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Silvercorp fraud battle rages on

Jon Richard Carnes has been accused of committing fraud by the British Columbia Securities Commission (BCSC), after he denounced Silvercorp on his blog and then made $2.8 million selling it short.

The executive director of the British Columbia Securities Commission issued a notice of hearing alleging that Jon Richard Carnes, who ran a hedge fund and operated the Alfred Little financial blog, committed fraud.

The notice alleged that beginning in 2010, Carnes began writing negative reports about issuers traded on a North American exchange with business operations in China. Carnes attempted to profit from his negative reports by shorting the issuer's securities before publishing the negative report, and then covering his short position after the issuer's share price dropped in response to his negative report.

The BCSC staff contended that in about June 2011, Carnes targeted Silvercorp as the next issuer he would try to profit from by issuing a negative report.

Silvercorp is a mining company and reporting issuer with its head office in Vancouver, British Columbia. It has business operations in China, and its securities trade on the Toronto Stock Exchange and the New York Stock Exchange.

On 15 August 2011, Carnes began building a short position in Silvercorp's shares by purchasing put options that expired on 17 September, 2011.

In the notice, the BCSC alleged that Carnes attempted to find a mining expert to support his theory that Silvercorp's Chinese filings contradicted its North American regulatory filings for the company's SGX mine, as the Chinese filings had lower production, quality and resource estimates.

read**more p3**

FINRA slaps Deutsche with $6.5 million fine

The Financial Industry Regulatory Authority (FINRA) has fined Deutsche Bank Securities (DSBI) $6.5 million due to financial and operational deficiencies in its enhanced lending programme.

The violations, which were originally identified during a 2009 examination, included lack of transparency in the firm's financial records and inaccurate calculations resulting in overstated capitalisation and inadequate customer reserves.

Brad Bennett, FINRA executive vice president and chief of enforcement, said: "First and foremost, a brokerage firm must ensure that its customer assets are protected. DBSI's financial accounting lacked the transparency and accuracy necessary to enable FINRA to oversee the firm and to protect customer assets."

read**more p3**

Agencies issue final rules implementing Volcker Rule

Five federal agencies have issued final rules developed jointly to implement Section 619 of the US Dodd-Frank Act, also known as the Volcker Rule.

The final rules prohibit insured depository institutions and companies affiliated with banking entities from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own accounts.

The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds and private equity funds, as well as clarifying that certain activities are not prohibited, including acting as agent, broker, or custodian.

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Silvercorp fraud battle rages on

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When two mining experts failed to support his theory and with his put options about to expire, Carnes wrote a false negative report about Silvercorp and published it anonymously on 13 September 2011 on Alfredlittle.com, a financial blog controlled by Carnes, said the BCSC.

Carnes also made what the BCSC called "numerous false claims" about the second mining expert to support his theory, including that the expert had serious concerns about the reliability of Silvercorp's North American filings.

"In reality, the second mining expert had explained that the differences between the Chinese filings and the North American filings were due to different reporting standards and different legislated cut-off grades," said the BCSC.

After Carnes published his report on AlfredLittle.com, Silvercorp's share price closed down 20 percent for the day, wiping out over $275 million in shareholder value. Carnes closed his short position in Silvercorp's shares by the next day, earning a gross profit of almost $2.8 million, said the BCSC.

During the period in question, Carnes was a resident of Vancouver and ran a hedge fund called EOS Holdings. EOS Holdings was operated through a number of corporations and entities in various jurisdictions and had a staff that reported to Carnes.

Alfred Little has posted various blogs on Silvercorp. One of them alleged that the company misled investors by publishing and repeatedly promoting a "patently false" fiscal 2013 operating cash flow forecast of $160 million, an increase of 42 percent over 2012.

"Management published and touted this forecast despite only generating $43 million in operating cash flow in the first half of fiscal 2013, a decrease of 38 percent from 2012. Furthermore, I will show that management selectively disclosed lower operating cash flow guidance in presentations to one group of investors, while continuing to show the higher cash flow forecast to all other investors. Then in early 2013 management staged a series of positive announcements to boost the stock price while delaying disclosure of negative developments including a write-down, project delay and sharply reduced production guidance," said the Alfred Little blog post.

The BCSC's allegations have not been proven, but the counsel for the executive director will apply to set dates for a hearing into the allegations before a panel of commissioners on 4 February.

In a 20 December 2013 blog post on Alfred Little, Carnes called the BCSC's allegations "false and without merit", adding: "I am taking legal action to both defend my reports and to hold accountable those public servants at the BCSC who have ignored my warnings about [Silvercorp]."

FINRA slaps Deutsche with $6.5 million fine

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Under DBSI's enhanced lending programme, which involves mostly hedge fund customers, the firm arranges for its London affiliate, Deutsche Bank AG London, to lend cash and securities to DBSI's customers. FINRA's 2009 examination of the firm uncovered a number of serious problems in connection with this programme.

For example, the firm's books reflected that it owed $9.4 billion to its affiliate, but neither the firm nor FINRA examiners could readily determine which portions of that debt were attributable to the customers' enhanced lending activity, and which were attributable to DBL's own proprietary trading.

The lack of transparency in DBSI's books and records meant the firm was unable to readily monitor the accounts originating out of the enhanced lending business.

FINRA also found that there were instances where DBSI made inaccurate calculations that resulted in the firm overstating its capital or failing to set aside enough funds in its customer reserve account to appropriately protect customer securities.

For example, DBSI incorrectly classified certain enhanced lending stock loans; when it reclas-

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sified them in April 2010, DBL was obligated to pay a margin call of $3.1 billion. DBSI improperly computed its payable balance, thus reducing the firm's reported liabilities and inaccurately overstating the firm's net capital. Separately, in March 2010, the firm incorrectly computed its customer reserve formula. As a result, the firm's customer reserve fund was deficient by $700 million to $1.6 billion during March 2010.

In settling this matter, DBSI neither admitted nor denied the charges, but consented to the entry of FINRA's findings

Agencies issue final rules implementing Volcker Rule

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The compliance requirements under the final rules vary based on the size of the banking entity and the scope of activities conducted.

Banking entities with significant trading operations will be required to establish a detailed compliance programme and their CEOs will be required to attest that the programme is reasonably designed to achieve compliance with the final rule.

Independent testing and analysis of an institution's compliance programme will also be required.

Banking organisations covered by Section 619 will be required to fully conform their activities and investments by 21 July 2015.

Court case throws up implication for lending agents

In its analysis of the court case between AP-Fonden and BNY Mellon, law firm RPC has stated that the judgement against the bank underscores the need for securities lending agents to act fairly when communicating with their clients.

In October 2013, the Commercial Court in London awarded undisclosed damages to Swedish fund Första AP-fonden (AP1), after an action was lodged by the fund in response to losses incurred as a result of securities lending transactions handled by BNY Mellon.

The judge noted in the ruling that BNY Mellon failed in its care when handling the fund's mandate, which was to act as manager of AP's cash collateral investment portfolio and would perform its duties with "care, skill, prudence and diligence".

In March and April 2007 BNY Mellon acquired two tranches of medium-term notes issued by Sigma Finance, a structured investment vehicle, for AP's account as collateral.

Sigma began to experience financial difficulties and the price of its medium-term notes declined sharply.

The bank told AP about Sigma's difficulties, but maintained that it was confident that the Sigma medium-term notes would continue to perform and pay out on maturity. However, at the same time BNY Mellon was warning other clients of the potential risk to their portfolios and recommending alternative solutions in relation to their Sigma medium-term note investments.

In particular, BNY Mellon wrote letters to other clients stating that "there is a significant likelihood that Sigma will not be able to continue to meet its commitments in respect of the Sigma notes in the medium term".

The judge found that although there was no deliberate attempt to mislead, BNY Mellon's communications had given rise to misrepresentations and negligent misstatements.

In a report, Leonora Howard and Jonathan Cary of RPC stated that although the judgement confirmed that a securities lending agent generally does not owe its clients a fiduciary duty, an agent is required to provide its clients with a fair assessment of the situation once it becomes aware that an investment is at serious risk of default that would result in significant losses to the client.

"In this case, that BNY Mellon did not do so was brought into sharp relief by the fact that it provided quite different information and guidance to other clients in the same position."

"The case also stands out as one of the rarer examples in which a bank has been found liable for losses resulting from false representations in the wake of the financial crisis."

Equity hedge fund assets achieve five-year high

Hedge fund assets under management have reached a five-year high, according to a report from eVestment.

The institutional investment research firm found that hedge funds are on track for assets to rise $256 billion in 2013, an 80 percent increase over the rise seen in 2012.

Investor flows into hedge funds were positive for a fifth consecutive month in November 2013, and new allocations of $15.3 billion brought the five-month total of inflows to $68.5 billion.

Industry assets hit a five-year high in November of $2.84 trillion, and are now just 3 percent below figures last seen before the 2008 financial crisis. Total industry assets are on pace to increase by an estimated $256 billion for 2013, an amount nearly 80 percent greater than 2012's $144 billion increase.

Equity strategies took in the majority of new assets in November 2013 as investor preferences for alternative exposure to current equity markets has become clear. Allocations to long/short equity funds in November were the largest in more than 50 months, since August 2009.

The turnaround of investor interest towards equity exposure has been significant, and appears to be at the expense of credit exposure. In the months 38 from May 2010 to June 2013, investor flows to equity outpaced credit only four times. In the five months since the end-of-taper alarm and ensuing US treasury rate spike, monthly equity flows have outpaced credit three times.

Credit strategy assets rose in November, a reversal of October's redemptions, but at a muted pace. Investors allocated $3.5 billion into the space during the month, meaningfully below their prior 12-month average inflow of $7.1 billion.

Macro and managed futures fund flows were both negative in November 2013. Redemptions from macro strategies reversed a recent string of new allocations. Flows were mixed for the largest macro funds and investors appear to be aligning new allocations with those funds able to perform well in the recent global environment.

Emerging market hedge fund flows were positive again in November, the sixth month of positive flows in the last seven. When compared to institutional traditional long-only emerging market flows, eVestment reports a diverging trend.

Long-only emerging market allocations had been firmly positive dating back to 2009, however, flows turned negative in Q3 2013. Conversely, emerging market hedge fund flows had been negative from early 2010 until Q2 2013. It is an important market sentiment indicator when institutional investors opt for hedged over long-only exposure to developed and emerging markets.

US SEC shuts down NIR Capital Management

The US Securities and Exchange Commission has charged the managing partners of a North Carolina-based investment advisory firm for compromising their independent judgment, and allowing a third party with its own interests to influence the portfolio selection process of a collateralised debt obligation (CDO) being offered to investors.

The investment managers have agreed to collectively pay more than $472,000 and exit the securities industry to settle the SEC's charges.

According to the SEC, disclosures to investors indicated that NIR Capital Management was solely selecting the assets for Norma CDO I as the designated collateral manager. However, NIR's Scott Shannon accepted assets chosen by hedge fund firm Magnetar Capital for the Norma CDO's portfolio, and Joseph Parish III allowed Magnetar to influence the selection of some other assets.

Shannon himself called at least one of the residential mortgage-backed securities ultimately included in the portfolio a "real stinker."

Magnetar bought the equity in the CDO but also placed short bets on collateral in the CDO and therefore had an interest not necessarily aligned with potential long-term debt investors that relied on the CDO and its collateral to perform well.

The SEC also announced charges against Merrill Lynch, which structured and marketed the Norma CDO.

"Shannon and Parish could not serve two masters," said George Canellos, co-director of the SEC's division of enforcement. "They allowed Magnetar to influence asset selection and abdicated their duty to pick only the assets they believed were best for their client."

Shannon agreed to be barred from the securities industry for at least two years and must pay disgorgement and prejudgment interest of $140,662 and a penalty of $116,553. Parish agreed to be suspended from the securities industry for at least 12 months and must pay disgorgement and prejudgment interest of $140,662 and a penalty of $75,000.

Without admitting or denying the SEC's findings, Shannon and Parish consented to dissolve the NIR business.

SEC approves new FINRA lending rules

New rules in the US on securities loans and borrowings, permissible uses of customers' securities, and callable securities have received Securities and Exchange Commission (SEC) approval.

The Financial Industry Regulatory Authority (FINRA) proposed the three new rules for securities lending and borrowing transactions, which the SEC approved on 4 December 2013.

Under Rule 4330, a member firm cannot lend securities held on margin for a customer without prior authorisation, and those that borrow on behalf of a client must notify FINRA at least 30 days before doing so while ensuring that the transaction is appropriate for the client's financial position.

Rule 4314 stipulates that a member firm must disclose that it is acting as an agent in a securities lending or borrowing transaction, making the distinction between agent and principle clearer. It must also maintain books and records reflecting the details of the transaction.

Clarifying requirements applicable to callable securities, Rule 4340 requires member firms to establish an impartial lottery system to allocate callable securities in the event of a partial redemption or call.

AXA IM extends partnership with State Street

AXA Investment Managers has extended its investment operations outsourcing mandate with State Street for an additional five years.

The firms have been partnered since 2004, when State Street was appointed to provide middle-office services, including transaction management, investment books and fund accounting, collateral management, performance measurement and reporting, across three countries for €300 billion in assets.

Since 2004, State Street and AXA IM have broadened their relationship and State Street now services more than 1200 AXA IM funds and mandates with approximately €500 billion in assets.

The relationship has also expanded globally and now includes servicing in 10 different locations across Asia, Europe and the US.

Christophe Coquema, chief operating officer of AXA IM, said: "At AXA IM we constantly strive to ensure that excellent service and a focus on the needs of our clients remains at the forefront of everything we do. This contract extension is a reaffirmation of our confidence in State Street's ability to support our growth plans worldwide, and recognition of the quality service they deliver to us and to our clients".

Raphael Remond, head of State Street in France, said: "Asset managers face a challenging environment and are looking for growth through innovation. To support this they need flexible and agile infrastructures that enable them to quickly

launch the new products and solutions that their investors require, increasingly on a global scale."

"These pressures are driving a new, closer relationship between asset managers and their servicing partners, and opening up a new frontier of outsourcing based on wide-ranging, innovative solutions."

FTT is alive and deadly, warns UK parliament group

The European Commission's approach to the enhanced cooperation behind the Financial Transaction Tax (FTT) has been "unjustified and misconceived", according to a UK House of Lords committee.

The Economic and Financial Affairs Subcommittee of the House of Lords EU Committee issued its report, Financial Transaction Tax: Alive and deadly, on 10 December 2013 following the release of its initial thoughts on the tax in March. The European Commission outlined the details of the FTT in February.

The report blasted the 11 member states' decision to move forward with the FTT under enhanced cooperation, which is an extraordinary procedure that EU countries can use if broad agreement on a rule or law is impossible.

Enhanced cooperation has been used to create an EU-wide patent system, and in the field of divorce law. The 11 countries going ahead with the FTT are Germany, France, Italy, Spain, Belgium, Austria, Portugal, Greece, Slovenia, Slovakia and Estonia.

The Lords committee is worried that European Commission has ignored the effects that the FTT could have on non-participating EU member states, including the UK.

A Council Legal Service opinion, issued in September, concluded that the proposal does not comply with EU law, while the Lords committee rejects the artificial distinction between the FTT's imposition and its collection, "which the commission draws in order to play down the impact of its proposal for the 11 participants on the non-participating majority of member states".

The report said: "We believe that impact would be considerable. The tax would have to be levied in the UK on behalf of the 11, with potential damage to our markets but no benefit to the exchequer. All EU markets would suffer if, as we think likely, the effect were to drive transactions offshore."

The Lords committee slammed the commission's approach to enhanced cooperation, which it described as "unjustified and misconceived".

"This approach undermines the commission's obligations to defend the interests of participating and non-participating member states alike. We were surprised by the commission's assertion that its proposal was deliberately radical, with the intention that the participating member states could cut out what they disliked."

The UK government was next to be criticised, because of its "diffident approach" to the FTT and a reluctance to listen to the committee, all of which has been "deeply frustrating to witness".

"It was only after constant and repeated warnings on our part that the government finally awoke to the serious threat to the UK's, and the broader EU's, interests that an FTT pursued by other member states might present."

The Lords committee backed the UK government's decision to challenge the legality of creating the FTT under enhanced cooperation. It filed a complaint with the Court of Justice of the EU in April 2013.

Lord Lyndon Harrison, the committee's chairman, said: "The committee is still firmly of its original view that an EU Financial Transaction Tax is flawed and potentially damaging to the economic well-being of the UK."

"What we now have before us is a proposal to allow a breakaway group of EU countries to proceed with their own FTT, which would have a serious negative impact on the UK and other non-participants."

"The commission has a duty to all 28 of its member states equally, and this sort of cavalier approach to legislation risks making losers of us all."

One commentator warned in June 2013 that the FTT could have a damaging effect on returns and prevent securities finance participants from making a profit.

Repo markets would be the hardest hit, said the commentator, with an estimated cost of €198 billion to Europe's largest banks. The short average duration of repo transactions make them particularly susceptible to the tax, he explained.

He added that proposed exemptions to the tax, including collateralised loans, central bank funding and central counterparties, could become a focus for business.

The International Securities Lending Association is also fearful. In June 2013, it said that the tax could "close down" the securities lending market.

"At least 65 percent of the European securities lending market would disappear as a result of the FTT."

It noted that more than €2 billion of revenue would be lost to long-term investors, while close to €500 billion of EUR government bonds would be removed from the lending/ collateral markets.

Shorter dated transactions would be disproportionately affected, increasing the risk of settlement fails by possibly as much as 100 percent, and securities lending fee levels would need to increase by more than 400 percent just to maintain current revenue streams for long term institutional investors.

The real problem with the FTT is that it would hit pension funds and savers in the UK, not just in the 11 participating member states, according to James Walsh, policy lead for EU and international matters at the National Association of Pension Funds (NAPF), who spoke in response to the Lords committee's report.

"The FTT would apply when UK pension schemes buy shares in companies or do business with banks based in the 11 FTT member states."

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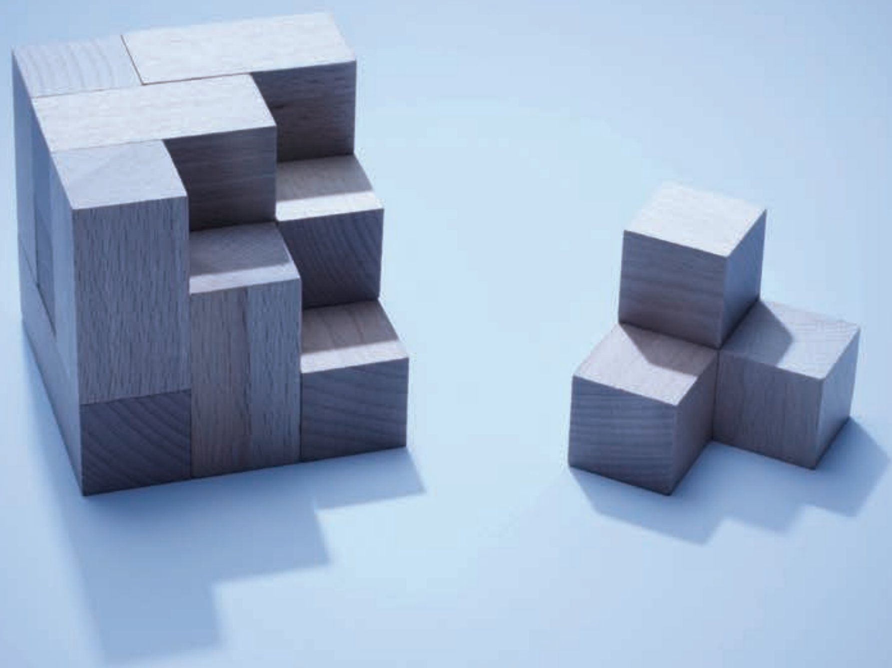

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"EU policy chiefs should be looking for ways to encourage saving and extend workplace pensions to the 60 percent of EU citizens who currently have no access to one. Taxing saving more heavily will not help."

TradeStation adjusts pricing on equities

TradeStation has implemented new "unbundled" equities commission pricing designed to benefit traders who trade very actively and seek lower trading costs.

The new pricing plan aims to give participating clients the flexibility to route their orders directly to exchanges or market centers that offer fees and rebates with the potential to offer considerable commission savings.

The new commission plan builds on TradeStation's efforts to develop pricing options that give equities and options traders greater flexibility and better value in choosing commission plans that best align with their trading frequency and style.

TradeStation recently unveiled new, lower-priced "flat-fee" equities and ETF pricing to benefit active traders, as well as new "flat-fee" options pricing. TradeStation also offers per-share equities and per-contract options pricing to clients who prefer those pricing alternatives.

"Unbundled pricing continues our efforts to provide clients with the greatest possible flexibility and value in choosing their commission plans," said Salomon Sredni, CEO of TradeStation Group and COO of Monex Group.

"Each exchange or market center charges different fees and awards rebates based on how a trader's order interacts with the markets. Unbundled pricing will give clients the ability to route their orders to the exchange or market center offering pricing that best suits their trading style and objectives."

"We'll continue to review and revise our menu of pricing options to ensure that TradeStation offers flexible, value-added pricing for traders at every level."

IOSCO publishes regulatory issues report

The International Organization of Securities Commissions has published its report on regulatory issues raised by changes in market structure, making four recommendations that seek to promote market liquidity and efficiency, price transparency, and investors' execution quality in a fragmented environment.

The report identified possible outstanding issues and risks posed by existing or developing market structures and described how these risks should be addressed.

Finally, it recommended that regulators monitor the impact of fragmentation on market quality.

The report comes in response to a 2010 request from the G20 that IOSCO "develop recommendations to promote markets´ integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments".

The report looked at the trading of equities and exchange-traded funds on the most common trading spaces identified in a survey of different jurisdictions, including exchange trading market systems, non-exchange trading market systems, and over the counter trading.

It did not include the trading of derivatives products.

The consultation report was published for public comment on 21 March 2013. Twenty-one comment letters were received from associations, brokers, banks, and data providers.

This final report outlined the current state of play in market structures in most IOSCO jurisdictions, affirming the main findings and chal-

lenges identified through the 2012 survey and the 2013 public consultation.

Hedge fund launches fall to three-year low

New hedge fund launches declined to the lowest level in nearly three years in Q3 2013, while the number of hedge fund liquidations rose to the highest level since Q4 2012, according to the HFR Market Microstructure Industry Report.

The trends in launches and liquidations occurred in Q3 as US regulators proceeded toward approval of the Volcker Rule.

The Volker Rule prohibits companies affiliated with banking entities from taking short positions with certain securities and derivatives.

New fund launches totalled 231 for Q3, declining from 288 in the prior quarter and 275 in Q3 2012, representing the lowest quarterly launch total since the Q4 2010 when 220 funds were launched.

A total of 816 new hedge funds launched in the first three quarters of 2013, narrowly trailing the 824 funds launched in the same period in 2012.

Hedge fund liquidations increased to 222 funds in Q3, an increase on the 190 liquidations of the previous quarter and the 211 liquidations of Q3 2012, representing the highest quarterly total since 238 funds liquidated in Q4 2012.

Continuing the trend of prior quarters, average hedge fund management and incentive fees declined industry wide, with average management fees falling 1 basis point (bps) to 1.53 percent, while incentive fees declined 11 bps, to 18.2 percent.

Similarly, management and incentive fees charged by the funds launched in 2013 were lower than those charged by funds launched in 2012.

Kenneth Heinz, president of HFR, said: “Hedge fund launches declined in the third quarter, as both managers, investors and financial institutions awaited the finalization and regulatory approval of the Volcker Rule, which includes provisions restricting proprietary trading by financial institutions, as well as restricting ownership of hedge fund firms by financial institutions.”

“While the increased uncertainty has likely adversely impacted hedge fund launches in the short-term, over the intermediate to long term, the adoption of the rule is likely to result in increased hedge fund launches, as experienced investment professionals set up new funds utilising their trading acumen.”

Daiwa Europe migrates repo to Inferno

The investment banking arm of Japan’s Daiwa Securities Group has successfully transferred its multi-billion dollar repo business onto Torstone Technology’s back-office processing platform, Inferno.

Torstone’s Inferno now processes Daiwa Capital Markets Europe’s bilateral repo, buy/sell back, triparty, pledge and securities lending trades, and also trades settled via a central counterparty from repo electronic communication networks such as BrokerTec and TP Repo.

Jim Baseley, head of operations at Daiwa Capital Markets Europe, said: “This project represents a huge step forward in our programme of organisational change. With the extra capacity and flexibility Inferno gives us we can respond much faster to the market and provide a sound platform to grow our business.”

Torstone CEO Brian Collings added: “The success of this project is not only down to the experienced, excellent development team but also the flexible nature of the system. Inferno has been built in such a way that new business logic can be added with relative ease.”

The Finnish line

Lago Kapital's Jarkko Järvitalo shines a light on Finland, where securities lending and borrowing is on the rise, but obstacles to business remain

MARK DUDGALE REPORTS

What is Lago Kapital and what does it do?

Lago Kapital provides securities lending and financing services. Located in Finland, it is regulated by the local financial authorities, is owned by its key personnel and is fully bank-independent. We essentially act as a securities borrowing and lending broker for our clients

When did securities lending begin as a practice in Finland?

Securities lending started in the late 1990s with the LEX stock lending product run by the Helsinki Stock Exchange. It was regarded as a derivative instrument, where the stock exchange was the central counterparty to each loan. LEX lending was designed mainly to help with delivery failures.

OTC lending started when Finland's corporate tax law was amended to facilitate securities lending. It was amended so that securities could be lent without the transfer being regarded as a sale. This was, however, limited to a maximum period of 10 days and it was mainly used for delivery failures. For short sales, the loan had to be re-booked every 10 days, resulting in high settlement costs.

But the OTC lending market truly kicked off in 2008 when the 10-day rule was eliminated and the new maximum period was set to one calendar year. The Nordic banks quickly took over the securities lending market and the LEX product was soon closed down.

What does Finland's securities lending market look like today?

The current OTC market is cash collateralised due to tax legislation (there is no tax exempt transfer of ownership in non-cash collateral). Business is quite small on a global scale, but the top five names in the OMX Helsinki 25 index are very liquid. Indeed, there have been lots of specials lately, including Nokia, Outokumpu, Outotec, Talvivaara and Neste Oil. The rest of the market is now catching up as new lenders are coming on-board.

Beneficial owners, including fund and investment companies, are increasing their interest in lending, while hedge funds and private investment companies are increasing their demand for both Finnish and foreign securities. We are working with independent fund companies, and there are also insurance companies, foundations and investment companies.

There are two main problems with securities lending in Finland. The first is that in Finland, as I mentioned above, securities cannot be used as collateral. Unfortunately, Finnish law has not been updated to reflect EU directives, so the transfer of funds as collateral is viewed as a sale and a purchase. In the past, the tax authorities have discussed the possibility of derivatives transactions not being viewed as sales, but they have said nothing about securities lending.

As a result, collateral has to be cash, although there is a legal way around it. If a party lends securities to another and is owed collateral, the party can borrow securities, so there will be netting.

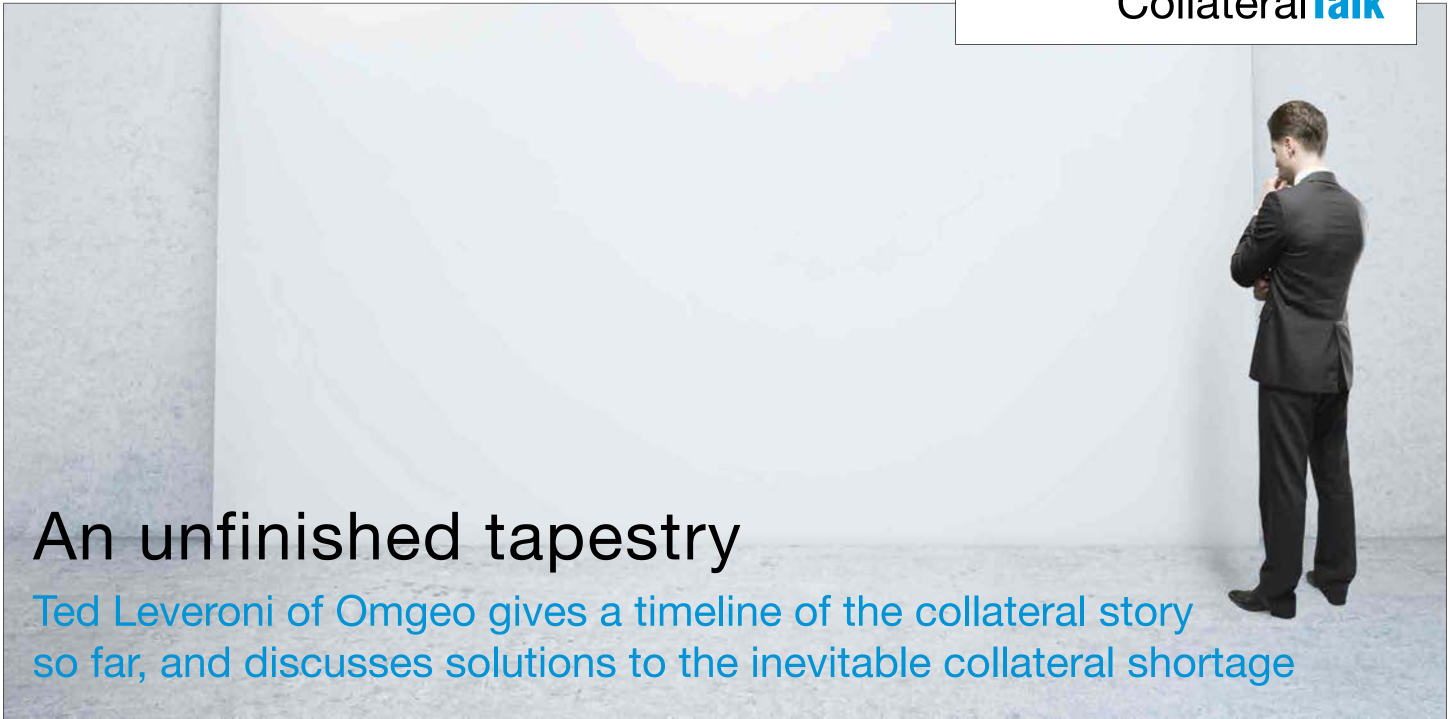
The other problem is that only companies under the Finnish corporate tax law can lend securities with no tax issues. A private individual can only borrow securities. It has been said that private individuals cannot lend out securities because they do not do the same book keeping as institutions. It is a very bad situation for us because there are a lot of specials in Finland at the moment. We have a lot of private clients who are actually borrowing a lot of securities from us. They can borrow it in but not lend it out, so you can see the frustration.

How can Finland help with the elusive Russian market?

Finland can be used as a safe gateway to Russia and vice versa: Finnish funds have significant Russian holdings, and Russian counterparties have trust in the Finnish market regulation and transparency.

The Finnish government is in fact pushing Finnish companies to do business in Russia because they see that opportunities are growing and risks are reducing. We were chosen for a government-sponsored project where we get a lot of help from professionals in Russia. What we are exploring right now, with the help of local attorneys and specialists within the Russian markets, is a pre-study on whether we can do securities lending on a much bigger scale in the Russian markets. Right now, we are borrowing and lending Russian securities, but they are mainly from Finland-based Russian companies, and now we would like to work with Russian clients as well. **SLT**

Jarkko Järvitalo
CEO
Lago Kapital



An unfinished tapestry

Ted Leveroni of Omgeo gives a timeline of the collateral story so far, and discusses solutions to the inevitable collateral shortage

The collateral story continues to attract attention from participants in the derivatives market, and concerns over the potential collateral squeeze are still evident in the industry. The new rules relating to how and where trades are executed, settled and cleared will, as a consequence, place a strain on collateral availability.

There have been various attempts over the past 12 to 18 months to analyse how much additional collateral will be required as a result of central counterparty clearing for standardised derivatives. However, it's impossible to know what the final collateral requirement will be as estimates are based on existing volumes. Regulatory rules will change the way market participants behave—some may chose not to trade swaps, while others may turn to new products such as futurised swaps. This will impact which collateral obligations firms need to adhere to, and in turn, how much collateral they will need.

A collateral shortage, of some degree, is inevitable. This year, the US got off the starting blocks and began phased implementation of central clearing under the Dodd-Frank Act. Europe is following suit with its own variation of rules under the European Market Infrastructure Regulation (EMIR). This is already impacting how firms are using their collateral.

But the story does not end here. Two further initiatives will heighten the problems around collateral availability. The first is the new requirements for two-way margining for forward-settling agency mortgage-backed security transactions (ie, to be announced transactions) and the second is Basel Committee on Banking Supervision/International Organisation of Securities Commissions (BCBS/IOSCO) rules relating to the margining requirements for bilateral OTC derivatives transactions. These initiatives, while necessary from a risk mitigation perspective, will cause additional strain on collateral resources, which will reverberate across the entire derivatives markets.

The US Treasury Market Practices Group (TMPG) published new recommendations for best practices for mortgage-backed securities markets in November 2012. Its recommendation that "forward-settling agency MBS transactions be margined in order to prudently manage counterparty exposures" will significantly impact the industry, to varying degrees across market participants, especially given the end of the year deadline to be substantially complete in implementing a margining process.

While predominantly a US market, any foreign entities trading TBA's with US counterparties will be subject to the new rules. And regardless of the geographical scope of the MBS market, its sheer size of approximately $270 billion in value traded daily (where the majority of transactions are forward-settling TBA trades) means that the impact on collateral availability will be global.

A similar sentiment applies to BCBS/IOSCO's rules relating to the margining of bilateral OTC derivatives transactions. There is wide acceptance that OTC derivatives play an important role in firms' abilities to hedge their risk, but the decision has been made and these trades will soon be subject to both initial and variation margin requirements. As a result, firms which trade these instruments are now under increased pressure to define and implement an effective response to this forthcoming requirement.

Policymakers have, seemingly, listened to the industry's concerns about the potential collateral squeeze and extended the list of eligible collateral, including, for example, equities. It is now up to national regulators to devise their own rules, based on BCBS/IOSCO recommendation, but the fact that the list has been expanded is a positive move.

Today, equities aren't that commonly used as collateral. However, with the appropriate haircuts and protection strategies to account for what might come of the equity markets, such as concentration limits and market cap weightings, more firms are likely to be comfortable using equity as collateral.

But even with an expanded list of eligible collateral, firms that do not have a robust, flexible, sophisticated collateral management process and technology in place will be affected the most.

Some firms already have collateral management departments that leverage sophisticated and flexible technology across asset classes. For those firms, it will be important that they review their processes and technology to ensure that they can handle all changes in margining processes where applicable.

However, others firms do not have the operational or technical expertise in collateral operations, nor do they have the systems to properly support collateral processes. For those, building an in-house solution or leveraging their existing licensed technology is not an option. They will need to find a suitable collateral management solution that can process and manage collateral. In either case, firms must consider the impact on their operations—people, processes and systems—when selecting a solution to address these new requirements. **SLT**

Ted Leveroni
Executive director of derivatives strategy
Omgeo

EMIR: full steam ahead

Rule Financial's Emily Cates takes a look at the progress of European Market Infrastructure Regulation compliance programmes and implementation

The European Markets Infrastructure Regulation (EMIR) rules governing trade reporting came in to force on 23 February 2013. Eleven months on, what are the current delivery timeframes for compliance initiatives and how are firms and institutions responding to the implementation of the legislation?

Trade reporting

Trade reporting obligations were originally expected to be enforceable from 1 July for credit and rates and 1 January for foreign exchange (FX) and equities. However, due to delays in the approval of trade repositories by the European Securities and Markets Association (ESMA), the mandatory reporting requirement for all trades is now set for February. There has also been much confusion with regards to the products that are classified as a derivative trade under EMIR and therefore fall within its scope. For example, FX spot transactions have been confirmed as out of scope by the UK Financial Conduct Authority (FCA) (in line with the Markets in Financial Instruments Directive, or MiFID), although any type of FX forward remains within scope.

To further complicate matters, ESMA's recommendation to delay exchange-traded derivatives (ETD) reporting due to a lack of clarity in the marketplace was rejected by the EU Commission. It was initially anticipated that ETD transactions would not need to be reported until 2015. This revelation has proved troublesome for those firms that have deferred the implementation of an ETD trade reporting solution.

A number of aspects of the trade reporting mandate are currently proving difficult to implement. Foremost among these is the creation of a unique transaction identifier (UTI), which both counterparties will need to use in order to identify the trade with a trade repository. Deciding which counterparty will need to generate the UTI, and then determining how best to exchange, consume, track and maintain it over the life of a derivative transaction, are just some of the IT headaches currently being experienced.

Allied to this issue is the task of back-loading. ESMA has stipulated that all trades that were live between 12 August 2012 and the go-live date need to be back-loaded to the chosen trade repository. This is not a trivial task and as the need for an agreed UTI is thrown into the mix, it is causing many an operational headache.

Reconciliation and dispute resolution

EMIR business conduct rules were enforceable from 15 September 2013, and dictate that all institutions (financial and non-financial) have in place processes and procedures for confirmation matching and escalation, portfolio reconciliation and escalation, portfolio compression, mark-to-market models, and inter-group transactions. Many of the processes for meeting these requirements are still extremely manually intensive and, although there are a plethora of third-party vendors offering services in this space, many are still in their infancy. For this reason, a number of firms have not made decisions on whether to implement third-party solutions.

The initial challenge faced by firms striving to comply with the business conduct rules is the need to amend existing legal documentation so that it incorporates the operating procedures for the new requirements. This can either be achieved through contract re-negotiation or by implementing the International Swaps and Derivatives Association (ISDA) 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure protocol. The protocol requires that active resolution of disputes is achieved within five business days, and some derivative operations departments have stated that they will need to increase their department's dispute resolution resources significantly in order to accommodate this new regime.

Many institutions are behind the curve in this area, having devoted a large proportion of their compliance efforts to meeting the trade reporting mandate. Although it is anticipated that authorities will initially be reasonably lenient with firms that are not fully compliant, it's only a matter of time before regulators will have to start enforcing the rules in order to hit home the point.

All on board?

Central counterparties (CCPs) all over the world are applying to ESMA for recognition under EMIR. This is because in order to continue offering services to EU members and their subsidiaries without inflicting a 2 percent risk weighting on their transactions, CCPs will need to be EMIR compliant. Although 29 non-EU CCPs have already applied, the prevailing view is that this is not enough, as many non-EU CPPs are not fully aware of the implications of not being a qualifying central counterparty (QCCP). From 15 September 2013 (which was the CCP application deadline), ESMA has six months to approve CCPs for QCCP status. The earliest a CCP could be approved was 15 September 2013 and the latest is 15 March. ESMA will then take a further six months to publish the technical standards for the clearing obligation.

At some point between April and September, QCCPs will start to launch central clearing for OTC products that have not been cleared before. It remains to be seen whether there will be a front loading rush of CCPs wanting to be first to market. However, it is important to keep in mind that ESMA also needs to deliver a public register for the CCPs—this will then inform wider industry activity, which will then trigger on-boarding, etc.

For CCPs, the process of launching a new product is highly complex as they will have to develop standardised pricing models, back testing, and 'what if' scenarios, and fully test the product in Beta test environments before launch. The participants that are then obliged to clear the product through a CCP will need to decide which CCP to use (if there are more than one), agree the pricing models, standardise the confirmations, and accept the margining terms. It's a resource-hungry process for all involved (the exchange, CCP and participant) and the concern is that volume capacity will be reduced by the added impetus of imposing a clearing obligation deadline on the participants.

There is also the possibility that while some participants will meet the clearing obligation threshold and will be forced to trade OTC, others will not and will therefore be able to continue to bilaterally trade the same product that those meeting the threshold will have to clear. This could lead to pricing arbitrage opportunities where a clearer may use a different pricing model compared to two bilateral counterparties.

Parking your collateral

Once the initial trade reporting deadline in February 2014 has been met, firms have six months to report the collateral associated with those initial transactions, and will need to report any collateral changes thereafter on an ongoing basis; this can be done either at a portfolio level or an individual trade level.

Because most participants are focusing on the 86 fields of information required for day one reporting, few are considering the longer-term collateral reporting requirements. In many institutions, the collateral management systems are independent from the OTC and ETD trading/back-office systems and the collateral associated with each is not directly linked. In the same way that UTI generation, exchange, mapping, and tracking are causing problems in the world of trade reporting, the linking and tracking of collateral baskets to UTIs or portfolios will create challenges for collateral management and the trading/back-office systems.

The inclusion of collateral as part of the broader trade reporting mandate is intended to ensure transparency around client portability and risk mitigation in the event of a default. Most custodians and general clearing members are still formulating their client segregation models and are currently looking to offer three to four different options depending on the client's requirements. Despite wanting to keep their primary assets with their preferred custodians, many firms will be prohibited from doing so by an ESMA directive that stipulates that CCPs must keep collateral with custodians that have a recognised securities settlement system.

Understandably, custodians are now considering the huge business impact of not becoming a recognised securities settlement system, with many exploring the option of partnering with recognised securities settlement systems in order to satisfy the criteria. Others are considering white label arrangements with securities settlement systems. All of the above considerations need to be made in a developing landscape of quad party arrangements and TARGET2-Securities, which are gradually harmonising the securities settlement systems landscape.

En route

With the impending regulatory deadlines and the need to show compliance with EMIR, most firms are speeding along the road to compliance. However, it's clear that CCPs, custodians and other major infrastructure service providers, which have arguably faced the most formidable of regulatory challenges, have some catching up to do if they are to get their compliance initiatives across the finish line before the deadlines hit. They will be the ones that have the most to gain or lose in the race to comply and, although they may have gotten off to a slow and uncertain start, they are beginning to gather pace. Some uncertainty remains, but most firms are at least en route to regulatory compliance. **SLT**

Emily Cates
Operational processing specialist
Rule Financial

The path most travelled

Northern Trust is tracking multiple regulations, including Basel III and Dodd-Frank

MARK DUGDALE REPORTS

Which regulations are of most concern to Northern Trust as an agent lender?

At Northern Trust, we track regulations that may directly impact the services provided to lenders by securities lending agents, as well as those that would have an indirect effect on borrower demand for securities. The regulations that we are particularly focused on at this time, due to timing and scope, are the US implementation of Basel III capital rules, Dodd-Frank Section 165(e) single counterparty credit limits, Basel III large exposure and leverage ratio proposals, the Volcker Rule, and the Financial Stability Board Review's (FSB) of shadow banking.

Many of these regulations affect lending agents because of the borrower default indemnification they provide to the clients in their securities lending programmes. Two of the proposed rules, Basel III large exposures and Dodd-Frank single counterparty credit limits, are similar in concept and limit an institution's cumulative exposure across business lines to a given counterparty. Indemnified securities lending is one type of activity that is part of the exposure calculation. Both of these regulations are currently in draft form.

The US implementation of Basel III capital rules, on the other hand, was finalised in July 2013 and affects the amount of capital agent lenders must set aside as a result of the indemnified lending activity. Given the introduction of a standardised approach in the rules for the US implementation of Basel III, along with the Collins Amendment, indemnified securities lending activity may be more capital intensive for agent lenders in the future.

The Basel III supplemental leverage ratio proposal is an example of a regulation that may have more of an indirect impact on agent lending activity. Under the draft rule, indemnified lending transactions would not have a material contribution to the leverage ratio measure for agent lenders, but the treatment of securities lending activity for borrowers acting as principal on such transactions may affect their demand for certain types of securities. Additionally, compliance with the Volcker Rule may have implications on the securities lending cash collateral vehicles that an agent lender offers.

Finally, the FSB's Review of shadow banking published recommendations in August 2013 for securities lending matters related to transparency and cash reinvestment. It is also considering further policies on minimum haircuts.

How is securities lending being treated in terms of exposure?

The way that securities lending exposure is measured under certain regulations is punitive relative to the actual risk associated with the transactions. Generally speaking, several of the regulations apply a haircut-based approach to measuring securities lending exposure, with the haircuts themselves being conservative. Under the haircut-based methodology, the securities lending exposure is calculated based on the difference between collateral and loan values, with both collateral and loan amounts being adjusted (either down or up, respectively) by prescribed regulatory haircuts driven by their security type and other characteristics. Additional haircuts are applied in the instance of a currency mismatch between collateral and loan.

The rules are particularly penalising on indemnified loan transactions collateralised by non-cash collateral, such as equities, given that there appears to be an implicit assumption that the loan and collateral positions (even of the same security types) move in opposite directions. It would be more appropriate to take into account whether the loan and collateral positions are correlated and to consider the likely direction of markets in times of stress and counterparty default. Custody banks (including Northern Trust) have urged regulators to consider alternative ways of measuring securities lending activity using methods that capture some of these correlations and an element of right way versus wrong way risk.

Which regulation will have the biggest impact?

This will likely depend on the institution. Certainly, institutions that have been deemed to be in the Basel global systematically important banks (GSIB) or the global systemically important financial institutions (G-SIFI) categories by the FSB are going to be subject to more stringent rules under certain regulations. These institutions may be more sensitive to the Basel III large exposures or Dodd-Frank single counterparty credit limits since the threshold concentration for exposure to any single counterparty is lower (10 to 15 percent) for activity between institutions having GSIB and G-SIFI status compared to the 25 percent for others.

How will indemnification be affected?

It is difficult to say at this point. Although the capital rules have been finalised, other regulations are still in draft form.

Historically, borrower default indemnification was an accommodation that agent lenders offered to clients. In the past, this indemnification may have been more explicitly priced in the clients' fee arrangements. The industry has evolved, and due to competitive pressures, borrower default indemnification is more commonplace and in most cases, an expectation or a requirement for clients to participate in securities lending.

Given the finalisation of the US implementation of Basel III capital rules, indemnified securities lending activity will become more expensive for US agent banks to offer. There is an effective date of January 2015 for the new capital rules, but institutions will need to disclose their capital ratios prior to that time, such that the impact may be seen sooner. Basel III capital rules do not prevent banks from offering indemnification altogether, but their return on capital may be impacted by the increased cost of offering such indemnification.

Securities lending profitability is very much considered in the custody bank's pricing models, so the broader custody pricing may also be impacted in the future. Finally, under either the Basel III large exposures or Dodd-Frank single counterparty credit limits as proposed, there may be more limitations on an agent bank's capacity to provide indemnification. **SLT**

Kristin Missil
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Curbing the market maker

Repo desks in Europe are a critical tool and important for financing European debt—but the activity could be subject to the Financial Transaction Tax

Tim Keenan
Global product manager
BondLend

Arne Theia
Head of repo and collateral trading markets
UniCredit Bank AG

Oscar Huettner
Senior consultant
Finadium

Nick Gant
European head of repo and securities finance
Newedge UK Financial

How important a financing tool is the repo desk in Europe?

Nick Gant: Financial institutions have a number of options when it comes to the management of their balance sheets. Repo has traditionally been a heavily used part of the management toolkit, and prior to 2008, unsecured funding played a significant part in this activity. However, post 2008 and the demise of Northern Rock, a huge reduction in unsecured funding occurred, propelling repo to play an even more significant role. The European Central Bank (ECB) clearly demonstrated the value of repo with their short and long term repo operations, with the long term refinancing operation (LTRO) having a huge impact across the market when launched, bringing greater stability and a massive improvement in market sentiment.

As the marketplace has changed, the role of the repo desk has evolved, linking it to collateral management and transformation. The new requirements placed on repo teams, linked with a greater use of previous skill sets, has made the desk a hugely important financing tool.

Tim Keenan: Repo desks in Europe are a critical tool and vastly important for financing European debt. It is effective for funding sovereign bonds as well as corporates and emerging market debt. You can fund bilaterally by trading directly with another counterparty or settle the collateral by triparty repo with any of the major custodians. It is possible to trade anonymously on an electronic platform where all of the trades would be automatically novated to a central counterparty. It is estimated that the size of the European repo market is over €5 trillion, which to me suggests how important the repo market is in the financial markets.

Oscar Huettner: It is difficult to overstate the importance of repo desks to the functioning of the European financial markets. From a dealer's point of view, they provide the most efficient and cost effective method of carrying inventory and covering short positions and therefore are vital to the support of market making activities. From the point of view of an investor, the combination of safety and flexibility make repos a vital option for investing large amounts of short term cash. For clients, they allow the cost effective funding of long positions and the ability to cover shorts efficiently.

Finally, repo remains the primary tool for the ECB to affect monetary policy. No other product or combination of products can fulfill all of these functions as efficiently and with lower market risk than repo.

Arne Theia: The financial market crisis and resulting regulations are changing the world of liquidity and collateral. The big trend is that funding, collateral and clearing is coming together. Modern collateral management is the buzzword. It is a centralised management of cash and non-cash collateral where all resources are pooled and optimised. In many organisations, modern collateral management is done by the treasury or repo desk.

Has the year-end bank levy affected your activity in non-sovereign debt?

Theia: In Germany, the bank levy mostly affects banks that are relying on interbank funding rather than on wholesale or retail funding. Therefore, real client money becomes more important. As the bank levy is not term adjusted, a one day repo causes the same costs as a one year repo. Therefore, trading activities over the declaration date are reduced to a minimum.

Gant: The bank levy is charged on UK banks and building societies, being first announced in June 2010 by the chancellor in his budget. It is levied on both short term and long term chargeable equity and liabilities, but exemptions are granted for repos and stock loans in sovereign and supranational debt. The charge has varied since its inception and currently stands at 13 bps, non-annualised, for short term liabilities exceeding the allowances granted. Clearly a 13 bp non annualised charge removes the profitability of many non SAS repo/securities lending and borrowing trades, especially those of short duration. Therefore, the incentive for conducting non essential activities over the year end is not particularly high and an impact on book size has been felt.

Keenan: If the transaction levy comes into effect for non-sovereign debt, the impact will be huge. The transaction levy will take away any economic benefit that the short-term repo trade could have produced, and consequently any repo trade, short in duration, would wind up producing a trading loss after accounting for the levy. Because the economics will not work, if the levy is introduced, you can expect to see a dramatic reduction in financing transactions in non-sovereign debt. Effectively, this will affect how much outright business is done, if it can no longer be funded in the traditional way through repo.

How expensive is repo business becoming in Europe, and why?

Keenan: I would not say that repo is becoming more expensive in Europe, but things like the Financial Transaction Tax could certainly make a short-term repo transaction completely uneconomical. There are always going to be some securities that trade special or expensive in any repo market. Many times it is the result of market dislocation in that security. It could be that the holders of that security are not lending, and thus the supply is not adequate to meet the demand, hence the rate on that security would become more expensive. There is a view that higher-quality collateral, such as governments and sovereigns, could become more expensive as the regulations regarding derivatives trades kick in. These regulations will require high-quality collateral, making demand for sovereign collateral increase. But as of now, we have not seen that happen.

Theia: Financial business will become much more difficult and expensive, thanks to upcoming regulations. Banks will need more and higher quality of collateral to cover the liquidity ratios under Basel III. Also, more structural term funding is essential. The European Market Infrastructure Regulation (EMIR) requires that OTC derivative business is collateralised. Asset encumberance might limit the reuse of received collateral, and do not forget the Financial Transaction Tax.

They will all drive the costs of repo and funding tremendously. Currently, the monetary policy of the ECB is subsidising the repo markets. But financial institutions have to get ready for a post central bank withdrawal, which will trigger substantial additional costs.

Gant: The regulatory cost increases when conducting repo have already been touched upon, and transactional charges have also risen, despite a faster more flexible settlement process. The drive to conduct more repo activity through a CCP is certainly laudable and practical, but the cost of doing so should not be underestimated. Aside from any transactional charges levied by the CCPs—and these have certainly increased—the cost of pledging cash or non-cash to honour margin requirements has risen due to greater costs of generating margin and the increase in margin requirements , especially during times of stress. Costs of trading through a CCP can reach 2.5 bps before incurring charges levied by any of the main electronic trading platforms themselves.

When you add all of these variable costs together it feels as though Europe has a far higher cost base for conducting repo than other financial centres. The upside to the extra cost burden is that institutions are looking at maximising their use of eligible and ineligible assets to reduce the collateral cost of their activities. New innovations such as the Newedge/MTS sponsored ACM platform to increase the efficient flow of collateral or old techniques such as collateral upgrades are all being utilised to offset an increased cost of trading.

Huettner: All of the following add to the cost of repo: the FTT, mandatory haircuts, the costing of a bank's liquidity buffer, longer term funding for non-liquid assets, increased RWAs and potentially central counterparty clearing. The FTT is far and away the most problematic, as it basically makes repos as we currently know them prohibitively expensive. While many of these other regulations may reduce market risk I believe it is important to point out that they come with a trade-off in that by increasing the cost of financing and short covering they will lead to less liquid financial markets in Europe.

Fixed income in Europe is seeing traction. What would automation for repo bring to the European government market?

Theia: Automation is key to trading markets that are characterised by high volumes and turnovers with low margins. The repo market in sovereign bonds is a centrally cleared electronic market with a high degree of automation. Automation offers cost reduction and is a strong support for the liquidity in primary and secondary markets.

Huettner: Automation of the European repo markets includes a number of different market dynamics each with their own solution. MTS and Brokertec succeeded in automating the inter-dealer sovereign bond market in the late 1990s and continue to dominate in that space. This has been at least partially linked to their use of central counterparty clearing as well as the ease of execution they allow. BondLend has provided automation in the agent lender to dealer space; initially in corporate bonds but increasingly in sovereign securities. ACM initiated a customer to dealer service for tri-party repo in 2013 and several other service providers are entering the secured finance markets in either automated securities lending or cash management.

Where automation has succeeded to date is when low return, repetitive, time consuming trades can be moved to an automated environment and consequently a dealer, lender or borrower can free up valuable time for higher value trades and client relationship management. It has been a slow process as it is often difficult to change the daily routine of market participants but in the long run, platforms that can clearly add efficiency or that can lower cost through central counterparty clearing will succeed.

The one space that I feel is overdue for automation is the dealer to hedge fund market where numerous client positions need to be updated and rolled (short and long) on a daily basis. This applies to equity finance as well. The process of managing these relationships over the phone or by sending emails or Bloomberg screens is increasingly out-dated and is ripe for an automated solution.

Keenan: The more automation that you build with straight-through processing, the more efficient trading becomes. BondLend does just that. It allows for borrowing, lending, repo and reverse repo in an automated, straight-through fashion. It allows you to trade with a number of counterparts at once, with all trades booking into your proprietary system at the point of trade. After an initial setup of schedules by counterpart, your financing in the fixed income markets is processed automatically. Numerous counterparties are using this automation to book the vast majority of their transactions on a daily basis.

What would be the impact if a Financial Transaction Tax is levied on repo activity?

Huettner: There is no way to sugar coat this. The FTT as it has been proposed will kill the repo market in those jurisdictions which implement it and drive volume to those jurisdictions that do not. I generally see two rationales for the FTT. One is the concept that a large amount of revenue can be raised by the imposition of a small tax on financial transactions. The second is that the imposition of a tax will drive out speculative trading and leave only true investors in the market. Both of these approaches are flawed.

Regardless of how it is done, any tax that extracts a large amount of revenue from the European capital markets will have a massively detrimental effect and will ultimately be passed on to investors who will see a reduction in their returns. As for the discouraging high volume trading because it is perceived as somehow speculative and therefore should be discouraged, the precise opposite is true. Allowing market participants to trade what ever volume the market requires without artificial constraints is what give markets liquidity and should be encouraged.

Gant: The Financial Transaction Tax is still clouded in uncertainty. There are a number of different scenarios that have been heavily discussed from no tax to a fully annualised 10 bp charge per transaction. Time frames discussed also vary greatly, indeed even the very legality of the tax has been called into question. The European Repo Council (ERC) and the Internationa Securities Lending Association (ISLA) have worked hand in hand to ensure relevant financial authorities realise that the worst case scenario would be disastrous for the repo market, instantly reducing activity and causing a huge increase to the cost of doing business. The cash market would be negatively impacted leading to an increase in the cost of raising debt by both sovereign and corporate borrowers.

It should also be noted that a long period of uncertainty will be hugely destabilising for the market. Firms need to make investment decisions for the medium term and a lack of clarity usually results in a conservative approach, especially with such a large potential impact.

Keenan: The imposition of a Financial Transaction Tax on repo activity would be devastating. An article put out by the International

Capital Market Association (ICMA) estimates that the repo markets would contract by as much as 66 percent. The knock-on effect of not being able to fund transactions will have further serious negative consequences for other financial markets as well as the real economy. The repo market is critical to the functioning of any financial market. In its current form, the repo market provides a cost-effective and secured funding tool for the market. If an FTT were to be levied to recover the tax, a repo market-maker would have to charge a spread on an overnight general collateral repo of 7205 bps. This is simply unrealistic and would destroy the short-term repo markets.

Theia: The FTT should kill two birds with one stone. But what kind of birds do we kill? On the one hand the financial sector should contribute its share to cover the costs of the crisis and raises public revenues. But what if the implementation costs more than the tax burden? On the other hand it should stop speculative transactions and intermediation, which destabilise the financial system. But less volumes means less tax income. The most negative aspect will be its impact on collateral in the system.

How highly placed is repo on the collateral chain, and what can repo businesses do to ensure that it has an adequate share come a potential crunch?

Gant: Repo is a very efficient and effective tool to acquire large quantities of exchange eligible collateral or LAB eligible assets and to transform or upgrade assets unsuitable for collateral activities into those which are. It is often the starting point of the collateral process and as such it is one of the primary tools to be utilised in the event of difficult market conditions. More and more the collateral manager and the Repo team are intertwined in order to provide both internal and external customers with the most efficient collateral solutions, especially in times of significant market stress. A continuation of this evolution should see a repo business thrive in the face of new regulatory requirements (Basel III, EMIR, etc)

Theia: Regulations seek to create a single market for wholesale and retail transactions in financial instruments. Markets will get more commoditised and transparent. Business will be become more mainstream. Banks might have to offer more of the same and will get less profitable. Cost reduction will make the difference whether to stay competitive in the market or not. And that's the good news for the securities financing industry because their products can reduce funding and collateral costs. To optimise resources, collateral has to be utilised and mobilised in the most efficient way. That also mitigates the risk of a potential collateral crunch.

Huettner: For markets to remain liquid, repo must retain its stay in a liquidation. Any effort to compromise this treatment will dramatically reduce the value of repo. Dealers and clients must be able to continue to fund their positions without any uncertainty around what may occur in the event of a default. I would, however, suggest that repo is a product which is designed for liquid collateral and may not be suitable as a funding alternative for all collateral classes. A deep and transparent market for the underlying collateral class is essential to the safety of a repo transaction. I am not suggesting that non-liquid assets should be excluded from a repo structure, but I do feel that the over use of leverage for some non-liquid assets should be addressed.

What, if any, new asset classes do you foresee being utilised by repo desks in the near future?

Huettner: Staying with the theme that repo is best used for asset classes which have a deep and transparent underlying market, I believe there is significant opportunity in the listed equity space. The efforts of Clearstream and Euroclear to mobilised assets held in domestic depositories should be of significant value here.

Keenan: The repo market can be used for any asset in the financial markets. The important thing to analyse when accepting collateral in a repo trade is how liquid is the underlying market of the collateral being assigned. If the liquidity is generally low, that will mean that you may not be able to sell the collateral if your counterpart defaults. The risk of taking collateral in less-liquid markets is typically offset by the haircut assigned to the price of the collateral. However, if it is likely that the liquidity in the market could dry up, even a high haircut could prove insufficient if the security cannot be sold in a timely manner.

Gant: The beauty of repo is it's simplicity. As long as an asset has a definable value and a mechanism for exchange it can be swapped for cash. Bonds and equities have shown themselves to be excellent repo assets over a number of years, reducing the unsecured funding activities and therefore costs of financial institutions accordingly. Commodities have been suggested and with defined discoverable pricing would lend themselves well to triparty repo. Future receivables can be discounted to their present value and although concerns may exist over their liquidity, especially in difficult market conditions, I would suggest that a rate could be derived to justify this increased liquidity risk—an appealing prospect for those institutions looking for enhanced yields. The brake to this progression into other assets may be regulatory but that aside it is natural to utilise the repo platform to provide secured financing in a wider range of asset classes.

Frost in the air

Fees to borrow social media stocks have cooled over the past two years. With most securities in this sector faring well for long investors, EquiLend's Christopher Gohlke looks at what this mean for the shorts

Securities lenders and borrowers watched the Twitter IPO with eagle eyes as a gauge for the state of the social media sector as a whole. Less than a year and a half prior, when rival Facebook went public, fees to borrow the stock kicked off white hot amid general uncertainty about the staying power of the social media industry's stocks. The short sellers had prudent foresight; within four months the stock had dropped to half its IPO price, and fees to borrow spiked.

But the dip was relatively short-lived. By fall of 2012, Facebook's stock price began to reverse its decline, and fees dropped back down to warm and ultimately general collateral levels, according to DataLend data. Following that experience, how would Twitter fare in its IPO? And what would that mean for the sector?

By the end of trading on 7 November 2013, Twitter's first day as a public company, the stock closed more than 70 percent higher than the $26 IPO price paid by institutional investors to Twitter's underwriters, in contrast to the post-IPO slump that Facebook weathered.

So far, with Twitter, both longs and shorts have avoided the wild ride that Facebook investors endured in its first few months as a public company. In contrast to Facebook's decline, Twitter rose to more than double its IPO price just one month in.

Upon its debut in the securities lending and borrowing market following those first settled trades, fees to borrow Twitter stock were hot—but just a third of the levels Facebook was trading at on its first day of lending. DataLend data show that a week later, Twitter's fees to borrow dropped to lukewarm levels, and despite a slight gradual incline since then, they remain generally low after that day-one peak.

With the social media sphere's (arguably) two most important companies lending at relatively low rates today, it is worth a look at other examples in this sector too.

The social media industry saw plenty of IPO activity prior to the well-publicised debut of Facebook. LinkedIn went public back in May 2011, hot on the heels of the IPO of RenRen, the Chinese Facebook equivalent. In November that year, social coupon company Groupon and crowd-sourced review website Angie's List went public, followed by rival Yelp in March 2012.

Table 1 depicts some of the highest-profile social media companies that have been public for more than a year. Of the six stocks, five are lending at considerably lower rates than a year prior. LinkedIn, the only exception, has been trading almost exclusively in the 7 to 12 bps range for more than a year. With most social media stocks now lending at relatively low rates, short interest in the sector as a whole is fairly low and continues to decline.

That was not the case even further back, when many of the aforementioned stocks were trading at vastly higher rates. In early 2012, Angie's List was lending at upwards of 7000 bps, Groupon at more than 4000 bps and RenRen at more than 1000 bps. The others have followed similar trajectories, all dropping to the general collateral to lukewarm levels of today.

Of course, there are particularities in each stock that have impacted their fees to borrow, and rallying equities markets have resulted in a decline in borrowing rates overall in the past couple years. But the steep declines in fees to borrow social media stocks suggest investor confidence in this sector.

Naysayers claim social media stocks are riding a bubble akin to that of the dot-com era. Forbes, Barron's, Businessweek, CNBC and the Wall Street Journal, to name a few, have drawn comparisons between the two in recent months. But as social media stock prices continue to tick upward, and lending rates cool, it seems short sellers are not buying it for now.

Christopher Gohlke
PR and social media manager
EquiLend

Table 1

	IPO Date	Fees to Borrow 13 December 2012 (bps)	Fees to Borrow 13 December 2013 (bps)
RenRen	04 May 2011	712	123
LinkedIn	19 May 2011	8	11
Groupon	04 November 2011	263	11
Angie's List	17 November 2011	333	87
Yelp	02 March 2012	227	7
Facebook	18 May 2012	14	0.19

Source: DataLend


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A Turning Tide

Taking advantage of cheap capital in the short term is not a fix for a company trading at the wrong price, says David Lewis of SunGard's Astec Analytics

Never one to be short of water or sailing-based metaphors, I preferred a "turning tide" to the oft-cursed phrase of "green shoots" in reference to the changes in the global economy. "A rising tide floats all boats" could also have worked, but is better suited to being used as a mix of compliment and criticism particularly when looking at a company's performance. During 2013, there was certainly a wave of cheap money washing around the market, and that kept more than a few companies afloat, including those potentially uncharitably labelled "zombie firms". But what other events left their mark in 2013 and what part did the preponderance of cheap cash play?

Last year saw several high-profile IPOs, with Twitter leading the charge in terms of size and notoriety if nothing else, but new listings were not the only ones coming to the market. Existing firms looking to raise additional capital have also been to the markets for much needed boosts to their flagging balance sheets. In fact, the first three quarters of 2013 saw listed companies (ie, not including IPOs) raise more than £10.2 billion from investors according to research by Capita. This was more than twice the combined total of 2011 and 2012.

Looking further back, the numbers are even more striking: In 2008 and 2009, a total of £123.6 billion was raised from the markets, 72 percent of that being by financial services companies scrabbling to recapitalise post financial crisis in an environment where ordinary lending had all but dried up. Noting also that this was more than had been raised over the preceding 10 years in total brings this peak into perspective.

While somewhat lower, the 2013 total is still expected to breach £11.5 billion by the end of the year. However, there was one major skewing factor in that statistic—Barclays accounted for more than half this number in one rights issue alone, and at £6 billion it is said to be the fourth largest secondary issue in British banking history. Even after discounting for Barclays, 2013 still exceeded the prior two years put together.

But is this investor appetite for share issues further evidence of the tide turning in the UK and perhaps the global economy or just refinancing opportunism attracted by the cheap cash? Opinion is mixed, of course, but some data would suggest a recovery of some sort is well under way. UK employment was reported to hit new heights in the middle of December 2013 and shares were gaining new highs in major world indices as fears of the effect of the Federal Reserve tapering of its asset purchase programme receded a little. Along with an investor base ready to fund rights issues, these are likely all good signs.

Perhaps it is the reason to come to market that is key: Barclays did not raise the new capital to expand—it was raised to meet new regulatory requirements. Other capital raising, some argue, was done just because it is a good time to lock in low rates and take advantage of the cheap money available. That may be helpful for the bottom line in the short term, but it is more about lowering expenses that enable a growth strategy.

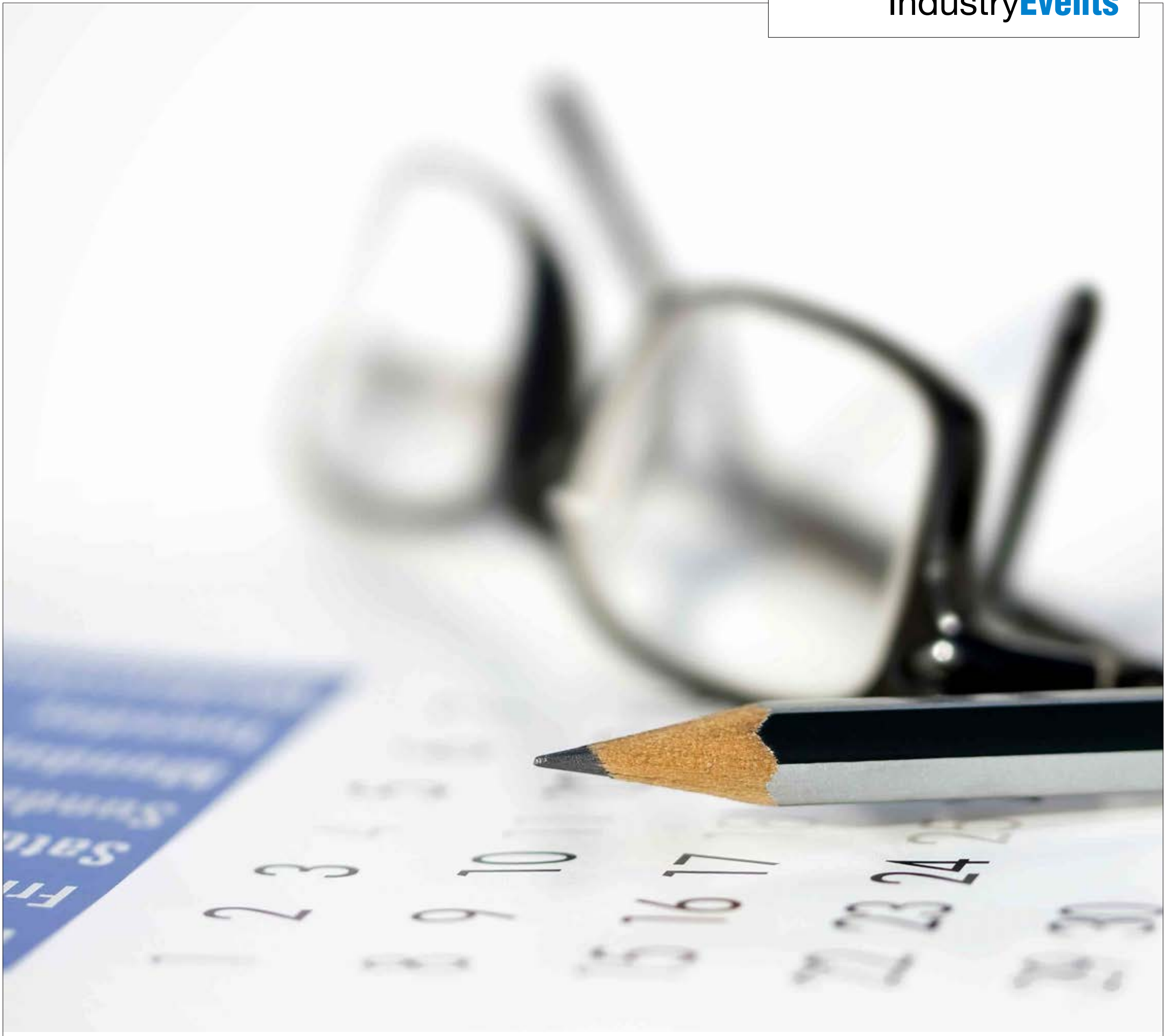
Compare and contrast two other UK-listed firms which both raised new capital in 2013: FirstGroup plc (FGP) and The British Land Company (BLND). FGP issued a rights issue in June last year offering three new shares for every two existing investors held. With the objective of "easing balance sheet constraints" and to part fund asset renewals (replace old buses to you and me) an issue price of 85p was announced on 20 May when the market price for the share was around 155p, implying a discount of 45 percent on that day's market price and 70 percent off the 2013 high of 223p reached only the previous day (Friday 17 May).

Clearly, a dilution of value is expected when additional shares are issued, and in simple mathematical terms, the additional shares at the lower price would indicate a new price level of around 113p per share, ignoring any value benefits the new capital may bring of course. However, short sellers appeared to be banking on a fall of this magnitude and more when borrowed positions soared from 10 million to more than 50 million shares on 23 May. Balances continued to rise to a peak of more than 72 million before dropping away more than 90 percent almost overnight on June 24. Over the same period, FGP shares dropped to 95p which kept them above the issue price, but some way below the theoretical post rights price of around 113p, banking up to 18p per share profit for the short side. Figure 1 shows the volume of shares on loan and the closing price for FGP from 1 January 2013, forward.

British Land (BLND) by contrast placed shares with the market directly, aiming to raise investment capital to support the purchase of new property—what might be more easily identifiable as a plan to raise capital for growth in a recovering property market. BLND saw its share price oscillate between £5.50 and as high as £6.58 following this and other share placing events across the globe.

At the time of writing, BLND shares were worth around £6. Short interest in BLND was negligible throughout the year, ignoring dividend peaks, suggesting that it is not raising capital alone that is the warning signal for share price falls. Raising capital for well-defined expansion plans is potentially viewed much more positively than refinancing, even if both such actions are intended to enhance the issuer's bottom line.

Identifying new trends, especially when they are at the tip of a potential recovery, is notoriously risky, but there does appear to be a distinction that could be drawn from this high level analysis, and that appears to be based on the traditional values of fundamentals. Taking advantage of cheap capital in the short term is not, in itself, a fix for a company trading at the wrong price. Short sellers will seek out such anomalies and the tracks they leave in securities lending data can provide valuable insights for the rest of the market, particularly when trying to steer their ships clear of metaphorical rocks. **SLT**



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Date: 27-29 January 2014
Location: Texas
www.imn.org

IMN is pleased to be heading to Austin, Texas for our 20th Annual Beneficial Owners' International Securities Lending Conference, January 27-29, 2014!

Advanced Risk Management Programme

Date: 09-13 February 2014
Location: London
www.cass.city.ac.uk

On behalf of RMA and Cass Business School, we want to bring to your attention our Advanced Risk Management Programme offering. The 2014 Programme is scheduled to take place on 9-13 February. As the process to identify an appropriate participant and budget for their attendance can be fairly long, we wanted to raise your awareness as soon as possible.

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Date: 17-19 June 2014
Location: Berlin
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Industry appointments

Richard Wallace has joined the Options Clearing Corporation as senior vice president and chief compliance officer.

Wallace moves to OCC from Foley & Lardner in Washington DC, where he was a partner.

He represented securities broker-dealers, hedge funds, mutual funds, and investment advisers and their employees, in US Securities Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) investigations and disciplinary proceedings.

Previously, Wallace served as vice president and chief counsel in FINRA's market regulation department. He has also served as a branch chief and attorney with the SEC's division of enforcement.

Wayne Luthringshausen, chairman and CEO of OCC, said: "It is a pleasure to welcome Wallace to OCC. [His] proficiency in securities law and regulation qualifies him as a fine fit to lead OCC's compliance department in the new and continually evolving regulatory environment."

SIFMA has appointed **Ananias Blocker** as executive vice president of public policy and advocacy. Blocker was most recently managing director, federal affairs manager in the US Office of Public Policy at UBS.

In his new role at SIFMA, Blocker will be responsible for SIFMA's governmental affairs and advocacy initiatives. He will begin in January.

Blocker represented UBS on a wide range of issues with a primary focus on banking, securities, and other financial services issues on Capitol Hill and in the executive branch.

Prior to his role at UBS, Blocker was vice president of government relations at the New York Stock Exchange (now NYSE Euronext), where he was responsible for developing and coordinating lobbying strategy regarding market structure, corporate governance, international economic relations, and tax issues.

SIFMA also confirmed the appointment of **Kenneth Bentsen** as president and CEO.

Bentsen previously served as SIFMA's president.

This follows former Senator Judd Gregg stepping down as CEO. He will continue working with the association as a senior advisor.

Jim Rosenthal, SIFMA chairman and COO of Morgan Stanley, said: "Bentsen has been an outstanding member of the SIFMA management team for the past five years and we are pleased he will lead SIFMA in our important mission of ensuring trust in our financial markets and fostering an understanding of the important role effective and efficient capital markets play in financing a growing American economy."

Bentsen added: "SIFMA will continue to communicate the important work our members do in promoting effectively functioning markets as a critical underpinning of broad economic growth and job creation. SIFMA has the benefit of an outstanding member base and a talented employee team both of which I look forward to working with in this new role."

Prior to being appointed president of SIFMA, Bentsen served as executive vice president of public policy and advocacy since 2009.

In that role, he oversaw SIFMA's legal, legislative and regulatory affairs. Prior to joining SIFMA, Bentsen was president of the Equipment Leasing and Finance Association. He was also a member of the US House of Representatives.

Wedbush Securities has hired **Sean Trager** to spearhead the firm's prime brokerage offering.

Trager's role will be vice president of the firm's correspondent services group.

His role is to enhance the platform to optimise service for emerging and mid-sized money managers, as well as start-up hedge funds.

"From our dedicated securities lending team and robust reporting capabilities to our strong emphasis on risk management, Wedbush's prime services capabilities are designed to streamline operations for the small and mid-sized money manager," said Rich Jablonski, senior vice president of Wedbush Securities, Correspondent Services Group.

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