Lawsuits in Securities Lending, Part 1: A Primer on the Current Hedge Fund Legal Action against the Major Prime Brokers

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"Whether or not the hedge fund lawsuit against Prime Brokers is successful or not, it will have major consequences for creating transparency in securities lending."

A class action lawsuit was filed on April 12, 2006 against 11 major Prime Brokers alleging illegal practices in securities lending. Whether or not the lawsuit is proven in court, what we are seeing today is the beginning of a seismic change in the securities lending business. This change will ultimately kill the high margin business of securities lending for the Primes while creating a more equal distribution of lending fees across Primes, custodians and asset owners, including pension plans and mutual funds. Hedge funds might even wind up getting fairer treatment too. In this report we discuss the reasons for the lawsuit and the mechanics of the alleged abuses. We also give our predictions for the growth of open electronic marketplaces in securities lending and the next, even bigger lawsuit against the Primes.

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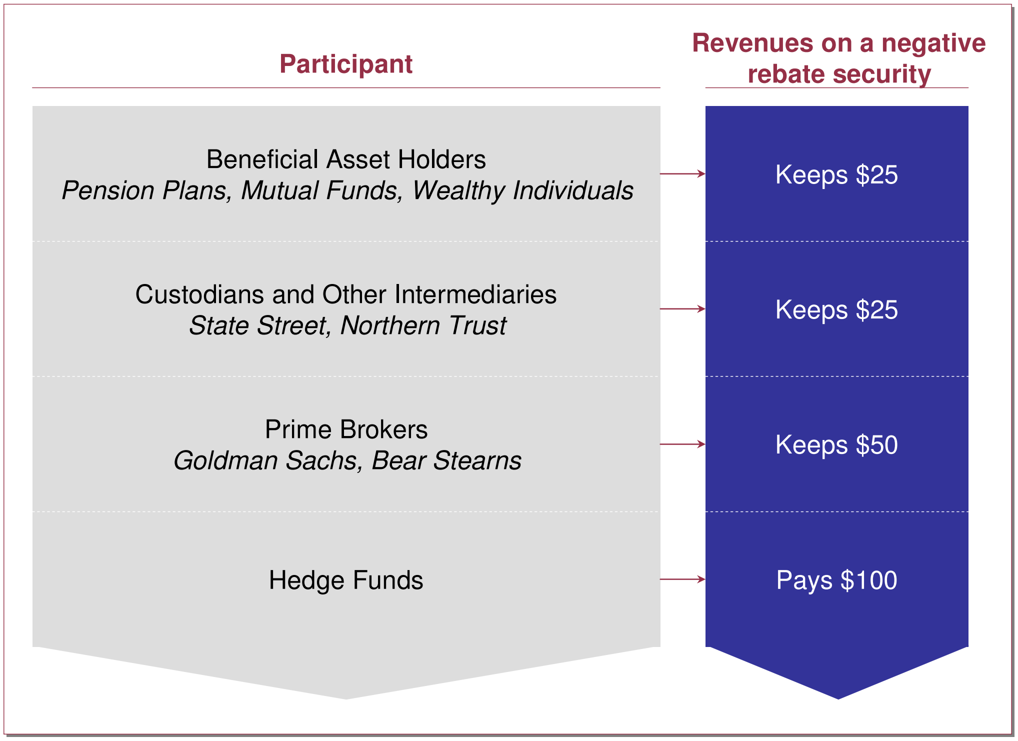
The Value Chain for Securities Lending

To understand the lawsuit it is important to get a sense of how securities on loan move through the financial services infrastructure and who makes money at which points. The chain starts at a beneficial asset holder, which may be a pension plan, mutual fund or retail account holder. These firms all represent the little guy in one form another, because even as large institutions with clout, they have aggregated the savings of the average worker who dreams of retiring one day. These asset holders keep their money and securities held with a custodian such as State Street, Mellon or Northern Trust.

With assets in hand, the custodian looks at their total portfolios, bunches them together so that no one can cherry pick the hard to borrow securities and leave the securities that no one wants, and gives the right to borrow the portfolio to a Prime Broker. With the right to borrow securities in hand, Prime Brokers then turn to their hedge fund clients and tell them which securities are available for loan. Hedge funds take the securities they want and short the stock. The critical language here is *right to borrow*, because while the Prime may legally and commercially access the security, they may or may not do it in practice.

In each step of this chain a rebate rate is paid to the lending party (see Exhibit 1). The rebate rate is actually an annual interest rate that the *lender* pays in interest on the collateral that the *borrower* puts up to borrow the stock. If typical collateral is 102% of the value of a security, and a margin rate is 3%, then the lender will pay the borrower 3% annual interest on that 102% cash left with them in exchange for borrowing the security. The lender then turns around and invests that 102% cash in a very low-risk investment, say treasury bonds, that hopefully are earning 3.5% or greater. The lender pockets the spread on the cash collateral, the borrower gets interest on the cash in the lender's bank, and the borrower gets the stock. As stocks get harder to borrow, the rebate rate that is charged moves from positive, where the lender pays the borrower, to negative, where the borrower pays the lender. For a hard to borrow stock, a borrower may both give a lender 102% of the value of the stock in cash plus pay the lender a hefty interest rate.

Exhibit 1
Securities Lending Participants and Revenue Example



Source: Vodia Group

The Lawsuit

The lawsuit alleges that Prime Brokers have allowed their clients to illegally short stock without having the security in hand, also called naked shorting. Naked shorting is agreed to be a bad thing by pretty much every regulated participant in the industry, at least in a public forum. Typically hedge funds are made into the bad guys in naked shorting because they are the holders of the shorted positions. Not to shed tears for the hedge funds, but in fact they can not short stock illegally without their broker's consent.

The lawsuit says that the 11 Prime Brokers named effectively told their clients that they had stock, allowed their clients to short the stock, then did not deliver the stock as promised, leading to a naked short position. By naming all 11 major Primes as defendants, the plaintiffs are effectively saying that broker-driven naked shorting is an established industry practice.

In addition to simply allowing naked shorting, the hedge funds allege that the Primes charged for services they did not deliver. The funds allege that while they were charged, often up to 25% in interest for the right to borrow rare or in-demand securities, they did not receive any services in return. If they did not receive services such as delivery of the actual stock available to borrow, then, they say, they should not have been charged. The allegation is that the brokers used their positions of influence to manipulate the securities lending system for their own benefit.

The Mechanics of Naked Shorting and Borrowing Stock

While it is not our place to comment whether or not the lawsuit has merit, or if and who is responsible for naked shorting, there are some facts that are clear. For example, if broker-sanctioned naked shorting is or was occurring, how it is done can be explained.

In a naked short, a broker allows a fund to short a stock without having the stock in hand. This creates a failure in clearing and settling a stock and is frowned on by the SEC. Recently the SEC strongly suggested that naked shorting is bad practice by passing Regulation SHO. Among other things, Reg SHO gave firm deadlines for when excessive naked short positions had to be bought in (closed out) in the form of a Threshold List. Notably, SHO does not address the reasons that brokers fail to locate shorts or deliver stock. It simply mandates that brokers must get the stock delivered in certain timeframes.

In shorting a stock, there is a concept known as an affirmative or guaranteed locate. This means that before shorting, a hedge fund must know concretely who holds the stock that it wants to short and be approved by that firm for shorting their position. In practice, most hedge funds call their Prime Broker Securities Lending desk (known in equities as "Stock Loan"). This back office trading desk tells the fund whether or not they have their stock for shorting. In the lingo, they confirm whether or not a "locate is good." If a locate is good, even verbally, the hedge fund is cleared to trade. It is the Prime's responsibility to ensure that they make good on the verbal agreement to deliver the lendable security to the hedge fund's account.

So what happens if the Prime does not give the hedge fund their stock at the end of the day, even if they said their locate was good? The hedge fund shorts the stock and the Prime notes a short position that needs to be covered either from their inventory, from a friendly custodian or by calling around to other Prime Broker desks. Often the stock is not found and the Prime may choose to let it go for a while. Other times the stock is found and the Prime fills the hole in their position, or the Prime does not borrow the stock but knows that it can access that inventory at any time because of their relationship with the asset holder.

As an example of a broker-sanctioned naked short, say hypothetically that a hard to borrow stock carrying a negative rebate rate (borrower pays the lender) was verbally guaranteed to one hedge fund at 11AM. At that time the Prime held the stock in hand. Then at 3PM, another hedge fund came and asked for the same stock. The Prime guarantees the second fund the stock and creates the conditions for the first fund to have a naked short position. The Prime is now receiving a negative rebate rate (getting paid to lend the stock out) by both funds. Both funds have done their required due diligence by verifying with their Prime that the locate was good.

The Prime now goes to locate the remaining stock at an inventory supplier. The Prime may have guaranteed access to a portfolio of securities at a custodian or retail broker dealer as part of a master agreement between the two firms. The Prime knows that the security is available for loan but elects not to take the security in house, because that would force the Prime to pay out a negative rebate rate to the asset holder, or may be able to coerce the asset holder to give them the stock without payment. A week later, the first borrowing hedge fund covers (closes out) its position and completes the transaction without the Prime ever having borrowed the stock from the asset holder. To run through the outcomes for the players:

- The Prime gets revenues twice (from the first fund and the second fund) but violates industry regulations and best practice by allowing a naked short

- The first fund pays for services that were not rendered and has shorted stock illegally
- The second fund pays fairly for the services it received
- The custodian or retail broker dealer loses out on revenues it could have earned if the stock were lent and a negative rebate paid
- The actual owner of the assets, typically an individual or a pension plan, gets nothing

By failing to deliver stock to the first borrowing hedge fund, the Prime creates a failure in the clearing and settlement process. Primes could have a number of ways to plug this hole, ranging from creating IOUs on fails with counterparties, creating options around the fail, or creating contracts for differences on the fail. All of these new financial instruments may have value in the marketplace. However, if used, none accurately enable a Prime to meet their obligations in the securities settlement process.

Again, we can not judge whether or not this has been occurring or in how many firms. The lawsuit alleges that this is industry practice, and whether it is or is not is a matter for the courts to decide.

How Much Money Is At Stake?

Hedge funds are suing for the return of a portion of cash that totals an estimated $27 billion since 2000 for the 11 Primes named in the suit.

From our earlier work ("Shaking the Tree: Unbundling Securities Lending, Financing and Derivatives Transactions," produced with our friends at Aité Group), we calculate that the Prime Brokerage industry currently earns roughly $10 billion annually from their securities lending operations. We based this number off of Greenwich Van's database on how much borrowing is going on in the markets multiplied by the spread that Prime's capture by lending and financing trades. Here's the math:

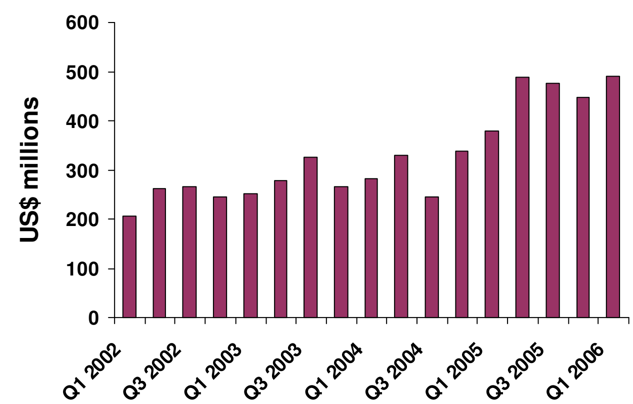
Figure 1: Prime Brokerage Securities Lending Revenues

	Hedge Fund AUM	Securities Lending Volume	Margin Financing Volume	Spread	Revenue	Outlay	**Net Profit**
Low End	$1T	$700B	$800B	65 bps	$33.2B	- $24.5B	**$8.7B**
High End				115 bps	$33.2B	- $21.0B	**$12.2B**

Sources Vodia Group, Greenwich Van

To test the validity of these figures we look at Goldman Sachs. Goldman Sachs earned $1.9 billion in revenues in the last four quarters from their Securities Services division, which also includes structured derivatives, custody, clearing and other hedge fund services (see Exhibit 2). We interpret the bulk of revenues to come from securities lending, or roughly $1.5 billion. This figure suggests that Goldman has a 15% revenue share of the portion of the securities lending industry that Prime Brokers earn from hedge funds. While the exact number is debatable, this seems to us to be in the general ballpark. This figure does not include Goldman Sachs' revenues from their wholly owned subsidiary Boston Global Associates (BGA), which serves as agent for pension funds lending to Prime Brokers.

Exhibit 2
Goldman Sachs Securities Services Division Revenues, Q1 2002 to Q1 2006



Source: Goldman Sachs

Reviewing Goldman's historical financials indicates that they have earned over $5 billion in securities lending revenues since 2000. If we agree that Goldman earns 15% of the hedge fund industry, then the entire industry would have earned $34 billion since 2000.

We believe that 80% of that figure was earned by the 11 Primes named, or $27 billion. Granted, there are many assumptions made here on uncertain data; we trust readers to understand that our calculations are intended to get us into a ballpark for discussion.

Outcomes of the Lawsuit

Regardless of whether the lawsuit is proven in court and the hedge funds get the payback they desire, a few outcomes are likely. First, there is likely to be more regulation for compliance in the securities lending industry. We believe that the SEC and Congress will think that where there is smoke, there is fire, and even an unsuccessful class action lawsuit merits greater compliance and enforcement. This new regulation may range from a minor expansion of Reg SHO to a set of sweeping new guidelines about monitoring and guaranteeing stock availability, including Prime's firmly decrementing their audited (or auditable) inventory on a first come first serve basis.

We also expect more hedge funds to seek alternative sources for locating and getting good guarantees on stock availability. If a fund now suspects that its Prime is not delivering the stock they said was good, and they are being charged handsomely for that lack of service, then they will seek out alternatives that may charge less, give a good guarantee, or both. Several start-ups offer alternatives to funds of different sizes, and new regulations that enforce transparency will certainly encourage more to come.

Enter Eliot Spitzer

If the current lawsuit is found to have merit, it will strongly support the efforts of a second one, much bigger in dollars and scope, representing the average American investor. This next lawsuit would be launched most likely by the New York State Attorney General.

The argument here is that by not meeting their own lending obligations and not borrowing securities from custodians, the Primes have short-changed America's pension plans and mutual funds. The value of this lawsuit could be just huge. To do the simple math for the pension plans alone, US plans manage $15.3 trillion in assets. 13.4% of those assets, or $2.05 trillion, are managed in US small cap stocks. If 10% of those assets were unfairly not lent, that represents $205 billion in assets left committed by custodians but unpaid for by the Primes.

The debt to America's savers is based on what those lent assets would have generated in their own captured spread. If $205 billion were lent and firms were able to capture a spread between the rebate they had to pay and the interest they earned on the collateral, say 1%, that comes to $2.05 billion annually not including negative rebate fees. For the last six years. Thatsalotta retirement money; it certainly dwarfs the value of what the Primes might owe hedge fund borrowers. We'll be watching this space closely.

About the Author

Josh Galper is Managing Principal of Vodia Group LLC. His expertise centers on corporate development for financial services and financial technology firms, including mergers and acquisitions, strategic market analysis and new business development. He is a regular speaker at industry conferences and has been quoted in papers including *Forbes*, *Wall Street and Technology*, *MarHedge*, *Institutional Investor* and *Securities Industry News*, and has appeared on Bloomberg TV. He holds an MBA from the MIT Sloan School of Management. He can be reached at jgalper@vodiagroup.com.

About Vodia Group LLC

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