

Addressing Misconceptions in Securities Lending



Securities lending is a well-established practice with many documented benefits to the broader capital markets. For those lenders engaged in a securities lending program, it is a means to generate incremental returns on long positions. Securities lending generated \$9.28 billion in lending revenue in 2021, according to Datalend.⁽¹⁾ According to RMA data, the global securities lending market includes approximately \$30 trillion in lendable assets and on-loan balances of \$2 trillion. Despite securities lending being a widely adopted practice, misconceptions still exist. The intent of this paper is to address some of these misconceptions.



Myth: Short selling leads to market volatility and drives down security prices

Short selling is important for price discovery and the efficient working of capital markets. Despite these benefits, short selling at times receives negative press, including concerns about whether short selling may have contributed to the 2008 global financial crisis.

Empirical evidence shows that short selling does not drive down asset prices nor does it increase volatility. There have been numerous studies over the years that address this concern. In one study conducted by S. Kaplan, T. Moskowitz, and B. Sensoy,⁽²⁾ sizeable quantities of securities generating high lending fees were added to the lending market over two periods in 2008 and 2009. The study showed that while the additional supply had an impact on stock loan fees for these securities, there was “no evidence that returns, volatility, skewness, or bid-ask spreads [were] affected. The results provide novel evidence on the impact of shorting supply and do not indicate any adverse effects on stock prices from securities lending.”

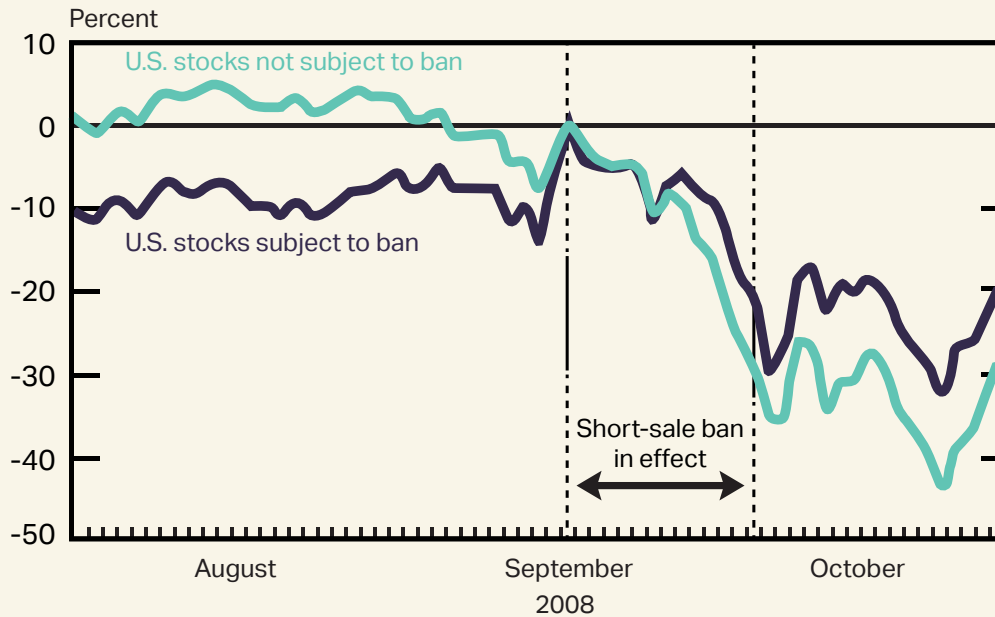
Increased market efficiency and liquidity support the price discovery process, which can help prevent pricing bubbles from occurring and contribute to reducing trading spreads and lowering costs for investors.

Impact of Short-Selling Bans

Empirical evidence suggests that short-selling bans have little impact on stock prices. In perhaps the most comprehensive analysis of these bans, Beber and Pagano examined the effects of short-selling bans in thirty countries between January 2008 and June 2009. Consistent with this assertion, they found that the excess returns generated by the stocks subject to short-sale bans were similar to the returns generated by the stocks that were free of bans. The authors conclude that imposition of short-sale bans in 2008 and 2009 was “at best neutral in its effects on stock prices.”⁽³⁾

The Federal Reserve conducted a similar analysis of stock prices following the US short-selling bans on financial stocks in 2008. Their research has shown that short selling does not systematically drive down asset prices, and that restricting short selling could actually lead to reduced liquidity and higher transaction costs for investors. They concluded that “the bans seem to have the unwanted effects of raising trading costs, lowering market liquidity, and preventing short-sellers from rooting out cases of fraud and earnings manipulation. Thus, while short-sellers may bear bad news about companies’ prospects, they do not appear to be driving price declines in markets.”⁽⁴⁾

Equal-Weighted cumulative returns for U.S. stocks
August 1, 2008–October 31, 2008



Source: Daily return data: Center for Research in Security Prices now.⁽⁴⁾



Myth: Securities lending lacks transparency

Transparency is important in understanding how the market works, what the risks are, and the magnitude of the risks. Thus, transparency provides the information necessary to develop effective and efficient policy tools to prevent systemic risks.

How lenders view their program

Transparency is a core component of any lending program and key to proper program oversight. Lending agents provide their lending clients with regular reporting to monitor and evaluate risks and performance. Reporting will typically include the data points listed below. Lenders are encouraged to work with their lending agent to ensure the data and frequency of reports provided meets the transparency need of the lender.

Common securities lending reported attributes:

- collateral type and amount
- collateralization levels
- borrower counterparty
- loan duration
- securities on loan, including security name, identifier, quantity, and price
- earnings generated
- fees charged
- recalls issued
- restrictions

Lenders and lending agents may also subscribe to vendor services for benchmark data. Several vendors offer daily securities lending market information, representing

over \$2 trillion in open loans. Available data points include loan volumes, utilization rates, and fees paid. These tools are useful for general market color as well as for benchmarking a lending program's performance versus the broader industry. Benchmarking results can also be filtered to compare against peers based on domicile, fund type, collateral type, and other criteria.

Lenders have full control over the direct counterparties to which they lend securities and can restrict borrowers they are not comfortable with or legally not allowed to lend to. Some lenders have expressed concerns about transparency into the ultimate borrower in lending transactions. This is less of a concern in the U.S., as Regulation T specifies the conditions under which a U.S. broker dealer may engage in a lending transaction. The rule, known as "the permitted purpose requirement," allows for the borrowing of securities solely "for the purpose of making delivery for short sales, or failure to receive securities required for a delivery and other similar situations."⁽⁵⁾

How the public views securities lending

Public disclosures of securities lending activities vary by lender type.

U.S. Mutual Funds and ETFs

- Prospectus discloses if the fund participates in securities lending.
- Statements of Additional Information disclose additional information about the fund and fees, and revenue involved. Information may not be consistent across providers.
- Semi-Annual & Annual Reports contain information on securities lending income, securities on loan at the end of the period, and collateral held across cash and non-cash. However information may be located in multiple places and in different formats.
- To further improve transparency, some lenders elect to have a public statement of their approach to securities lending available on their website.

U.S. Pension Funds

- Assets, liabilities, income, and expenses related to securities lending transactions should be reported in the financial statements in the manner that best reflects the true nature of these transactions, consistent with the provisions of GASB Statement No. 28.
- There is no single template or best practice that U.S. pensions adhere to when reporting information on the Annual Comprehensive Financial Report.
- All funds report cash collateral holdings as a liability in their Statements of Fiduciary Net Position and some indication of gross or net revenues in the Statement of Changes in Fiduciary Net Position. Most pensions disclose securities lending expenses, but may specify what those expenses include. Most funds provide some additional information in the notes that accompany financial statements.

U.S. Insurance companies

Since 2010, securities lending transactions are subject to more defined valuation rules and disclosure requirements. A new Schedule DL was implemented in 2010 that includes a detailed listing of the invested collateral, including separate categories for bonds, preferred stock, and common stock. These reporting changes provide more transparency whether insurers are overcollateralized or undercollateralized.

How regulators view securities lending

United States

Following the financial crisis of 2008, the Dodd- Frank Wall Street Reform and Consumer Protection Act ("the Act") was established to help promote stability of the United States financial system. Section 984 of the Act calls for "increased transparency of information available to brokers, dealers, investors, with respect to loan or borrowing of securities". As a result, improved transparency has been a key initiative for US regulators in recent years.

- The Securities & Exchange Commission (SEC) adopted new disclosure rules and forms in 2016, Investment Company Reporting Modernization . The rules improved the access and quality of information available to the SEC and investors about fund investments, including forms N-PORT and N-CEN which provide details around securities lending activities including earnings, fees, collateral and loan balances, and counterparty exposures.
- In 2021, the SEC proposed new rules aimed at increasing transparency in the securities lending market. Proposed Rule 10c-1 would require certain securities lending transactional details to be submitted to a registered national securities association (RNSA). Certain lending terms would then made available publicly.
- In 2022, the SEC proposed an amendment to the short-sale disclosure rule aimed at increasing transparency of short-sale activity. Proposed Rule 13f-2 and proposed Form SHO would require short-sale data over a certain threshold to be reported to the SEC on a monthly basis. Certain data points would then made available publicly at an aggregate level.

Europe

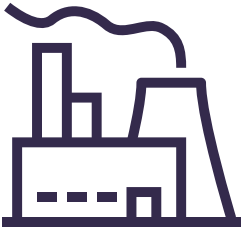
In 2015 the European Union adopted the Securities Financing Transactions Regulation (SFTR) to increase the transparency of SFTs by requiring:

- all SFTs, except those concluded with central banks, to be reported to central databases known as trade repositories.
- information on the use of SFTs by investment funds to be disclosed to investors in the regular reports and pre-investment documents issued by the funds.
- minimum transparency conditions to be met when collateral is reused, such as disclosure of the risks and the obligation to acquire prior consent.

The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, requires holders of net short positions in shares traded on a EU regulated market, to notify the relevant national competent authority (NCA) if the position reaches or exceeds 0.2% of the issued share capital.

Asia

Each market has its own requirements around short-selling disclosures. Some market regulators require disclosure of short positions based on certain conditions or when specific volume thresholds have been reached. Other short-sale controls across various markets include price uptick prerequisites, specific flagging or identification of trades as short sales at the time of trade, and one exchange collects short-sale and borrow data from brokers at the end of every day. Finally, there are other market-specific nuances around lending such as no on-lending in Taiwan as well as finite rollover term restrictions.



Myth: Securities lending is inconsistent with ESG

A white paper published by RMA in 2020, "Complementary, not Conflicting: Securities Lending and ESG Investing Coexist,"⁽⁶⁾ addresses this misconception. As part of the paper, a global survey of beneficial owners was conducted and found that 95% of survey participants agreed that ESG investing and securities lending can coexist. While there is a general consensus that securities lending does not run contrary to ESG investing, there are different approaches and considerations for lenders engaged in a lending program. It is important for lenders to engage in active communication with their lending agent to understand the impact any lending restrictions or guidelines may have on a lending program. As a best practice, lenders should review these guidelines periodically for applicability and relevance.

Short Selling

Short selling is an important component of efficient capital markets. Not allowing for short selling in certain assets, for example ESG-focused assets, might make them more prone to price bubbles and decreased liquidity, and trigger higher trading costs for investors. Short selling is essential in enabling investors to hedge against ESG risks and has bolstered market transparency by uncovering corporate wrongdoing and environmental negligence, according to a study⁽⁷⁾ by the Alternative Investment Management Association and global law firm Simmons & Simmons. The study found that responsible investing does not necessarily require long holding periods, and suggested shorting can be "an excellent tool" for achieving two key goals for responsible investors: mitigating undesired ESG risks, such as climate damage, and



creating an economic impact by influencing the nature of capital flows through “active” investing. The report said short positions can be used to trade on ESG concerns over corporate governance, environmental issues, and alleged human rights abuses, among other things – in turn, exposing failings of issuers and bolstering market transparency for investors.

Should lenders still wish to restrict certain securities, lending agents should be able to accommodate.

Proxy Voting

Can I still vote if in a lending program?

Yes. While the lender forgoes the ability to vote when shares are on loan over a proxy record date, active proxy voting does not prohibit participation in a lending program. By establishing a corporate governance/proxy policy and working with your lending agent, you can build a lending program around your voting and corporate governance needs.

The vast majority of securities are available for voting as the average overall market utilization for equities is typically in the range of 3%-5%. A general proxy restriction and recall policy can be implemented based on the predicted/anticipated record date of upcoming votes. When defining a proxy strategy within a lending program, factors to consider should include:

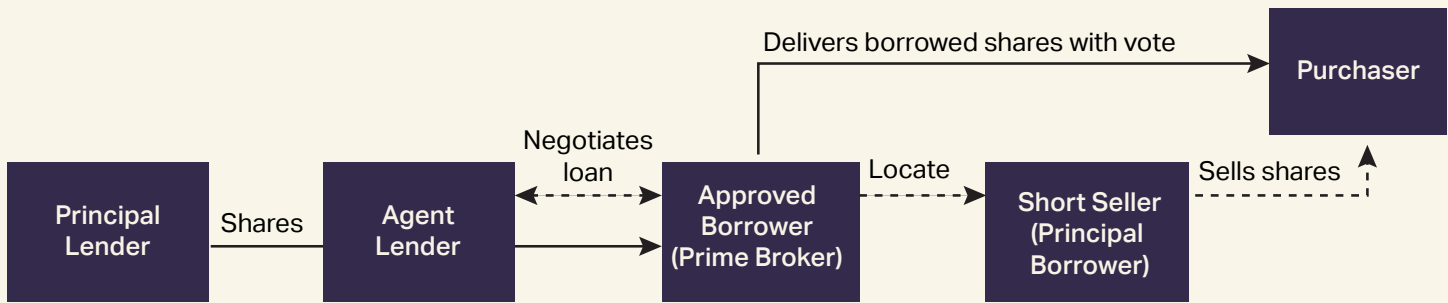
- Materiality of the vote. This can be based on a lending client’s analysis or proxy-service definitions/parameters;
- Percentage ownership and security thresholds. Does the lending client need the full position to participate in the proxy vote? If not, and only a threshold amount is needed to vote, then perhaps the shares on loan will not need to be recalled.
- Lending revenue potential. What is the potential lost revenue/revenue estimate for that security and does this factor into the decision to restrict/recall? Is it more valuable to the lending client to keep the securities on loan due to the revenue estimate for lending over a record date?

When implementing a proxy strategy, lenders should work with their lending agents to understand the impact any proxy guidelines or restrictions may have on the overall lending program.

The Global Alliance of Securities Lending Associations (GASLA) has also published a best practice paper, *Voting Practices and Shareholder Engagement*,⁽⁶⁾ to assist lenders with establishing a voting policy for their securities lending program.

Is borrowing shares to vote proxy a driver of lending activity?

No, when a security is lent to cover a short sale, neither the borrower nor the short seller votes the shares. The long holder who purchased the shares and is holder of record will receive the right to vote.



Responsibilities

Principal Lender

Makes shares available for lending
Has the ability to recall shares from loan at any time

Agent Lender

Negotiates loan on behalf of the principal lender. Facilitates delivery of shares from lender's custody account to the borrowing broker

Approved Borrower

Borrows stock to facilitate short sale/meet failed delivery requirement

Short Seller

Sells stock short

Purchaser

Receives shares along with voting rights.

Additionally, there are a number of rules and regulations that address borrowing shares for the purpose of voting. In the U.S., Regulation T specifies the conditions under which a U.S. broker dealer may engage in a lending transaction. Under Regulation T, borrowing or lending of securities by broker-dealers is limited to "situations involving short sales or 'fails' to receive securities needed for delivery."⁽⁵⁾

In Europe, the UK Money Market Code has similar language addressing this concern, and states. "It is accepted good practice in the market that securities should not be borrowed solely for the purpose of exercising the voting rights."⁽⁹⁾ Further, the Global Master Securities Lending Agreement (GMSLA), an industry standard document, includes borrower representations that they are "not entering into a loan for the primary purpose of obtaining or exercising voting rights in respect of the loaned securities."

Does increased recall activity for proxy voting impact who borrowers choose to source shares from?

Stability of supply is of the utmost importance, especially when it comes to hard-to-borrow securities. If the source of supply is not stable, the preference would typically be to borrow elsewhere. Outside of ESG related matters, a beneficial owner's characteristics are becoming increasingly important as borrowers face different binding constraints where exposures matter. A decision to recall for proxy may just become another defining characteristic when it comes to the ability to direct borrows.

Does increased recall activity for proxy voting impact liquidity and lending fees?

It depends on the supply and demand of the security in question. If there is already limited liquidity at the time of the proxy recall, an additional decrease in lendable assets will likely impact lending fees for the name. On otherwise liquid names where supply outpaces demand, there could be little to no impact on lending fees. This is similar to existing practices in certain markets.

Collateral

Is it possible to apply certain customized collateral restrictions?

- Non-cash collateral:

Lenders should discuss any restrictions that they might like to impose on acceptable collateral with their lending agent. Restrictions can be made for a number of reasons, such as having a restricted asset list or certain beliefs. It is important that beneficial owners work with their lending agents to discuss the impact that a restrictive collateral schedule might have on the lending potential of a portfolio. The purpose of collateral as protection against counterparty credit risk should also be considered. Collateral is held in safekeeping in a third-party collateral account and would only be liquidated in a borrower default scenario, where the proceeds from the sale would be used to buy back replacement securities. Other than in borrower default scenarios, the lending fund does not have direct exposure to the collateral and does not derive benefits. Lenders need to balance restrictions with being able to generate meaningful returns for their portfolios. Should lenders still wish to restrict certain collateral types, lending agents should be able to accommodate.

- Cash collateral:

Factoring ESG considerations into a cash collateral vehicle might change the risk or return profile for lenders, but this is unlikely to change brokers' demand for borrowing from a portfolio. So far the industry has not seen a trend into ESG focused cash reinvestment products in the U.S.



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