SECURITIES LENDING: YOUR QUESTIONS ANSWERED

ISLA

INTERNATIONAL
SECURITIES
LENDING
ASSOCIATION

CONTENTS

Introduction	2
Securities Lending - The Basics	4
What Role Do Agent Lenders Play	5
Why Should I Lend?	6
ETF case study	8
What Are The Risks Involved In Securities Lending	10
What happened when Lehman Brothers collapsed?	13
Does Securities Lending Improve Market Efficiency	16
If I Lend Securities, Wont They All Be Used To Support Short Selling?	17
Is There Academic Evidence That Upholds The Benefits Of Short Selling	19
Aren't Regulators Against Short Selling	20
No Link Between Stock Lending and Negative Stock Returns	22
Is There A Conflict Between Securities Lending and Corporate Governance	23

INTRODUCTION

Mature and liquid securities lending markets (including markets for repurchase agreements and other economically equivalent transactions) generally improve the functioning of securities markets by allowing sellers ready access to securities needed to settle transactions where those securities are not held in inventory; by offering an efficient means of financing securities portfolios; and by supporting participants' trading strategies.

Draft Recommendations For Securities Settlement Systems, CESR/ESCB Consultation Paper October 2008.

The financial markets have been subject to unprecedented pressure since mid 2007 and few investment strategies have emerged from the resulting chaos unscathed. Quite understandably, this has given rise to a large amount of surrounding commentary and criticism - and while much of this has been balanced and well-meaning, some of it has been misinformed and led to a great amount of misunderstanding.

Although securities lending is designed to be a relatively low-risk activity, it has not been wholly immune from this confusion. The failure of Lehman Brothers presented many challenges for the industry, and whilst there were some losses in cash collateral programmes that have rightly led many lenders to reassess their risks, on the whole these were dealt with proficiently. In addition, there has been uncertainty both over the reasons behind the emergency short-selling bans imposed in certain markets and over how these temporary measures affect beneficial owners and their lending programmes.

The International Securities Lending Association has put together this publication in order to offer existing and potential participants a balanced and objective overview of the securities lending market. The booklet should help dispel some myths and showcase the potential revenues securities lending can offer beneficial owners as well as the wider benefits it brings; it also highlights some of the potential costs, risks and pitfalls that all owners should consider before embarking on a lending programme.

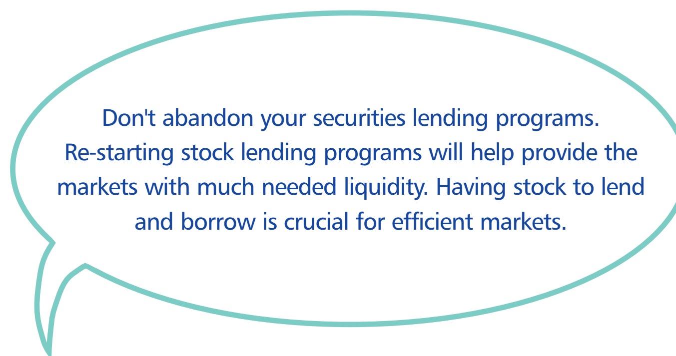
As well as affording owners a relatively low-risk form of gaining additional return from their securities portfolios, securities lending delivers tangible and well-proven benefits to market liquidity, pricing and securities settlement.

The benefits of securities lending have been widely recognised by regulators around the world, by national and supranational organisations and by academics. Index providers, such as FTSE International, include the existence of a well-functioning securities lending market in their criteria for a country's inclusion in their developed market indices.

ISLA and its members hope this publication is of use and welcome your participation in the market.

We have consistently made it clear that we regard short selling as a legitimate investment technique in normal market conditions. Both economic theory and empirical studies support this. Short selling can enhance the efficiency of the price formation process by allowing investors with negative information, who do not hold stock, to trade on their information. It can also enhance liquidity by increasing the number of potential sellers in the market. This tends to increase efficiency by increasing trading volumes and reducing transaction costs.

Temporary short selling measures, Consultation Paper 09/1 - Financial Services Authority, January 2009.

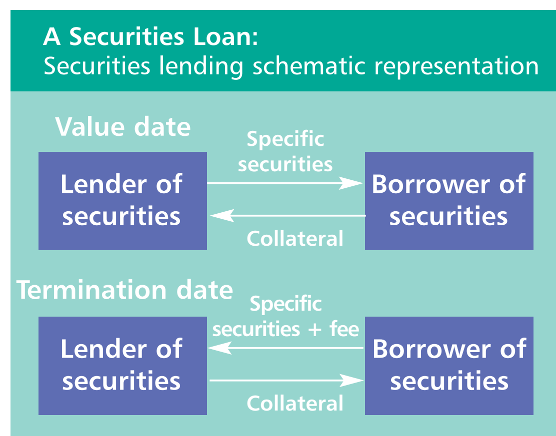


Chris Hitchin,
Chairman National Association of Pension Funds,
January 2009.

UK pension body urges funds to start lending stock again, David Walker, Financial News, 22 January 2009.

SECURITIES LENDING – THE BASICS

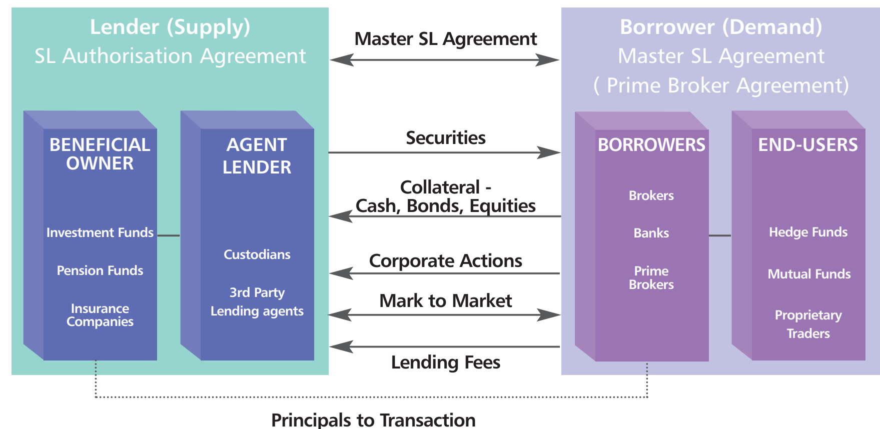
Securities lending is the temporary transfer of securities by one party, the lender, to another, the borrower. The securities borrower is required to provide acceptable assets as collateral to the securities lender in the form of cash or other securities. Legal title passes on both sides of the transaction so that borrowed securities and collateral can be sold or on-lent.



In general:

- Loans have no fixed maturity and either party can unwind the transaction on demand, known as an 'open' trade.
- The lender remains exposed to price risk on the lent securities since the borrower can return them at a pre-agreed price. Normally the lent securities remain on-balance sheet.
- The borrower agrees to compensate the lender for any dividends or similar benefits received on the lent securities by making ('manufacturing') equivalent payments
- The lender no longer has the right to vote on lent securities but can recall equivalent securities from the borrower if it wishes to vote.
- If the borrower provides securities as collateral to the lender, it pays a fee to borrow the lent securities. If it provides cash as collateral, the lender pays interest to the borrower and reinvests the cash at a higher rate, earning a spread.

WHAT ROLE DO AGENT LENDERS PLAY?



Agent lenders are third party specialists in securities lending services. Many beneficial owners choose to outsource their lending programmes to agents in order to reduce their operational workload and to gain from the agents' efficiencies and economies of scale as well as their established relationships with securities borrowers. By pooling together different clients' securities and managing their lending programmes, their services can prove attractive particularly – although not exclusively – to the smaller lender. Agent lenders typically trade with many borrowers, giving access to broad pools of demand and diversifying counterparty credit risk. A beneficial owner may choose the agency lending programme of its custodian bank or that of a third party specialist agent lender.

Agent lenders will typically: evaluate potential borrowers according to pre-agreed credit guidelines; negotiate rates; monitor loans; provide daily mark-to-market evaluations to ensure adequate collateral coverage; collect fees from borrowers; monitor client accounts for sale activities; provide clients with reporting on outstanding loans and revenue earnings on portfolios.

Most agent lenders can provide indemnities against borrower default. These will typically provide for either the full return of lent securities to a lender or the payment of cash equivalent to the value of lent securities at the time of the default.

In a typical agent lender relationship, a beneficial owner may place limitations as to which counterparties can borrow its securities, what type of collateral it will require in return and what haircuts and margining levels it requires for different types of collateral and counterparty.

WHY SHOULD I LEND?

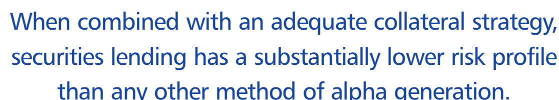
The business of securities lending can seem yet another obscure corner of Wall Street. But it is big business for funds with huge portfolios of stocks. The profits earned from securities lending are one reason why index fund companies like Vanguard can charge clients such small fees. They can also boost overall pension-fund returns.

Securities Lending Is Being Squeezed, Craig Karmin, Wall Street Journal, 1 October 2008.

Firstly, for profit. Securities lending revenue can be important in a field as highly competitive as fund management, where small differences in performance can significantly affect performance ranking. Looked at another way, the additional income can be used to defray custody charges or other expenses of the fund.

As should be expected, returns from securities lending programmes increase in proportion to: firstly, the interaction of demand and supply, secondly the amount of risk a lender is willing to assume. Demand for any given security will vary from time to time; whilst 'general collateral' securities, for which there is low demand and excess supply, will afford lenders lower returns, securities subject to greater demand will offer significantly higher returns.

On the risk side, lenders willing to take a wider range of collateral securities than the safest G-10 government bonds will have higher lending balances and therefore higher revenue. Those prepared to take cash collateral and reinvest in the money markets also have the opportunity to earn additional returns.



When combined with an adequate collateral strategy, securities lending has a substantially lower risk profile than any other method of alpha generation.

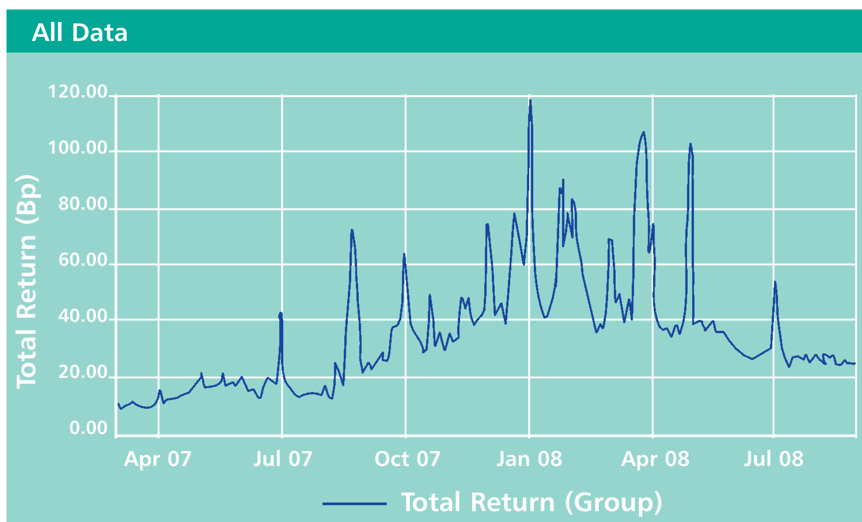
Roel de Groot, Head of Treasury, KAS BANK

Other factors influencing returns include: the nature and size of the securities portfolios available for lending; the stability of the portfolio; and the tax status of the lender.

The chart below shows how total returns across the market (ie including the intrinsic return from lending securities and potential cash collateral reinvestment returns) rose from an average of around 20 basis points between March and September 2007 to around 35 basis points between March and September 2008.

Mark Linklater, Head of Securities Lending at APG Investments, the asset manager of the €195bn Dutch civil service pension scheme.

Quoted in Stock lending – worth the candle? Nina Röhrbein. IPE.com, 21 January 2009.



Source: Dataexplorers.com

iShares ETF CASE STUDY

Barclays Global Investors (BGI), which manages the iShares programme, is the world's largest exchange traded fund (ETF) provider. It runs its securities lending programme in a manner that is consistent with the conservative nature of its institutional pension fund clients. Risks are actively managed by carefully selecting well-capitalised borrowers, taking collateral greater than the loan value, and revaluing the loans and collateral on a daily basis. For instance, the collateral instruments that BGI can accept for its European iShares funds are governed by UCITS rules and include G-10 government debt, high quality corporate debt (A1 or higher), and equities from approved market benchmarks.

The collateral types and limits are set to protect BGI's lending funds, with collateral margins varying from 102.5% to 115%, depending on the assets provided as collateral. BGI's independent Global Credit Group can quickly adjust counterparty credit limits and increase the level of over-collateralisation to reflect changes in market conditions. Finally, BGI never releases a loan until all the required collateral has been received and only releases collateral once the loaned security is returned. As shown below, many iShares ETFs have historically benefited substantially from securities lending activities, which have lowered the effective total expense ratio (TER) of the funds participating in the securities lending programme.

Table 1: Lending returns inside 10 selected European iShares ETFs for 2004 - 2008

iShares ETFs	Fiscal Year	Securities Lending Return to the ETF (bps)				
		2004	2005	2006	2007	2008
iShares MSCI Turkey	31-Oct				115	
iShares DJ Euro STOXX Select Dividend	29-Feb				15	33
iShares FTSE/Xinhua China 25	29-Feb			3	25	30
iShares DJ Euro STOXX 50	31-Oct	19	25	27	29	
iShares FTSEEurofirst 80	29-Feb		25	34	25	28
iShares FTSE/EPRA European Property	29-Feb				3	25
iShares DJ Euro STOXX SmallCap	29-Feb			5	13	25
iShares S&P 500	29-Feb		6	6	8	8
iShares MSCI Eastern Europe	29-Feb				9	7
iShares MSCI Emerging Markets	29-Feb				1	3

Securities lending intersects with ETFs in two different ways: firstly, investors can earn revenue generated by the manager who will lend out the constituent assets of the ETF; secondly, investors can lend out their ETF units themselves. The manager's activity benefits all fund shareholders, as the portion of securities lending revenue available to the ETF is paid directly to the funds and is reflected in their net asset value. Any individual ETF holder that decides to lend their units will meanwhile accrue that revenue directly. The combination of potential lending revenue from within and of the ETF can help investors partially, or in some cases completely, offset the TER incurred while holding their ETF position. As shown, the combination of lending within the iShares fund and lending of the iShares units exceeded the TER in selected cases, though the aggregate lending return was achieved in varying proportions depending on the fund.

Table 2: Lending returns inside iShares ETFs, and from lending the units

ETF	TER	Lending returns inside the ETF	Market data from lending the ETF units	Total revenue	Excess return
iShares Russell 2000 Index Fund (US)*	20	14	115	129	109
iShares FTSE 250	40	1	90	91	51
iShares DJ Euro Stoxx 50	35	29	20	49	14
iShares MSCI Emerging Markets (US)*	74	9	85	94	20

Sources:
iShares II plc ANNUAL REPORT AND AUDITED FINANCIAL STATEMENTS for the thirteen month period ended 31 October 2007 iShares plc ANNUAL REPORT AND AUDITED FINANCIAL STATEMENTS for the year ending 29 February 2008 iSHARES® RUSSELL SERIES 2008 Annual Report to Shareholders — March 31, 2008 iSHARES® MSCI SERIES, 2008 Annual Report to Shareholders — August 31, 2008. BGI and Data Explorers Limited – average data as of 11/2008, www.performanceexplorer.com
.

Audited lending revenue for each fiscal year, adjusted for a 12 months period
Past performance is not a guide to future performance and may not be repeated
** Please note that the regulatory framework for US iShares is different from European iShares, so if you would like further information on the securities lending process in the US please contact us.*

WHAT ARE THE RISKS INVOLVED IN SECURITIES LENDING?

There is no such thing as a free lunch – so it should come as no surprise that the maxim applies just as much in the securities lending business as elsewhere. The risks involved in securities lending should neither be under- nor over-estimated. However, they are quantifiable and, if properly understood and monitored, manageable.

Furthermore, lenders can assume more or less risk through their lending and/or cash collateral reinvestment programmes, depending on their risk appetite. As can be expected, lenders that seek higher returns either through cash reinvestment programmes, by lending out larger balances or by adopting more flexible collateral policies will incur more risk than lenders that employ more conservative policies.

The most important risk that beneficial owners should consider is the credit or counterparty risk - namely the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter, typically as a consequence of an insolvency.

Following a counterparty failure, under a robust legal agreement such as the Global Master Securities Lending Agreement (GMSLA), a lender is only exposed to loss if the value of collateral held is insufficient to cover the repurchase of the lent securities (together with any outstanding dividend and corporate action proceeds). This might occur because of large market movements in the intervening period between the lender's last margin call, and the point at which the lender is able to liquidate his collateral. Lenders may also be exposed if the markets for either the collateral taken or the lent securities are illiquid at the time of the default. As experienced in many sectors of the market in 2007/2008, illiquid securities will tend to realise much lower prices (if any) than liquid alternatives.

To minimise this risk, however, counterparts can define their acceptable collateral parameters to ensure that only liquid securities are used. Secondly, they can employ "haircuts" to ensure that they hold a buffer of collateral over and above the value of the lent securities.

Importantly, securities lending transactions are at-call products and are almost all conducted on an "open" basis, meaning that either side can cancel any outstanding transactions without penalty with a minimal notice period. In a deteriorating credit environment a lender can reduce his exposure to, or even cease trading with, a counterpart in very short order.

HOW CAN I MANAGE MY CREDIT RISK?

An analysis of securities lending market risk reveals levels significantly smaller than benchmark risk measures. Although its returns are smaller, securities lending – with Sharpe ratios in excess of market benchmarks – provides extraordinary risk-adjusted performance.

Assessing securities lending risk-return performance in a portfolio context, Ben Atkins & Glenn Horner, The RMA Journal, May, 2006.

In the first instance, lenders should undertake formal credit evaluations and select their counterparts carefully. Some beneficial owners will need to comply with specific regulatory requirements: for example, UCITS funds. The main risk control measures are:

- **impose credit and concentration limits vis-à-vis each counterparty** - Lenders should select their counterparts carefully, taking care to chose well-capitalised borrowers, and impose strict concentration limits on each. They can quickly adjust counterparty credit limits and increase the level of over-collateralisation to reflect changes in market conditions.

- **impose strict collateral selection criteria** – Lenders should determine collateral acceptability paramaters according to their risk thresholds – for instance a European pension fund might stipulate that the collateral it accepts includes G-10 government debt and, perhaps, equities from approved indices or high-quality corporate bonds. Lenders may set limits on risk concentrations and to ensure diversity of collateral. Since the likelihood of a collateral shortfall following the default of counterparty depends on: (i) the volatility of the value of lent securities (ii) the volatility of collateral taken in and, (iii) the correlation between two values, they should also examine the level of covariance between the collateral taken and the value of lent securities.

- **impose haircuts on loans** - Lenders should impose haircuts on the collateral received, varying these according to liquidity, volatility and co-variance parameters. These haircuts will help to protect lenders against the possibility that the value of the collateral will fall relative to the lent securities in the period between default and realisation.

- **mark to market and margin daily** – Lenders should further minimise their risk by marking their positions to market at least daily, and ensuring that collateral is topped up if necessary. This will help eliminate the risk of a collateral shortfall if a counterparty defaults.

- **secure indemnities from lending agents** – Beneficial Owners can secure indemnities from their lending agents which may provide for full replacement of the lent securities regardless of the value of the collateral, or for the return of the cash value of the lent securities at the time of default ('credit of proceeds').

During late 2007 and mid 2008 many securities lenders revisited their lending programmes, examining their counterparties' credit risk profiles and their collateral acceptability programmes. Many lenders ceased lending to weaker or weakening counterparts and recalled any outstanding loans they had on with

them; others adjusted their collateral criteria and or increased the haircuts and margin rates according to the liquidity or perceived riskiness of the collateral. An ISLA survey conducted in late-2008 found that most lenders which responded had stopped taking asset-backed securities as collateral and many had ceased to take corporate bonds. Some had restricted collateral to G-10 government bonds, although many were still taking equities listed on major indices as collateral against equity loans.

Historically, lenders had typically set haircuts of 102% on collateral denominated in the same currency as the lent securities and 105% on collateral with currency risk. The survey found that most lenders had raised these haircuts for some or all collateral types. Market practice had become more diverse, with haircuts varied by collateral type and, in some cases, by counterparty. But typical haircuts on equity loans were 102% or 105% against G-10 government bond collateral and 110% against equity collateral. As a mitigant against both counterparty and asset price volatiltiy risks, margins are clearly subject to change in the light of market conditions.

WHAT IF MY COUNTERPARTY GOES UNDER?

Following an event of default, securities lending agreements, such as the GMSLA, provide for the non-defaulting party to calculate a net exposure to the defaulting party. The non defaulting party has no claim on the defaulting party to return the lent securities, reflecting the fact that securities lending is, legally, a transfer of ownership, but in the event that the borrower defaults, the lender would set off the market value of its collateral against the market value of its lent securities. The value of the collateral, including haircuts, should normally be higher than that of the lent securities, leaving the lender with a net liability to the defaulting party. The lender owns the collateral and can either, in the case of securities, sell it or, in the case of cash, use it in order to repurchase the lent securities in the market. Due consideration should also be given to any indemnities offered.

> “The recent stress in the market has provided a real-world test of our programme risk controls. Through the Lehman default we learned that our collateral margin was enough to avoid any losses and our default procedures ensured a timely repurchase of any outstanding positions. To us the credit crisis has highlighted the importance of oversight vigilance and the importance of limiting reliance on the rating agencies.”
>
> *Mark Linklater, Head of Securities Lending at APG Investments.*
>
> *“Stock lending – worth the candle?” Nina Röhrbein. IPE.com, 21 January 2009.*

WHAT HAPPENED WHEN LEHMAN BROTHERS COLLAPSED?

Lehman Brothers, which was a major prime broker and borrower of equities and bonds, collapsed in late 2008. In the weeks up to its failure, many lenders had eliminated or reduced their securities lending exposures to the bank, taking advantage of the fact that most loans are callable, so that lent securities must be returned within the normal settlement cycle on demand. Others had tightened collateral eligibility guidelines or raised margin levels.

On the morning of 15 September 2008, administrators were appointed to Lehman Brothers International Europe (Lehman) and most securities lenders immediately declared an event of default, based either on the appointment of the administrator or the admission by Lehman that it was unable to perform its obligations under the lending agreement.

Most lending agents also took the approach of selling collateral in order to buy back lent securities in the market. In this way, lenders were restored to their original position of owning the lent securities. Any net exposure to Lehman was then calculated as the cost of repurchasing the lent securities less the funds raised from sales of collateral.

Given the margin requirements on collateral, most lenders were left with a surplus, even after deducting their costs, which is now owed to the Lehman administrators. Some, however, may have been left with a deficit, and therefore have a claim on Lehman in administration.

This was more likely to have been the case if they had been holding collateral that fell in market value relative to the securities they had lent in the week after 15 September. However ISLA believes few lenders in fact suffered material losses. And even in these cases, lenders with indemnities would have been protected from losses by their agents.

In some cases it was unfeasible to sell collateral securities and/or repurchase lent securities in the market: typically because the markets in those particular securities were illiquid. Legal agreements, however, gave the non-defaulting parties the alternative approach of valuing their securities using dealer quotes in order to calculate their net exposure to the defaulting party.

Those lenders were subsequently left holding the collateral securities until such time as it was feasible to replace them with the lent securities. Again, lenders that had indemnities from agents will have been protected from any consequent risk.

WILL THERE BE ANY CHANGES FOLLOWING THE LEHMAN DEFAULT?

Lehman was the biggest counterparty default in the history of the securities lending market. In general, the mechanisms designed to protect lenders against counterparty risk (collateral, margin, the set-off process under the legal agreement etc) worked well.

For beneficial owners, Lehman highlighted the importance of:

- Active management of counterparty exposures
- Choice of collateral in relation to the lent securities
- Liquidity of lent securities and of collateral; and
- Indemnities from agent lenders, including the nature of the coverage.

At an industry level, the process revealed the advantage for the non-defaulting party of having some flexibility in the close-out process. In particular, older agreements, such as the Overseas Stock Lending Agreement, require collateral to be sold and lent securities bought in the market on the day following the default. The GMSLA gives a longer five-day window, which worked much better.

In its work on the new 2009 version of the GMSLA, ISLA is introducing lessons from the Lehman default and incorporating additional flexibility: for example, over the exchange rates used to convert foreign currency amounts by the non-defaulting party and to give a valuation methodology even where dealer quotations for securities are unavailable. ISLA will support a protocol allowing lenders and borrowers to agree to adopt these new post-default provisions even if they choose to maintain existing, older agreements.

Finally, following industry lobbying, tax authorities in some countries (eg US and UK) have agreed that the disposal of lent securities following a default should not be treated as a sale for capital gains tax purposes, provided equivalent securities are repurchased in the market. It is also important to note that in the UK sales of collateral and purchases of lent securities as part of the post-default process are not subject to stamp duty.

ARE THERE ANY OTHER RISKS?

Yes there are – securities lending transactions involve daily movements of securities and cash associated with, for example, the opening and closing legs of trades, marking to market and dividend payments. These bring the potential for settlement, legal/documentation and operational risks that must be managed.

Settlement risk could arise if, for example, lent securities were delivered in one settlement system prior to the receipt of collateral securities in another system. In order to avoid this risk, most lenders will either require settlement of both legs in a delivery-versus-payment system or require securities borrowers to pre-deliver collateral at the initial borrow, and pre-deliver the borrowed securities, or funds, at the return. Pre-delivery does, of course, expose the borrower to settlement risk and many borrowers are taking steps to limit these exposures by favouring delivery-versus-payment settlement wherever possible.

Operational risk can be defined as the possibility that a transaction does not work as planned because of human or system error giving rise to a financial exposure. Because securities lending is operationally-intensive, many lenders choose to outsource their operations to specialist providers, such as agent lenders and, in the case of collateral management, triparty agents. Their investment in automated systems reduces operational risk.

In a triparty arrangement, securities and/or cash are delivered to a single independent custodian bank, clearing house or central securities depository (CSD). The lender is afforded the same legal protection it enjoys in a bilateral arrangement, but benefits from outsourcing the operational aspects of the transaction to the third party agent. In addition the lender avoids the expense of managing deliveries in or out of a depository account, since under a triparty arrangement agents merely make book entry moves between participants.

While not risk-free, participation in a well managed securities lending programme is generally seen as a safe method of adding incremental income to a portfolio without any significant impact on, or risk to, the overall investment programme.

Robert A. Dennis, C.F.A., PERAC Investment Director, Commonwealth of Massachusetts, Public Employee Retirement Administration Commission.
The Basics of Securities Lending & Commission Recapture.

All participants should be alert to possible settlement risks and take steps to ensure that daylight exposure is recognised and properly controlled; this should include controls on the replacement or renewal of collateral. Where securities and collateral do not move within the same settlement system or country, particular care should be exercised to ensure that value for security is provided in a timely fashion to minimise daylight exposure and settlement/counterparty risk. This may include requirements for the pre-delivery of collateral in appropriate cases.

Securities Borrowing and Lending Code of Guidance.[3]

3. *Securities Borrowing and Lending Code of Guidance, Securities Lending and Repo Committee, December 2004.*

WHAT ABOUT CASH COLLATERAL REINVESTMENT RISK?

Although conceptually separate from securities lending risk, for lenders that take cash collateral, reinvestment risk is key.

Lenders choose cash collateral in order to have an opportunity to generate additional returns from reinvestment in money market instruments. These returns reflect exposure to leverage, giving rise to potential credit, interest rate and liquidity risks. For example, the rebate rate may be based on an overnight lending rate while cash collateral will be invested in a 30-day money market instrument, creating an open interest rate position that generates market risk.

Cash collateral may be invested either in a separately managed account, or in a commingled investment pool. In the case of a separately managed account, the lender will be able to specify the investment mandate of the fund manager in detail. Agent lenders typically offer a number of pooled reinvestment funds with defined reinvestment paramaters and guidelines, offering beneficial owners a range of different risk and return profiles to suit their various risk appetites. In addition, some agent lenders should also be able to tailor the mandated guidelines to suit particular owners' requirements. At all times lenders should be able to obtain regular information about the asset composition of the reinvestment funds and should monitor these risks as they would any other managed fund in which they had invested.

DOES SECURITIES LENDING IMPROVE MARKET EFFICIENCY?

Yes it does. Securities firms and their customers depend on the ability to borrow securities to hedge risks and to arbitrage price differentials across markets. The extent of this arbitrage has an important effect in increasing the efficiency of market prices and in increasing the linkage between securities markets and other markets, such as associated futures and options markets. Short positions are often taken to hedge positions in equity derivatives related to share indices. Without a liquid securities borrowing market, traders would be unable to keep the value of the index contracts in line with the prices of the component shares by arbitraging between them. Liquidity in the futures contracts would thus deteriorate.

> "The informational efficiency of prices is a critical issue in finance because it is a key attribute of capital markets and can have important implications for the real economy. Efficiency is also a public good, because all market participants benefit from more efficient prices… Our evidence suggests that short sellers play an important role in the price discovery process and that their trading activity makes prices more informationally efficient."
>
> *Ekkehart Boehmer, Texas A&M University & J. Wu, University of Georgia.*
>
> *Short selling and the informational efficiency of prices, November 17, 2008.*

IF I LEND MY SECURITIES, WON'T THEY ALL BE USED TO SUPPORT SHORT SELLING?

Contrary to popular mythology, only a fraction of securities borrowing is used to cover short sales by investors with a simple directional view that a share price will fall. Much more commonly, securities are borrowed to cover short positions taken to hedge long positions in a share or a related instrument. Market Makers, for example, will enter into short positions to hedge long positions taken when they buy shares from clients. Their ability to provide liquidity to clients relies on a well-functioning share borrowing market.

Many securities are borrowed to facilitate arbitrage strategies, such as convertible bond, merger, statistical or index arbitrage strategies.

> Most shorting aims to hedge "long" positions in shares, and does not drive down prices overall

unAmerican activities,
The Economist,
October 12, 2001.

> Short selling has become an emotive subject, because its potential misuse is more readily understood than the variety of constructive reasons why a market participant might sell stock it doesn't own.

Adam Kinsley, Director of Regulation at the London Stock Exchange,
Press Release, 5 January 2009.

Exchange welcomes FSA changes to short selling regime.

Examples of arbitrage strategies involving securities borrowing

Convertible bond arbitrage
An arbitrage opportunity occurs when there is a discrepancy in the price of the equity security and its convertible component. If the stock price increases up to the point at which the options are "in the money" and the market value of the bond is lower than the current value of the shares for which the bond can be exchanged, a positive spread can be obtained by buying the bond and converting it immediately. To protect against a decline in stock prices, the bondholder can borrow and sell the securities.

Index arbitrage
At a given moment, an investor can lock in a profit by simultaneously borrowing the securities underlying the index, selling them, investing the proceeds until maturity at the risk-free rate, and buying back the securities underlying the index by taking a long position in an index futures contract. A profit is locked in when the amount that is received from the investment is greater than the futures price paid for the index.

Merger arbitrage
This opportunity arises when a one-for-one share merger is announced and the stock price of the bidding firm is higher than the target firm's stock price. Assuming the acquisition is consummated on the announced terms, investors that hold a number of stocks of the target firm prior to the announcement can lock in a positive spread by borrowing the same number of the bidding company's shares, and selling them.

Statistical arbitrage or Pairs trading
Arbitrageurs will seek to profit from mispriced yield or price spreads among related financial instruments, for instance by putting on a spread trades when the yield discrepancies between given stocks is determined to be statistically significant. The apparently undervalued security is bought, while the apparently overvalued security is sold short. Often they will borrow securities to satisfy the short position on the spread trade.

ARE THERE ANY OTHER REASONS FOR BORROWING?

Yes - at least another two. Firstly, short positions will arise as a result of failed settlement. If shares were not made available for borrowing, chains of failed trades would be common, as market participants would be unable to deliver shares themselves because other counterparties had failed to them. Securities lending has already been an important element in shortening settlement cycles and helping to avoid settlement failures.

Secondly, financing. Financing drives many transactions, particularly in the markets to borrow G-10 government bonds. For example, in the so-called 'collateral upgrade' trade, a bank might borrow G-10 government bonds against equity or high-quality corporate bond collateral with the intention of using those bonds, in turn, to raise cash in the government bond repo markets.

I ACCEPT THAT THERE ARE MANY REASONS PEOPLE MIGHT WANT TO BORROW MY SECURITIES, BUT I COULD STILL BE LENDING TO SHORT SELLERS; ISN'T THAT BAD?

No. Short sellers have no more influence over share prices than any other traders. Since most institutional investors are still constrained to be long only, the universe of potential buyers of shares is much larger than that of potential short sellers. If selling pressure caused share prices to fall below fair value, others would invest and the share prices would correct.

Furthermore, academic theory and common sense suggests that the best way to get a fair price for a share is to allow all market participants, with their varying views, to trade in the shares. Putting obstacles in the way of those that believe share prices are over-valued will only make prices less efficient. In effect, it removes a class of traders from the market who believe shares are overvalued but do not currently own them. Under such a scenario, all investors will then be worse off in the long run, because they would be more likely to trade at prices that are too high in relation to underlying fundamentals.

Virtually every piece of empirical evidence in every journal article ever published in finance concludes that without short sellers prices are wrong.

Charles M. Jones Professor Finance and Economics and Chair of the Finance and Economics Division at Columbia Business School.

Assessing the Ban.

Finally, short selling is no one-way bet. Buyers of shares can only lose the amount of money they invest and they benefit from the long-run bias for share prices to rise as economies grow. By contrast, short sellers face potentially unlimited losses and that bias is against them. Nor is it obvious how the rights issue process creates a one-way opportunity for short sellers. They may benefit if the share price falls below the rights issue price. But they have no magical powers to keep it there. The rights process does not prevent buying by investors who believe the share price is too low.

IS THERE ANY ACADEMIC EVIDENCE THAT UPHOLDS THE BENEFITS OF SHORT SELLING?

There is plenty of evidence from the world of academia to uphold the thesis that short selling benefits markets. Bris, Goetzmann, and Zhu (*Markets around the world,* 2006) conducted country-level analysis on short sales practices in 46 equity markets, showing that stock markets in which shorting is prevalent are more efficient compared to countries where short selling is prohibited.

Chang, Cheng, and Yu (Short-Sales Constraints and Price Discovery: *Evidence from the Hong Kong Market*, 2007) meanwhile found that individual stock returns at the Hong Kong stock market exhibited less positive skewness when short-sales restrictions were lifted, suggesting that short sellers were helpful in incorporating bearish information into prices.

For every short sale, there is a commitment to buy. That generates liquidity. Giving pessimists and optimists equal opportunities to commit their capital engenders competition that enhances price discovery. Since much short selling in equity markets is done to hedge risks, market volatility suffers in its absence.

Arturo Bris,
Professor Finance at IMD,
Opinion, WSJ, 29 September 2008.
Shorting Financial Stocks Should Resume.

Overall our results do not provide any reliable evidence to support the criticism of short sellers. Instead, our results suggest that the dominant role of short sellers is to facilitate the alignment of prices with fundamentals, promoting market efficiency.

Asher Curtis, David Eccles School of Business,
University of Utah & Neil Fargher, The Australian National University.
December 2008.
Does short selling amplify price declines or align stocks with their fundamental values?

AREN'T REGULATORS AGAINST SHORT SELLING?

There should be some parity between going long and going short. We need the shorts in our market in order to balance so we don't have bubbles...

SEC Chairman Cox – CNBC interview, July 16, 2008.

Absolutely not – although without a careful understanding of the bans, their background and the results, it would be possible to conclude that the 2008 bans on short selling reflected a regulatory refutation of the practice's benefits. In fact, nothing could be further from the truth, since senior financial regulators across the world have repeatedly spoken out in public about the benefits arising from short selling.

The first issue to note on the bans is that while each and every ban differed, none of the bans prohibited lending, most of the bans related only to financial stocks and many of them only prohibited the practice of naked short selling – rather than all short selling. Some regulators, for instance, had concerns about the effect on market prices of large 'naked' short sales, beyond the reasonable size that could be borrowed for settlement, and instigated the bans, in part, to encourage timely settlement and to prevent persistent fails to deliver.

BUT DIDN'T THE RECENT SHORT SELLING BANS DISPROVE THIS?

No strong evidence that restrictions on short selling changed the behaviour of stock returns. Stocks subject to the restrictions behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved.

Professor Ian Marsh and Norman Niemer of the Cass Business School, London November 2008.

The Impact of Short Sales Restrictions.

No - the market data and academic studies have shown that the temporary bans introduced in 2008 were ineffective in supporting stock prices.

Even more troubling was the ban'seffect on market liquidity. "Liquidity dried up", wrote Arturo Bris, a finance professor at IMD in an Opinion piece published in the *Wall Street Journal*. "With lenders halting their stock loans, volume down and regulatory uncertainty high, less capital flowed into trading of the 799 stocks. Bid-ask spreads increased more for the 799 stocks than for the market overall."

Bris also found that: the intra-day trading range almost doubled for the 799 stocks over the week; that investors had difficulty getting pricing for stocks, and that stocks reacted sluggishly to news.

In its study of the ban in the United Kingdom for the London Stock Exchange, the Capital Markets Cooperative Research Centre found that liquidity was significantly weaker in the stocks affected by the ban. In addition, the stocks subject to the short selling ban experienced a subsequent increase in spreads that was 150% greater than the increase in spreads in a control sample taken; market depth declined more markedly for the stocks subject to the ban, decreasing by approximately 59%, compared with only 43% for the control group and the number of trades and volume of shares traded fell by roughly 10% in the affected stocks after the ban, although it actually increased by 50% in the control sample.

Overall, the ban was a bit like drinking a Coke on a long-empty stomach. It might have stopped the growling for a little while, but it made the patient more jittery, the crash at the end of the sugar high was fairly unpleasant and the systemic pain returned in full force. Here's hoping there's no next time anytime soon. But if there is, we need to reach for something much more nutritious than the quick sugar fix of a short-sale ban.

Charles M. Jones,
Professor Finance and Economics and Chair of the Finance and Economics Division at Columbia Business School.

Given that for the vast majority of time, markets operate normally, we are firmly of the view that the positive benefits of short selling outweigh the negative impacts.
Short Selling, Financial Services Authority,
Discussion Paper 09/1, February 2009.

The Task Force will also examine how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions that are critical to capital formation
International Organisation of Securities Commissions (IOSCO) Technical Committee Launches Task Forces to Support G-20 Aims, 25 November 2008.

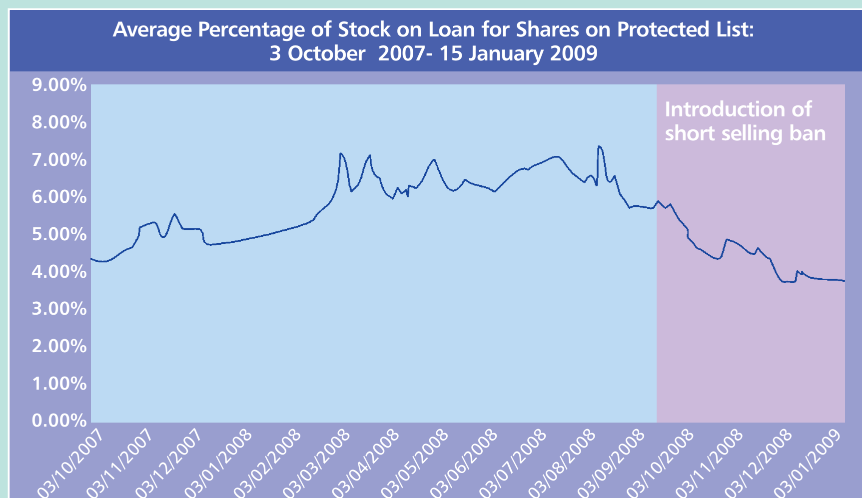
The Commission notes that short selling plays an important role in the market for a variety of reasons, including contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations.
SEC Release, 1 October 2008.

Although perhaps not readily apparent, short selling can advance important economic goals. It can result in more liquidity, more capital formation, and more efficiently allocated risk. Short selling can buttress buying by allowing investors that go long — in other words, that purchase shares to hold as investments — to hedge their positions; and short selling can encourage market participation by leading to improved price discovery. Investors may be more reluctant to buy if the more pessimistic views of short sellers are not fully reflected in securities prices.
Commissioner Troy A. Paredes,
Securities and Exchange Commission, Speech,
Washington, D.C., February 6 2009.

NO LINK BETWEEN STOCK LENDING AND NEGATIVE STOCK RETURNS:

excerpt from Short Selling: Financial Services Authority Discussion Paper 09/01

"We have obtained stock lending data from EUI* starting from October 2007 until the end of the temporary short selling ban on 16 January 2009. We can use this data as a – albeit imperfect – proxy for the level of covered short positions. The graph below shows the development of the average level of stock lending for the firms on the restricted list for the period 3 October 2007 until 15 January 2009.



A criticism of short selling is that it amplifies price declines forcing stock prices below their fundamental value. A relationship between stocks with higher levels of stock lending and those with a higher number of days with statistically significant negative returns would be an indicator for an amplification effect of short selling. We looked at the period 30 days before the introduction of the temporary short selling ban and used stock lending data supplied by EUI and Dataexplorers as a proxy for the level of short positions.

We tested this link in two ways. The first test is a correlation measure. A positive correlation between the level of stock lending and the number of days with significant negative abnormal returns would indicate an amplification effect. However, we observe that negative abnormal returns and stock lending levels are virtually uncorrelated in the 30 days before we introduced the temporary short selling ban.

The second test is a regression analysis where we used changes in the level of stock lending, stock price volatility, liquidity and the market value of the companies' equity to explain the number of days with significant negative abnormal returns. Again there was no link between negative stock returns and increased levels of stock lending."

Short Selling. Financial Services Authority, Discussion Paper 09/1, February 2009.

* *EUI = Euroclear UK and Ireland.*

IS THERE A CONFLICT BETWEEN SECURITIES LENDING AND GOOD CORPORATE GOVERNANCE?

There is consensus in the market that securities should not be borrowed solely for the purposes of exercising the voting rights at, for example, an Annual General Meeting or an Extraordinary General Meeting. Lenders should also consider their corporate governance responsibilities before lending securities over a period in which an AGM or EGM is expected to be held.

The Securities Borrowing and Lending Code of Guidance.[3]

No there isn't - but lenders engaged in the market and their agents must act to ensure they continue to exercise good corporate governance. They should stipulate, for instance, that shares should not be borrowed (or lent) specifically for the purpose of voting. Indeed, the new version of the industry-standard GMSLA will include a representation by the borrower that it will not borrow shares for this reason.

Securities out on loan cannot be voted by lenders as the borrower must obtain full title to the shares in order to be able, for example, to sell them in the market. However lenders can, if they wish, recall the securities by the record date in order to exercise their votes. The right to recall securities on loan is enshrined in the legal agreement underpinning securities lending activity, making the right part and parcel of the lending business.

Beneficial owners can adopt one of several positions with regard to votes and recalls – either voting and recalling securities at every opportunity; voting and recalling securities only on particularly contentious or important votes or not voting (or recalling at all). Another, complementary strategy is to maintain at least one share in each holding to ensure an efficient flow of information from the issuer.

To ensure compliance with good corporate governance, beneficial owners need to ensure that their agents – asset managers, custodians, lending specialists and broker dealer counterparts are fully briefed on their requirements.

Institutional shareholders should have a clear policy with respect to lending, especially insofar as it involves voting. A lending policy should clearly state, inter alia, the lender's policy with regard to recall of lent shares for the purpose of voting them. All lending conducted by the institution or on its behalf should be done in accordance with this stated policy.

International Corporate Governance Network, Stock Lending Code of Practice, 15 October 2005.

3. Securities Borrowing and Lending Code of Guidance, Securities Lending and Repo Committee, December 2004.

I WOULD LIKE TO LEARN MORE ABOUT SECURITIES LENDING: WHERE DO I GO NEXT?

If you would like to learn more about securities lending, ISLA and its members would be delighted to hear from you. In the first instance please visit our website, www.isla.co.uk, and contact us through the links provided.

The Securities Borrowing and Lending Code of Guidance sets out a summary of the basic procedures observed by market participants as a matter of good practice. It is drawn up by the Securities Lending and Repo Committee, a committee of market practitioners, infrastructure providers and the UK authorities, chaired by the Bank of England, and is kept under regular review. It can be found at http://www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf.

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