



**ABN·AMRO**

# **The Mechanics of Securities Lending**

**Howard B. Eisen**

**Director, Prime Brokerage Services**

**September 25, 2003**

# 1. Inside A Short Sale

**Premise:** Investor A, a customer of ABN AMRO, has decided to short Oracle at the current market price of \$13.

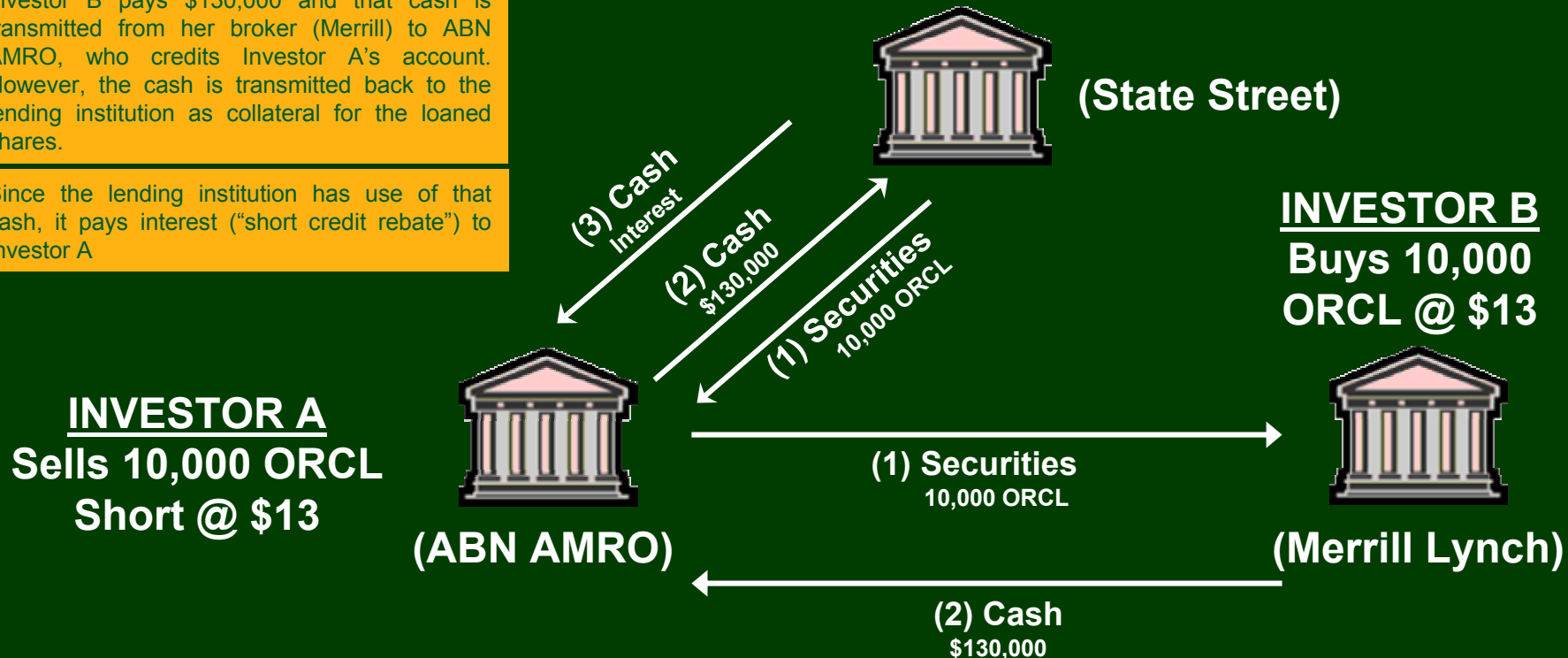
1. Investor A must first locate (and borrow at T+3) shares to sell. XYZ Pension Plan, whose pension assets are domiciled at State Street, will loan its 10,000 shares to Investor A.

ABN AMRO then transmits those shares to the buyer (Investor B, whose account is at Merrill)

2. Investor B pays \$130,000 and that cash is transmitted from her broker (Merrill) to ABN AMRO, who credits Investor A's account. However, the cash is transmitted back to the lending institution as collateral for the loaned shares.

3. Since the lending institution has use of that cash, it pays interest ("short credit rebate") to Investor A

**XYZ PENSION PLAN**  
**Loans 10,000 ORCL**  
**To Investor A**



## 2. Supply & Demand Considerations

- There can be a limited number of shares available to be borrowed
- Scarcity of the desired resource results in competition for securities to be borrowed
- Tension between supply and demand is reflected in classifications
- “GC” = General Collateral
- “Specials” or “Hard-To-Borrow”

# 2. Supply & Demand Considerations

*continued*

## General Collateral

- Blue Chip companies
- Huge float
- Tremendous two-sided liquidity
- Widely held both institutionally and individually

## Specials

- Deal stock, market event driven
- Merger arbitrage, convertible arbitrage, dividend, offering, tender offer, adverse news
- Usually less liquid, smaller float

# 2. Supply & Demand Considerations

*continued*

## Who Is Lending The Shares?

- **Custodians: State Street, Northern Trust, Mellon**
- **Assets of pension plans, mutual funds**
- **Generally institutions, but also retail**
- **Custodians only lend securities of plans that elect to “participate in in the lending program”**
- **Relationship between lenders and B/Ds is reciprocal**

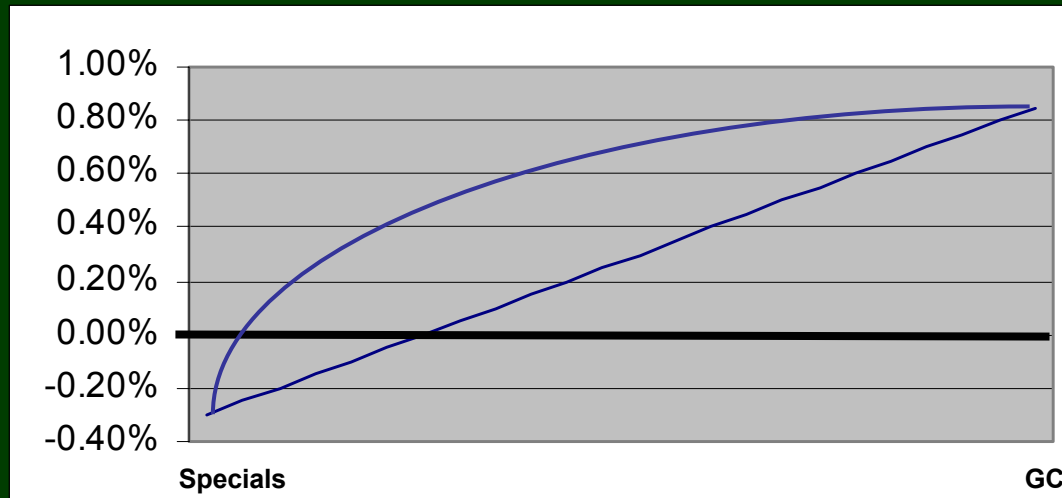
# 2. Supply & Demand Considerations

*continued*

## Economics of The Participants

### The Short Credit Rebate

Interest is paid by the institution lending the shares to compensate the short seller for the use of their cash proceeds



# 2. Supply & Demand Considerations

*continued*

## “Crowding of The Shorts”

- Fewer M&A transactions
- Fewer offerings
- Not as many dual class issues
- Limited number of “deal stocks” in general
- But similar size pool of money chasing them

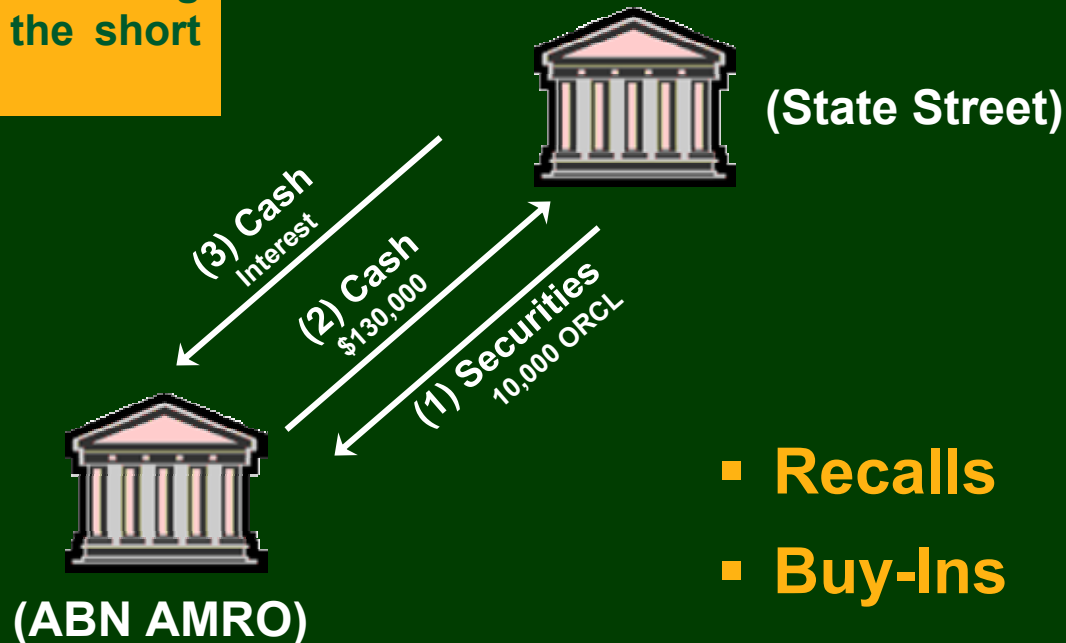
**Result:** Increasingly difficult to locate shares to borrow  
Spreads available from these strategies are compressing

# 3. Risk Considerations

The market risks associated with shorting are well documented – the theoretical unlimited loss and possible loss of capital far in excess of the capital originally placed at risk. However there are also structural risks stemming from the mechanics of the short sale transaction.

XYZ PENSION PLAN  
Loans 10,000 ORCL  
To Investor A

INVESTOR A  
Sells 10,000 ORCL  
Short @ \$13



- **Recalls**
- **Buy-Ins**



# 3. Risk Considerations, *continued*

## Recalls

- Shareholder elects to liquidate their loaned position, wants to vote, price decline forces sale, removed from index
- Notifies B/D holding short seller's account
- Shares must be returned

## Buy-Ins

- Replacement shares cannot be located
- Lender of shares buys them in the open market
- Short seller assigned gain or loss (tax implications)

# 3. Risk Considerations, *continued*

## Stability: Avoiding Recalls and Buy-Ins

- **Borrow from long term investors**
  - Mutual funds
  - Pension plans
  - Not retail boxes
- **Maintain large GC balances with biggest custodians**
- **Relationships with the lending institutions**

# 4. Market Impacts of Shorting

## Short Selling – Good or Bad For The Market?

- Provides an economic incentive for thorough analysis
- Identification of fraud, accounting issues
- Provides vehicle for hedged capital deployment, non-correlated results



# The Mechanics of Securities Lending

**Howard B. Eisen**

**Director, Prime Brokerage Services**

**212.251.3415**

**[heisen@abnamorprime.com](mailto:heisen@abnamorprime.com)**