growth, findings showed. "Prior research shows that high capital expenditures and high sales growth tend to precede lower future returns," said the report. "Naked short selling is therefore significantly associated with each of our three measures of accounting fundamentals in the direction indicating proper use of the information."

Lewis adds that trading patterns and research into failed trade statistics imply that naked short sales are of a much shorter duration than their covered cousins; which could suggest that the exposure created by naked shorts is less than for covered trades due to their relatively limited life spans, but that is determined by the share in questions volatility during that period. "Significant gains and indeed losses can be made very quickly, whether covered or not," Lewis said.

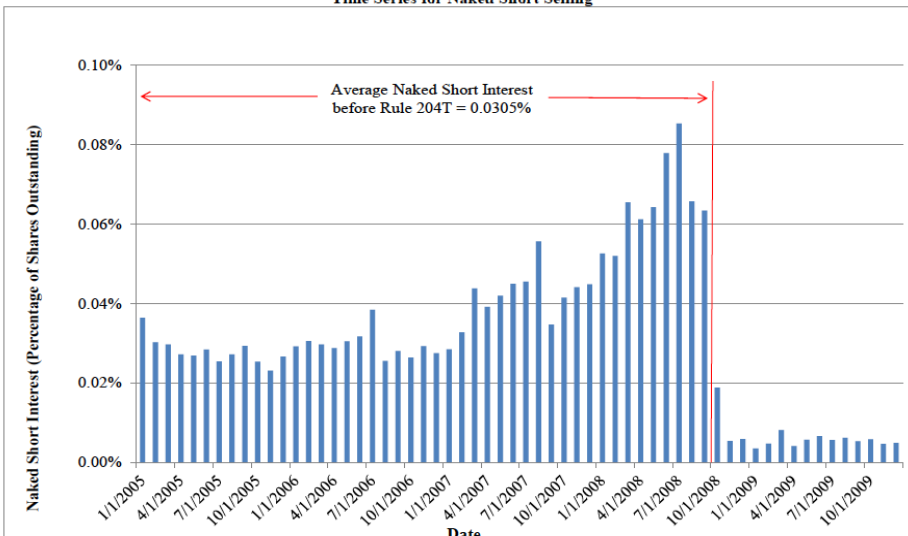
But while the report makes some persuasive arguments for the practice, it is unlikely to cause many ripples in the outside world.

"Regulators dislike naked short selling—like shadow banking, the very terminology has taken on a dark tone of something better people just do not do," says Lewis.

"Increased legislation will no doubt increase the costs of undertaking naked short selling, but this will simply drive the trading towards other routes."

"Imposition of a Financial Transaction Tax in France and Italy has seen equity trading decrease 30 and 45 percent respectively, yet tax exempt CFD and single stock futures trading have boomed. Eradication of naked short selling will not stop traders taking up positions reflecting negative sentiment over share valuations; other ways will be found to express market views and keep the market as efficient as it can be." **SLT**

Time Series for Naked Short Selling



Source: Naked Short Selling: Is It Information-Based Trading?

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## Unfailingly positive

Hit by a flat equity sector and a wavering currency—but Canada is not down and out just yet. SLT reports

GEORGINA LAVERS REPORTS

Finding Opportunities as Headwinds Continue was the hopefully entitled report by Ernst & Young in its Q2 2013 analysis of the Canadian mining sector.

The report told of gold prices declining in the second quarter due to growing concerns around the tapering of quantitative easing. By mid-July prices stabilised, but they stopped at a level far lower to that of last year.

Concerns over the precious metal had a knock-on effect on mining, with the sector's equities plunging in Q2. The Canadian Mining Eye index plunged deeper and closed down 34 percent in Q2 2013, and down 42 percent year-on-year.

But, said Ernst & Young, mining companies are strategising on how to turn the rain around; using examples of BHP Billiton disposing its copper mine and both Barrick Gold and Newcrest

Mining reducing headcount—to prove that changes are indeed being made.

Rob Ferguson, senior vice president of capital markets at CIBC Mellon, comments that from an asset allocation perspective, he is continuing to see a shift from Canadian equities into alternatives—within Canada as well as into emerging markets.

“From a lending perspective, the impacts depend on the specifics of the shift. Moving into emerging markets can be positive for lending returns, while moving into private equity or infrastructure typically yields no revenue opportunity.”

He adds that there has been flat demand for Canadian equities through the summer doldrums. Weak demand for resources may have led to falling gold prices, sluggish oil prices and flat commodities prices; but this has had little impact on securities lending volumes or rates.

“Exceptions have been few and unexciting: Canadian Oilsands and Barrick Gold have seen decent demand but at relatively low levels. Big deals in the retail sector: Loblaw Companies Ltd./Shoppers Drug Mart (\$12B) and Hudson's Bay Co/Saks Inc (\$2.4B) show promise that has yet to be fulfilled. The strongest demand is for Blackberry, with virtually all available shares out on loan at premium rates.”

### Currency woes

A weak currency has been another concern for the country. The Canadian dollar falling to its lowest level in more than 18 months in June, as the US dollar continued to flex its muscles.

But Ferguson says that according to research by the economics team at his parent company CIBC, the Canadian dollar has actually

been fairly resilient lately, strengthening just after many analysts downgraded their calls for the currency (based on fears of the effects on Canada of tapering by the US Federal Reserve Bank of New York).

“As in the US, uncertainty over American Federal policy has added to volatility. A number of current factors are lending strength to the Canadian dollar, including favourable rate differentials, rising oil prices and robust domestic economic figures.”

“While the CIBC economics team still projects that the Canadian dollar will be a touch weaker by year-end, they note that it could hold at current levels for the near term. Just a few months ago, there were quite a few foreign investors making public calls that they were ‘shorting Canada’—further mirrored in speculators’ increasing net short Canadian dollar positions. But that was ill-timed, as data quickly began to surprise on the upside, with housing and consumer indicators pointing to robustness.”

Ferguson adds that other factors are having a direct impact on Canada’s lending market as well; pointing to Stephen Poloz, the new Governor at the Bank of Canada leaving the central bank’s overnight target rate at 1 percent (where many economists and analysts are predicting it will stay until mid-2014), as an example.

“New demand for Canada Housing Trust and various Canadian provinces have boosted non-cash balances, and cash collateral

loans have also advanced. Credit rating downgrades in other parts of the world—particularly of sovereign governments—have pushed up demand for Canadian AAA-rated government collateral among lenders, with strong demand for Canadian treasuries and certain Canadian bonds going special for the first time in recent memory.”

### Finance data flourishing

The positive attitude must be catching, as securities finance data provider DataLend expressed enthusiasm in the market.

“Since the launch of DataLend in January 2013, several key Canadian firms have joined the securities finance market data provider,” says Alexa Lemstra, the vice president of sales for EquiLend Canada.

“On loan data for the Canadian market has grown to \$84 billion and \$1.4 trillion globally. Market data is a significant piece of the trading community’s day, and the release of DataLend has been met by strong market interest from the Canadian market.”

“Despite the slow summer, the Canadian securities lending picture is quite bright,” concludes Ferguson. “Clients continue to expand their participation in securities lending programmes as they seek additional stable sources of risk-adjusted returns. At the end of the day, Canada’s fundamental characteristics—prudence, stability and effective regulation—help set us apart in an uncertain world and give participants confidence as they grow their programmes.” **SLT**

### Canada - Top 10 revenue names as of August 2013

BLACKBERRY ORD
WESTPORT INNOVATIONS ORD
LOBLAW COMPANIES ORD
HOME CAPITAL ORD
RITCHIE BROS AUCTIONEERS ORD
THOMPSON CREEK METALS ORD
ONCOLYTICS BIOTECH ORD
COMINAR REAL ESTATE INVESTMNT TR
UNT
CRESCENT POINT ENERGY ORD
HUDSONS BAY ORD

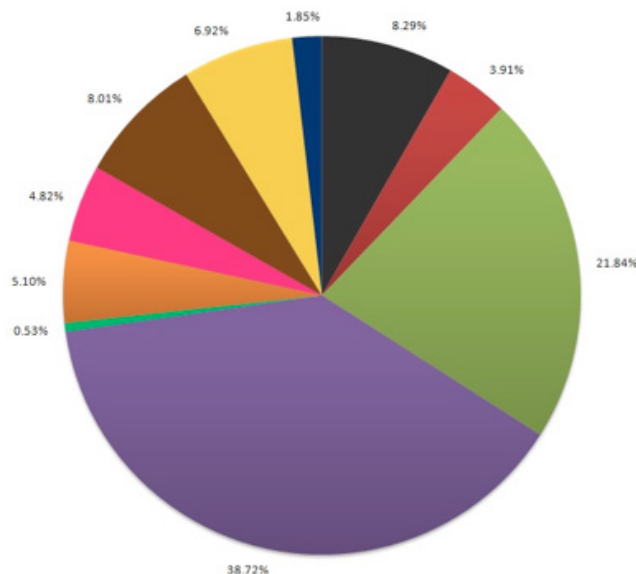
### Canada - Top 10 on loan names by value 2013

ROYAL BANK OF CANADA ORD
TORONTO DOMINION ORD
CANADIAN IMPERIAL BANK COMMERCE ORD
BANK NOVA SCOTIA ORD
BCE ORD
THOMSON REUTERS ORD
TRANSCANADA ORD
BANK OF MONTREAL ORD
ENBRIDGE ORD
HUSKY ENERGY ORD

Source: DataLend

Canada On Loan Value by Sector

- Consumer Discretionary
- Consumer Staples
- Energy
- Financials
- Health Care
- Industrials
- Information Technology
- Materials
- Telecommunication Services
- Utilities



Source: DataLend

# Arbitrage awakens

The securities lending markets are awash with supply. But research director of Markit Securities Finance, Will Duff Gordon, asks whether borrowing demand will be stimulated by a resurgence of arbitrage as M&A comes alive

There are signs that opportunities are becoming more plentiful for those funds which prefer to take calculated risk on corporate events rather than pick good or bad companies. However, borrowing demand remains subdued overall.

## Weak borrowing demand

Almost no one thinks that leverage will return the pre-crisis levels and there has long been a weakness at the core of equity borrowing due to the fact that few funds actually short sell equities in the scale this industry might hope for.

As the largest hedge fund strategy (over 60 percent) by assets, long/short funds are always miles more long than they ever are short. Shorting for a price fall is difficult and expensive and rarely profitable—they will tell you.

The real borrowers of equities are the market neutral funds, arbitrage funds and quant funds and these have fallen out of favour with allocators of capital with very few exceptions.

## Arbitrage assessment

But are things looking up for the prospective arbitrageurs? There are signs that opportunities are becoming more plentiful for those funds who prefer to take calculated risk on corporate events rather than pick good or bad companies.

## Event arbitrage

Pre-credit crunch, this segment of the hedge fund community was vibrant and a major borrower of stock. As companies withdrew from the cut and thrust of M&A to fix their core business these trading opportunities dried up to a trickle. But cost cutting only gets you so far, and companies would seem to be back on the front foot with some seeing strategic purchases as the best way to grow.

A simplistic event arbitrageur would take a position that assumes the price of the acquisition

target rising, while shorting the acquirer in expectation of its price falling—or so the theory goes.

Such strategies have outperformed all other hedge fund trading styles so far this year, the Financial Times recently reported.

Stats from HFR showed that the average event arbitrageur is up 5.7 percent, compared with an industry-wide average of 3.6 percent. Many individual managers have fared better.

KPN is back in the news after a €7.2 billion takeover approach from its biggest shareholder, América Móvil for the 70 percent of the Dutch telecoms group it does not already own. Demand to borrow KPN has held steady at 0.5 percent of the total shares.

The advertising world was caught napping when the 'merger of equals' between French giant, Publicis Groupe (PUB) and US-listed Omnicom was announced.

Yet a glance at securities lending flows shows a notable level of short covering in Omnicom (OMC) as borrowing demand has capitulated by two-thirds to around 2.5 percent of the total shares on loan.

On the other hand, demand to borrow Publicis has only declined marginally since the deal was announced.

Deals such as Dell's leveraged buyout and challenge from Icahn and Softbank buying Sprint/Clearwire are another two of the many examples. There is a theme of US M&A with telecoms, technology, pharma and media at the forefront.

## The hot dividend arbitrage

The spikes in borrowing for European equities seem to be getting more frequent and shorter in duration. This means borrowers are exploiting scrip dividend opportunities more which makes sense as EU tax harmonisation continues its march towards the elimination of cross border tax differences.

There is no doubt that regular dividend tax arbi-

trage is more complicated and costly to execute than ever before.

## Scrip dividends go continental

Equity finance desks have, for years, taken advantage of the scrip dividends issued by the UK banks with HSBC's quarterly scrip a perennial favourite.

Research from Markit's Dividend team shows that more companies opted to pay scrip dividends in 2012 versus 2011 by a considerable margin with a big increase in the Netherlands. 2012 saw 99 scrip dividends being issued in Europe. Deutsche Telecom issued its first scrip dividend this year.

With many European banks enduring major surgery to rebuild their businesses it makes sense to pay a dividend that, in theory, drains less cash from if shareholders opt for equity.

This is good news for the securities lending market since borrowers have a boundless appetite to do this trade since it is a bona fide arbitrage that, with skill, makes money every time.

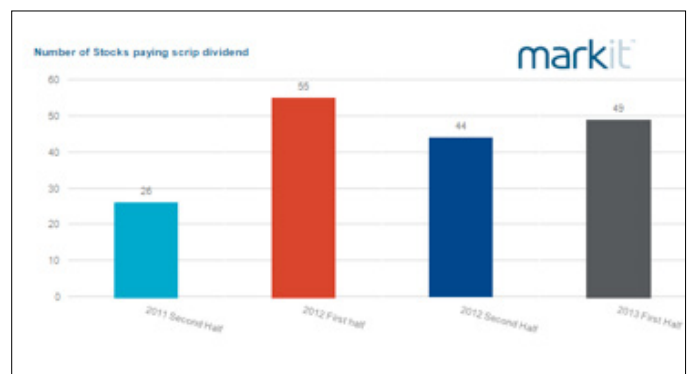
## Convertible bond arbitrage

The convertible bond market has been somewhat subdued this past few years since market conditions, or low interest rates, have not been in their favour.

If a company is forced to offer a yield higher than it can ideally afford to pay, then it might look to offer a convertible bond which enables a lower yield in return for the share conversion on offer.

Yields have started to rise as we enter the beginning of the end of the Fed's QE programme and the convert crowd have started to speak up.

Research by Dealogic has showed that companies used these instruments to raise \$22 billion in the first half which is more than the amount issued in the whole of 2012. [SLT](#)



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Location: London

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[www.finance.flemingeuropa.com](http://www.finance.flemingeuropa.com)

Europe's oldest, best known and most anticipated conference focused purely on collateral is back. The most prominent and the market leader, now more focused and innovative than ever.

## Securities Lending: 2014 Outlook

Date: 21 November 2013

Location: Citi offices, Stirling Square, London

[www.securitieslendingtimes.com](http://www.securitieslendingtimes.com)

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See below a sampling of who's already registered:

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Aberdeen Asset Management  
AEGON Asset Management  
Andra AP-fonden  
APG Asset Management  
Aviva Investors  
AXA Investment Managers  
Barclays  
BlackRock  
BNP Paribas  
BNY Mellon  
BNY Mellon Asset Management  
Brown Brothers Harriman  
Canada Life Investments  
Capital Market Authority  
Citi  
City of Edinburgh Council  
Coal Pension Trustees Services Ltd  
Cohen and Steers  
Credit Suisse  
Deutsche Asset & Wealth Management

Deutsche Bank AG  
Dimensional Fund Advisors Ltd.  
EquiLend Europe Ltd.  
eSecLending  
Eurex Clearing  
Euroclear SA/NV  
European Commission  
F&C Asset Management  
Fiderum Bank  
Fideuram Gestions S.A  
Goldman Sachs  
Howieson Consulting Ltd.  
IBM UK Pensions Trust Ltd.  
Ignis Asset Management  
Impax Asset Management  
ING Investment Management  
International Securities Lending Association (ISLA)  
Investec Asset Management  
J.P. Morgan  
J.P. Morgan Asset Management

Kames Capital  
Kuwait Investment Office  
Legal & General Investment Management  
Lloyds Banking Group  
M&G Investments  
Maple Financial Group / Maple Bank GmbH  
Markit Securities Finance  
Mediolanum Asset Management  
Mercer | Mercer Sentinel Group  
Merseyside Pension Fund  
MN Services  
Morgan Stanley  
MX Consulting Services Ltd  
Nationwide Building Society  
Norges Bank Investment Management  
Northern Trust  
Pension Protection Fund  
Petercam

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Pictet Asset Management UK Limited  
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## Industry appointments

A source has confirmed that **Bryan Biagioli** and **Stephen Cotter** have left their roles at UBS Investment Banking.

Both Biagioli and Cotter worked as associate directors at the firm's New York office.

Prior to joining UBS in 2009, Biagioli worked at Merrill Lynch.

Cotter previously worked in insurance derivatives for KBC Financial Products.

**Bruce Turner** has joined securities firm Interactive Brokers as vice president of securities lending services.

Turner joined Interactive Brokers in July and is based in New York. He reportedly left his role as co-CEO of Quadriserv in May. Pat Cestaro remains as CEO of the company.

Quadriserv, which runs the AQS central counterparty-based securities lending marketplace, expanded its relationship with SunGard in the same month. It also welcomed a new investor and revamped its board of directors.

Private investor Rohit D'Souza, the former CEO of Citadel Securities and head of Global Equities at Merrill Lynch, joined Quadriserv's board. Other company investors include Bessemer Venture Partners and Interactive Brokers.

Greg DePetris and Brian Traquair, president of SunGard's capital markets business, also joined Quadriserv's board of directors.



**Timothy Keenan** has left Quadriserv after four years at the company. Prior to this role he had worked at Barclays Capital, and was the global repo product manager at Credit Suisse First Boston.

The Hedge Fund Association (HFA) has made a few recent appointments to its advisory board and regional leadership divisions.

Global wealth consultant **Hannah Shaw Grove** has been hired to its high net-worth advisory board.

She is a founder and executive editor of Private Wealth, and the author of 10 books on topics including family offices, hedge funds and wealth management.

The HFA also announced new regional leadership appointments. Victor Hugo Rodriguez, the first director of the HFA's LatAm chapter, is passing the reins to **Juan Garrido** and **Les Baquiran**.

Juan Garrido is global head of investment solu-

tions at BBVA Global Private Bank in New York. Garrido oversees BBVA Wealth Management's global investment strategy and asset allocation.

Les Baquiran was a New York-based principal at Park Hill, an alternative investment placement agent that is part of the Blackstone Group.

Prior to joining Park Hill, he was a managing director at ISI in institutional sales and before that worked at Brown Brothers Harriman as an equity research analyst.

Victor Hugo Rodriguez became the director of the HFA's LatAm chapter when it was launched in March 2011. The founder, president and CEO of LatAm Alternatives, he was also partner and head of Latin American prime brokerage for Merlin Securities and director of global institutional sales at TradeStation Securities.

The Cowen Equity Finance Group has strengthened its team with four new recruits.

**Jon Wedrogowski** joins Cowen Equity Finance from Kellner Capital, where he worked as director for the KDC Alpha Fund.

He will be director and head of analytics at Cowen Equity Finance.

**Marylou Carluccio** is joining Cowen Equity Finance to work in sales. She was previously a securities lending representative at Penson Financial Services and an AQS specialist at Quadriserv.

Former BNP Paribas securities lending operations specialist **Stefanie Mangino** has also moved to Cowen Equity Finance to work in a sales trading and support role.

She successfully led the migration of the securities lending operations division from Bank of America to BNP Paribas following the sale of the prime brokerage unit.

Cowen Equity Finance has also added **Nina Dipaola** to its team.

The former Jefferies & Co associate, who specialises in securities lending sales support, will carry out a similar role at Cowen Equity Finance.

Financial services company Cowen Group bought the securities lending business and broker-dealer subsidiary Cowen Equity Finance, formerly known as KDC Securities, from Kellner Capital late last year.

Rory Zirpolo, the head of securities lending at Cowen, serves as managing director and head of the equity finance group.

Jill Mandarino, Stephen Grazioli, Dan Gee, CJ Romano and Richard DePaulis moved to the Cowen Group along with Zirpolo last year.

**Patrick Curry** has joined Cantor Fitzgerald as

a managing director to run the firm's securities lending desk, sources have confirmed.

Curry has previously worked as a securities lending manager at brokerage firm Crowell, Weedon & Co and Legent Clearing.

Former Synechron managing director **Raymond Vuyst** has joined ING in Amsterdam as a senior package solution consultant, a source has confirmed.

He took up the role on 19 August on a freelance basis. The source said that ING is considering changing its IT system for global equity finance.



Vuyst left Synechron, where he had worked for just over a year.

He joined Synechron from ABN AMRO on 1 May 2012 as managing director based in Amsterdam. He joined the IT company with Sander Baauw. In his role at ABN AMRO, Vuyst was in charge of IT solutions for the securities financing and the equities derivative departments.

Baauw reportedly left Synechron at the same time as Vuyst.

**Mihir Shah** has joined Scotiabank's prime finance business. Scotiabank confirmed the hire. **SLT**



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