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On Securities Lending

Day 1

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09 October 2018

A positive outlook

Fran Garritt of RMA provides an update on the US securities lending market and what the association is currently working on

Day one agenda inside

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A positive outlook

Fran Garritt of the Risk Management Association provides an update on the US and what the association is currently working on

Becky Butcher reports

What trends are you currently seeing in the US market?

The US securities lending market continues to grow but remains well below pre-financial crisis levels due to regulatory pressures and reduced leverage in the financial system. The US is currently in a slow rising-rate environment with a current target of 1.75 to 2 percent. There have been seven 25-basis-point moves since December 2015, with two more expected this year (it is likely that a move occurred between the time of this interview and publication). The slow-moving rising rate environment has generally been positive for securities lenders who take cash as spreads between rebates, and reinvestment yields have improved. However, rates have not risen—nor will they—to pre-financial crisis levels due to reductions in reinvestment risk by securities lenders. Duration mismatches are significantly smaller than a pre-financial crisis.

We have also seen an increase in the acceptance of non-cash collateral. Since 2014, cash collateral balances have remained within a fairly tight range; however, non-cash collateral balances have nearly quadrupled in that period.

What has been the biggest development in the US this year?

It is difficult to name just one as we have seen multiple developments occur across the industry. Additionally, most developments seem to be multi-year rather than a single big bang. However, from an RMA perspective, it is probably the work being done on qualifying financial contracts (QFCs) stay rules and the International Swaps and Derivatives Association (ISDA) stay protocols. The US rules were finalised in the second half of 2017 and we have been actively involved in terms of the ISDA stay protocol. We have also put in a great deal of effort to educate agent lenders and their clients of the impending implementation, and we put together an educational primer for beneficial owners, which is available on the RMA website. I definitely encourage agent lenders and clients to take a look at it, as well as the Debevoise and Plimpton client brief on our website.

What have been the biggest challenges for RMA and how did the association face them? Are there any further challenges on the horizon?

The biggest challenges for RMA and securities lenders over the past year have involved advocating on behalf of lenders to industry regulators and educating lenders on the impacts of new regulations. The bulk of the Basel-related regulations have been finalised, with the implementation of Single Counterparty Credit Limits (SCCL) still to come and the finalisation of the Net Stable Funding Ratio (NSFR) still pending. While work remains in terms of implementation, we are in the late stages of a multi-year journey. In this regard, RMA has led efforts on advocacy regarding standardised risk-weighted assets (RWA) and SCCL. These efforts resulted in a more rational measure of RWA being finalised by Basel. This more rational method has been applied to SCCL, which is a very positive result for the industry. We are still waiting for it to be applied for RWA purposes. This may take a couple of years, but we will continue to advocate.

Apart from the Basel-related rules, RMA has been keenly involved in work regarding the aforementioned QFCs stay protocol and the implementation of the Securities Financing Transactions Regulation (SFTR) in Europe. The RMA Legal, Tax and Regulatory (LTR) subcommittee have done a tremendous job of advocating with the Fed on the QFC stay protocol rules, and the US final rule which came out in late last year reflected many RMA comments. Since the rule was finalised, the LTR subcommittee has worked diligently on educating lenders and clients on the QFC stay protocol and its impending implementation. RMA has also been interacting frequently with ISLA in regards to SFTR. While this is a European-based rule, it will have a significant impact on US-based agent lenders and their clients. RMA has developed a working group to ensure that US agent lenders and their clients are prepared for SFTR implementation.

Finally, there have also been some recent tax-related challenges, particularly in Germany with the introduction of new rules that subject certain payments related to loans of German equities to German taxation. RMA submitted a letter to the German ministry of finance in support of an ISLA letter that sought and received important clarifications on the law's application.

What should securities lending industry players be aware of in the next 12 months?

In addition to the implementation of SFTR and the QFC stay protocol rules, industry participants should be aware of the move from LIBOR to alternative rates such as Secured Overnight Financing Rate. While this may be a couple years out, it is important that market participants start preparing and assessing the potential impacts.

What are the opportunities/challenges/market drivers you seeing?

Going forward we see opportunities in the US to move towards a more comprehensive tri-party model, which should benefit securities lenders. We also continue to monitor the development of central counterparties (CCPs) for securities lending. While volume from an agency perspective has been limited to date, development continues to take place and we are moving closer to viable alternatives becoming available. While we do not expect all business to flow through CCPs, a sizeable portion of the market may eventually migrate due to regulatory burdens on agent lenders and borrowers.

We also see opportunities in fintech. Notably, blockchain, artificial intelligence, and robotic processing all offer potentially significant opportunities for the back office, middle office, and front office alike. At some point in the future, fintech will completely alter trading in terms of optimisation, as well as change the way that cash and securities movements are tracked and corporate actions are monitored. Additionally, big data holds a great deal of promise in terms of market transparency.

What is RMA currently working on and is there anything in the pipeline for the rest of this year?

The QFC stay protocol and SFTR implementations will likely be the most significant items we will work on for the rest of this year. We continue to advocate for the acceptance of equities as collateral in the US. Finally, the Tax Subcommittee is preparing a letter to the US Department of Treasury on the need for tax guidance under the US tax code to address the growing demand for longer duration securities lending transactions. Many securities lenders refrain from participating in such transactions because of the uncertainty present under current tax law.

RMA has established a working group, which will address challenges of corporate actions that present a significant risk to the stock borrow/loan community and will continue to test the industry in new ways as anticipated event volumes increase and become increasingly complex. The industry has seen limited advancement on a strategic solution providing enhancements to effectively manage the inherent risk, which presents an opportunistic time to mobilise and take action. The group consists of representation from the global stock borrow/loan and asset servicing communities with a mission to identify existing as well as forthcoming challenges, collaborate amongst industry leaders to prioritise the greatest areas of risk, propose strategic enhancements, and coordinate with industry vendors to build a global solution. **SLT**

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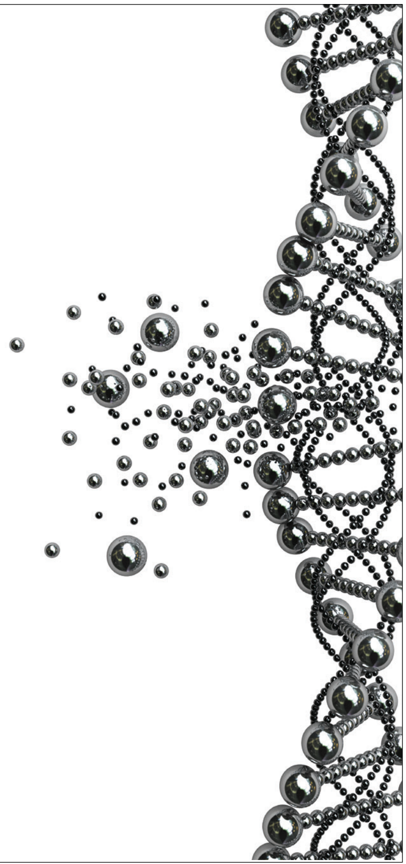


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Thinking about the future

Tamela Merriweather and Alex Blanchard, co-chairs of this year's RMA conference, discuss what delegates can expect from this year's event

Maddie Saghir reports

Since the 2017's RMA conference, what have been the biggest challenges in the securities lending industry?

Alex Blanchard: The biggest challenge facing the market continues to be the ever-evolving regulatory environment. Therefore, the ongoing education of clients about the multitude of regulatory headwinds facing financial intermediaries remains important. For instance, the ability for securities lenders to access liquidity is a key feature of their business—where this liquidity is sourced via the bank or broker-dealer community, all of whom have been impacted by various financial regulations over the last four to five years. While I wouldn't say this has necessarily changed in the last twelve months, the disparate binding constraints across drive the increasing need for a full understanding of what is a complex environment.

What can delegates expect from this year's event?

Tamela Merriweather: Delegates can expect a thorough review of what we expect to see in the coming year. It will be forward-looking and it will focus on the new regulations and changes that have started to emerge in the market—the event will not be as retrospective as it has been in the past.

Next year will mark the beginning of a change in the way that we engage in securities lending. The market is driven by regulatory changes, such as the Securities Financing Transaction Regulation potential changes that will come into play, and factors affecting the broker-dealers' strategy in terms of their demand. Therefore, we have tried to develop this conference in a way to tackle those issues head-on in a forward-looking manner.

Blanchard: We have tried to make the event as relevant as possible by providing practical information and potential solutions for some of these very acute issues. The dialogue over the three days will be less about 'woe is me—this is really hard', and more along the lines of 'these are the challenges that we have on the horizon, and these are the things that we are collectively thinking about doing in order to continue to serve our respective clients, for example, technology'.

What are you looking forward to the most about this year's conference?

Merriweather: The fintech discussion is going to be really interesting and it is a topic that will remain relevant throughout the next year. I will be very keen to see what changes in terms of innovation in the securities lending market. How can we leverage the fintech technology that has been developed and how does that become not unduly costly and also very useful for securities lending over the course of the next year? I think that conversation will start at this conference.

Blanchard: I am looking forward to hearing where the industry sits regarding preparedness ahead of London Interbank Offered Rate reform and engaging with attendees to dig into what is a topic fraught with challenges across the industry and one that will have a direct impact on securities lending.

Although 2021 may feel like a long way away, it is going to roll around pretty quickly—thus being informed and prepared is a joint responsibility.

What sessions are you looking forward to?

Merriweather: Instead of having a single keynote speaker, we are having representatives from Treasury Market Practice Group (TMPG). As conference organisers, we are keen to see how that goes and what the response from the delegates will be to that format.

I am also looking forward to a high degree of engagement from our delegates during the course of each of the sessions. We have tried to make the sessions more interactive and informative overall, particularly around that keynote discussion. We are hopeful that this will be a lively conversation and that the members of TMPG will get the degree of engagement and insight that they are seeking through their participation.

Between now and 2019's conference, what developments do you expect to see in the securities lending market?

Blanchard: Investment in technology is key. Increasing understanding of the regulatory environment and its impact on liquidity and market pricing must be complemented by continued innovation and by increasingly leveraging technology. Our ability to provide liquidity is the essence of what we do. This manifests itself in our roles as intermediaries, either be that be as a bank providing liquidity between the hedge fund community and the securities lending community, or as a securities lender providing liquidity between the beneficial owners and the banks.

Technological innovation will likely be a place where a lot of people are investing time and money. I would go as so far as saying that the securities lending and repo markets are being dragged kicking and screaming into the 21st century from a technology point of view by virtue of necessity. This can only be a good thing going forward. **SLT**

Tamela Merriweather
Senior managing legal counsel and senior vice president
Northern Trust

Alex Blanchard
Managing director
Global head, repo trading
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Who needs complexity in securities lending data?

Robert Levy of Hanweck discusses how the firm has applied machine learning methods to generate a dataset and create new insights from existing raw data with direct applicability to the securities lending market

Data and supporting technology within the securities lending industry are evolving with the same trends as the broader financial industry. It is now easier and cheaper to operate a data stack that consumes raw source data, performs data science and analytics, and delivers refined output and visualisation to users. It is increasingly practical within financial data to, for example, process text with natural language processing (NLP), generate and combine with structured data, and use machine learning (ML) methods to deliver information that might otherwise be prohibitively time-consuming for industry analysts to review. Prevalent computing and data trends are arriving in the securities lending market and offer the potential of competitive advantage in speed and content for early adopters. For example, Hanweck has applied ML methods to generate a dataset that is alternative in the sense of creating new insights from existing raw data with direct applicability to the securities lending market.

Earlier this year, Hanweck launched the Borrow Intensity Indicators (BI-Indicators) with the goals of both complementing existing sources of data for equity collateral and providing new and actionable insights, especially around high intrinsic collateral. BI-Indicators offer a unique view with intraday information arriving from exchange-traded markets, and content that is related to overnight rates but expanded in the form of a synthetic term structure. We have found that the topic of term structure generates considerable conversation, debate, and frankly outright challenge on whether the complexity warrants broadening in-house data schemes (and analytical approaches) to accommodate it. The term structure is a standard part of rates markets, and term transactions occur regularly in securities lending as a small but growing fraction of overall activity with details opaque to most participants. More broadly, term structure offers uniquely rich views into the market expectations of future lending conditions and the rate of decay of hard-to-borrow premiums. The analysis below seeks to provide examples of the potential applications and interpretations of observing the term structure of equity collateral rates in real-time.

Term structure in borrow rates

The following examples are intended to illustrate how BI-Indicators add a dimension to existing time series that market professionals follow in their own firms' data or that are available from major vendors of overnight lending data. Although Borrow Intensity is not a replacement for these overnight data sources, it offers a unique level of timeliness in that the data is transformed from millisecond level continuous pricing of exchange-traded options throughout the day. Some other sources will refer to data as real-time, but generally, that means spotting transactions that flow through a given vendor's operations platform or periodic contributions. These data points are useful but not actually real-time in trading time. They can suffer from asynchronous pricing issues since there is a considerable lag between intrinsic pricing information and the processing of a ticket arising from a given trade flowing back to a settlement platform.

BI-Indicators cover the breadth of the US equity universe with listed options and publish constant maturity terms from 45 to 360 days. The rate structure for general collateral tends to reflect risk-free interest-rate structure with a similar slope (for example, currently positive) and similar spreads between shorter and longer-term rates. This picture completely changes, however, as securities become harder to borrow (HTB).

HTB securities can exhibit flat to inverted yield curve structure between shorter and longer rates. Overnight rates can exhibit the most pronounced change and extreme levels when a security 'heats up' in the lending market. As market markers anticipate longer-term imbalances in the lending market, these expectations are instantaneously realised in option prices across the term structure. Shorter maturities such as the 45-day rate are most responsive to supply-demand effects that influence overnight rates, while longer-term rates such as 180-day are stickier and generally reflect expectations that HTB premiums tend to decay over time. The patterns of term structure and relative differences in levels, trend, and momentum between shorter and longer rates can inform on the prospects of future rate levels.

Scanning for changes that may inform the future

To provide examples for this article, we established automated screens that applied filters and rules to historical BI-Indicator data. As of this writing, there is now five years of BII data history at 20-minute increments. The goal with this screening was to find cases that offer insights into future trends of collateral rates.

To this end we focused on only the 45- and 180-day indicators, looking for cross-over events (for example, 45-day BI-Indicators moving below 180-day BI-Indicators) in the series that met certain criteria:

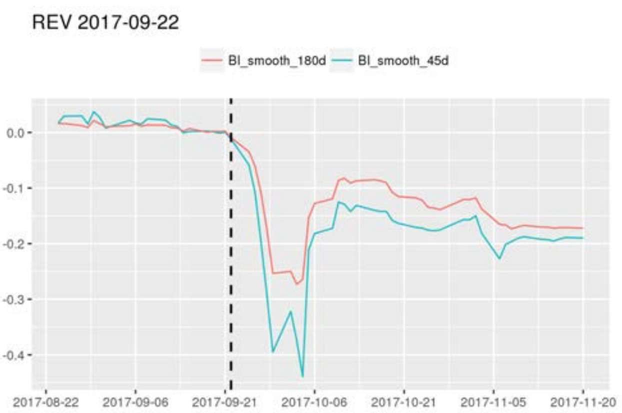
- Cross-over persists for at least 50 20-minute observations (approximately two and a half trading days)
- Both maturity indicators depart from their five-day moving average in the same direction
- Three-day average of the 180-day indicator at or below minus 1 percent (for example, collateral getting hotter)
- Sufficient levels of BI-confidence, the proprietary liquidity metric within the BI-Indicators data series

The use here of a 'cross-over' type rule is meant to take an approach familiar from equities technical analysis and apply it to the additional information that naturally flows from BI-Indicators. Let's look at some examples where there was downward cross-over with 45-day levels moving harder-to-borrow than 180-day.

Harder-to-borrow transitions

In the example of Revlon (REV), terms move closely together in the month prior to the event detected on 22 September 2017. A shift in term structure occurred with 45-day rates moving significantly below 180-day rates in a notable regime shift, and REV became very hard-to-borrow as shown below. (Note that borrow intensity is expressed in a decimal format corresponding to a rebate rate. For example, 10 corresponds to -10 percent).

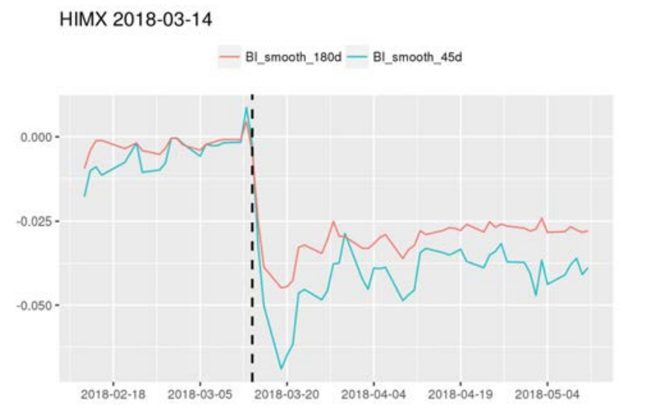
Figure one: Revlon, borrow intensity 45-day versus 180-day



The case of Himax Technologies (HIMX) is more typical in terms of the range of rates, although unusually persistent. Both shorter and longer-term BI-Indicators for HIMX are in the near-HTB range between

0 and minus 1 percent in the period of Q1 2018. On 14 March 2018, a significant cross-over occurs with the 45-day rate showing considerable momentum and moving below minus 5 percent in the next five days. HIMX then stays in a significant HTB condition across its term structure for the next few months.

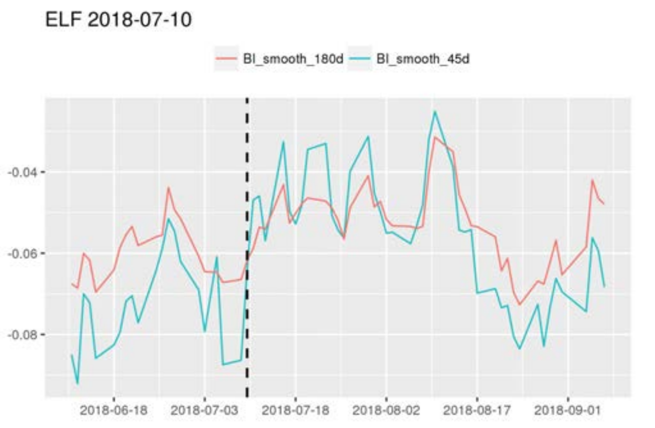
Figure two: Himax Technologies, borrow intensity 45-day versus 180-day



Easier-to-borrow transitions

Using similar search criteria but looking for transition events in the opposite direction (easing HTB) we find contrasting examples. The case of the company e.l.f. Beauty (ELF) shows an upward cross-over of 45-day over 180-day on 10 July 2018. ELF moved to less hard-to-borrow levels for roughly a month. This is not an unusual pattern for securities gradually coming out of persistent HTB conditions, with the additional and typical feature that the different terms begin to stay close to each other with levels more converged.

Figure three: e.l.f. Beauty, borrow intensity 45-day versus 180-day

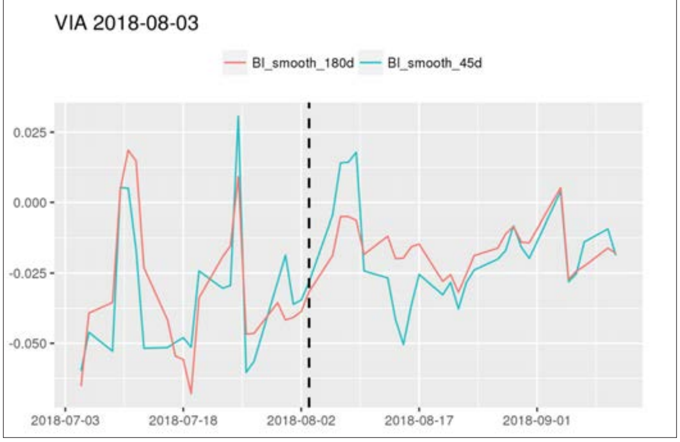


Another example of this type is Viacom (VIA). Viacom displayed volatile swinging patterns across the borrow term structure this past July and August 2018. An upward cross of 45-day over 180-day meeting search criteria occurred on 3 March 2018. In this case, the resultant shift was not as consistent. The 180-day rates showed more consistent cooling in HTB, although somewhat like the ELF case, the VIA rate structure began to show less volatility and stay better converged.

Benefits from integrating term structure into borrow data

The additional term structure that comes with borrow intensity data is indeed more work to consume and observe than the overnight-only series format of current datasets. The benefit of BI-Indicators exposes a term structure that is usually hidden but now can be viewed and applied to decision-making in a variety of ways. There is rich nuance in this data that may allow for slower decay of alpha generated with it. Human analysts can view series on charts, or automated trading strategies can harness the data within broader ensembles of source data. We are seeing take-up of the borrow intensity-indicator by equity trading strategies that already utilise a short-interest factor in their framework. In the securities lending market, participants can now see information that may tip the balance of pricing and trading convictions, enhancing the ability to manage risk and generate greater returns. **SLT**

Figure four: Viacom, borrow intensity 45-day versus 180-day



"The benefit of BI-Indicators exposes a term structure that is usually hidden but now can be viewed and applied to decision-making in a variety of ways"

Robert Levy
Head of business development
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Lessons learned from Lehman

The Lehman bankruptcy completely changed the world of banks, exchanges, clearing houses and their regulators, Thomas Laux of Eurex Clearing discusses the approach of the company during the Lehman crisis and what lessons the clearinghouse learned from 10 years on

Can you remember what you were doing when you first heard that Lehman was not too big to fail?

We were in the middle of the financial crisis in 2008 and were constantly wondering which bank would fail next. Bear Stearns had been bailed out a few months earlier. When I first heard in the news on Sunday that Lehman had been hit, it wasn't really a 100 percent surprise anymore. But it immediately became clear to me that this was a really big challenge, and because they were a large member of Eurex and Eurex Clearing it had to be dealt with quickly and with great care.

When you came to the office on Monday, how did the day go at Eurex Clearing?

As a central counterparty (CCP), we definitely had a clear goal to close the positions smoothly, transfer the clients to other clearing members and avoid any spill-over effects into the market. But that requires, in particular, the cooperation of the insolvency administrator, which was especially difficult on Monday and Tuesday because they weren't really prepared. The key focus was to get in detailed contact with the administrator and try to work with them.

What was the further procedure?

We have the legal right to terminate all the transactions with the defaulting clearing member once they cannot fulfil their obligations. A clearing member like Lehman typically has—apart from their own house position—also material client positions. These clients are usually still solvent and eager to be active in the market again to hedge their risks, especially in crises times with huge market moves. The focus is to transfer clients to solvent clearing members. If such a 'porting of clients' does not work, these positions must be liquidated through the market or via an auction.

This is the normal process. However, it is precisely where client positions are concerned that you need the support of the defaulting member as they usually know their customers best and know to whom they would be willing to transfer their positions.

You had to find clearing members who wanted to take over the positions?

Yes. But the problem was not only finding other clearing members—some were quite willing to do so, as it was a huge opportunity for them to extend their client base. The challenge was to get an agreement with the administrator to transfer client positions. Only after that, we could start to work closely with the Lehman team. The actual transfer was then done within two to three days.

It was impressive how supportive the Lehman employees were, even if it was pretty clear for them that they would lose their job in a couple of days. They helped to slice and dice their client portfolios and transfer them to other members. If this transfer had not worked, our last resort as a CCP would have been to liquidate everything in the market, which would have been even more stress for the already stressed market.

What are the most significant changes for you since the Lehman crisis?

First of all, the role of a CCP has become more and more important. CCPs are now considered as part of the solution to such a crisis. The regulatory regime around CCPs and especially CCP risk management is much more concrete and clarified today. I think European Market Infrastructure Regulation (EMIR) is a pretty good regulatory standard to ensure that CCPs in Europe are robust, and the bilateral margin rules ensure the right incentives for central clearing. Secondly, the way in which banks are regulated has changed dramatically since then, especially the capital requirements and also the supervision for banks.

What about the default management process in itself?

This process is now much more professional. Also in 2008, every CCP had this process as well but with less sophistication, less practice and less clarity. Today, at least at Eurex Clearing, we have a dedicated default management team with its own trading expertise. Their main objective is to establish and regularly test this process. We test at least once a year with all our clearing members and we include regulators. In the last two years, we have also tested together with LCH and CME Group, under the supervision of Bundesbank, BaFin, The US Commodity Futures Trading Commission and the Bank of England. The fact that the process is now much more resilient was most recently demonstrated during the defaults of MF Global and Maple Bank.

Has the financial world really become a safer place?

It clearly has, yes. Of course, there is always the tail risk that something could happen again. But if it does, then I would say we are much better prepared today.

You said that clearinghouses gained in importance. What about the risk—should a clearinghouse fail?

Basically, there are two types of events that could hit a central counterparty (CCP).

Firstly, a market-wide issue of an entire asset class, which is not a CCP-specific problem. In this case, the industry or the clearing members are, for example, not sure how to value certain products or how to support an auction. In such a crisis, a CCP is the 'perfect tool' with proven mechanisms to overcome it, manage the crisis centrally and even reduce a certain market segment. The big problem in 2008 was that it was uncertain who had what position at Lehman and who was affected and how much. Now the CCPs give a much clearer overview of where the positions are, who is involved and who is not involved, and especially the regulators look through the CCPs.

In the second case, there are CCP-specific issues, and the market is intact, let's say a system break-down or a cyber issue. Then service continuity is the key objective, and we have to use the recovery options of our recovery plan, for example, increase capital, ensure liquidity or transfer the systems to another location etc. Therefore, recovery and resolution of a CCP are important and a widely discussed industry topic today. There is European legislation underway, which is expected for next year.

Can you sleep well at night despite an outstanding volume of nearly €8 trillion at Eurex Clearing?

Yes, I can sleep well. For financial risks, we have a robust waterfall mechanism that tackles them. For liquidity risks, our central bank access helps to manage them. And, in line with the operational risks to date, we have installed all the controls and processes to manage them. I am not saying that nothing will ever happen at all. We cannot mitigate all tail risks, but you have to manage and tackle them when they materialise, and I think we have a solid framework here at Eurex Clearing. **SLT**

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Publisher: Justin Lawson
justinlawson@securitieslendingtimes.com
+44 (0)203 750 6028

Editor: Becky Butcher
beckybutcher@blackknightmedialtd.com
+44 (0)203 750 6019

Deputy Editor: Barney Dixon
barneydixon@blackknightmedialtd.com
+44 (0)203 750 6026

Reporter: Jenna Lomax
jennalomax@blackknightmedialtd.com
+44 (0)203 750 6018

Junior Reporter: Maddie Saghir
maddiesaghir@blackknightmedialtd.com
+44 (0)203 750 6019

Creative Director: Steven Lafferty
design@securitieslendingtimes.com
+44 (0)7843 811 240

www.securitieslendingtimes.com

Twitter: @SLTimes_

Office fax: +44 (0) 20 8711 5985
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Agenda Day 1

10:00 A.M.

Women in Securities Finance | Senior Leader Industry Panel and Round Table

Led By:
Arianne Collette, Executive Director, Morgan Stanley
Elaine Benfield, Senior Counsel, Vanguard
Jill Rathgeber, Managing Director, BNY Mellon

12:00 P.M.

Light Lunch and refreshments Courtesy of: UBS

12:30 P.M.

Global Legal, Regulatory, and Tax Update

Moderator:
Greg Lyons, Partner, Debevoise & Plimpton

Panelist:
Adam Hopkins, Managing Director & Deputy General Counsel, Mizuho Securities USA LLC
Bodgan Fleschiu, Executive Director, J.P. Morgan
George Rapalje, Vice President, State Street
Glenn Horner, Managing Director & Chief Regulatory Officer, State Street
Jill Rathgeber, Managing Director, BNY Mellon

1:45 P.M.

Modernization of Standard Industry Documentation

Moderator:
Colleen Kenney, Vice President, Product Development, BMO Global Asset Management

Panelist:
Alina Casner, Head of Markets Legal & Managing Director, BNY Mellon
Larry Kornreich, Vice President & Assistant General Counsel, Goldman Sachs & Co LLC
Lisa Stephenson, Executive Director and Assistant General Counsel, J.P. Morgan
Mary Breslin, Vice President & Senior Counsel, Deutsche Bank AG
Ranada Fergerson, Senior Vice President, Brown Brothers Harriman

2:30 P.M.

Coffee Break with Exhibitors Courtesy of: UBS

3:00 P.M.

Association Update. Get updates on the association's activities

3:30 P.M.

Continued Rise of Fintech and its Impact on the Industry

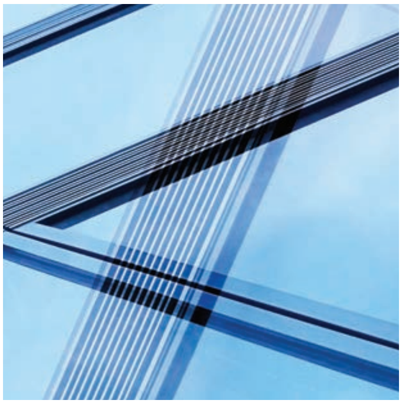
Moderator:
Dean Sakati, Senior Managing Director, State Street

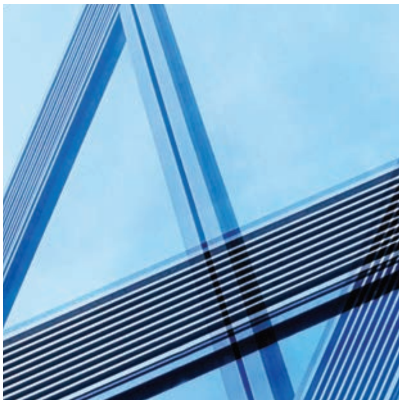
Panelist:
Charles Post, Managing Counsel and Director, Head of Legal Data Management and Advisory, BNY Mellon
Emmanuel Aidoo, Director, Global Markets Division, Credit Suisse
Michael Brock, Executive Director, Process Automation and Workforce Transformation, J.P. Morgan
Nickolas Delikaris, Managing Director, State Street
Jennifer Peve, Co-Head of Fintech Strategy, DTCC

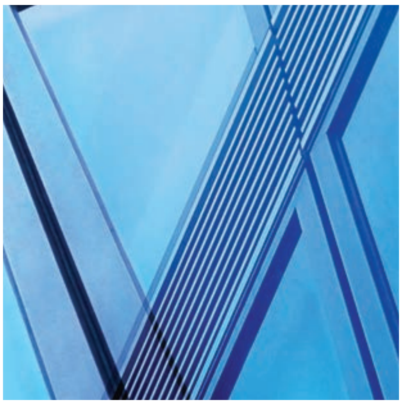
6:00 P.M.

Gala Cocktail Reception

Courtesy of:
Deutsche Börse Group
ETrade
J.P. Morgan
Mirae Asset Securities
Morgan Stanley
National Bank of Canada Financial Inc.
Pirum
State Street Corporation







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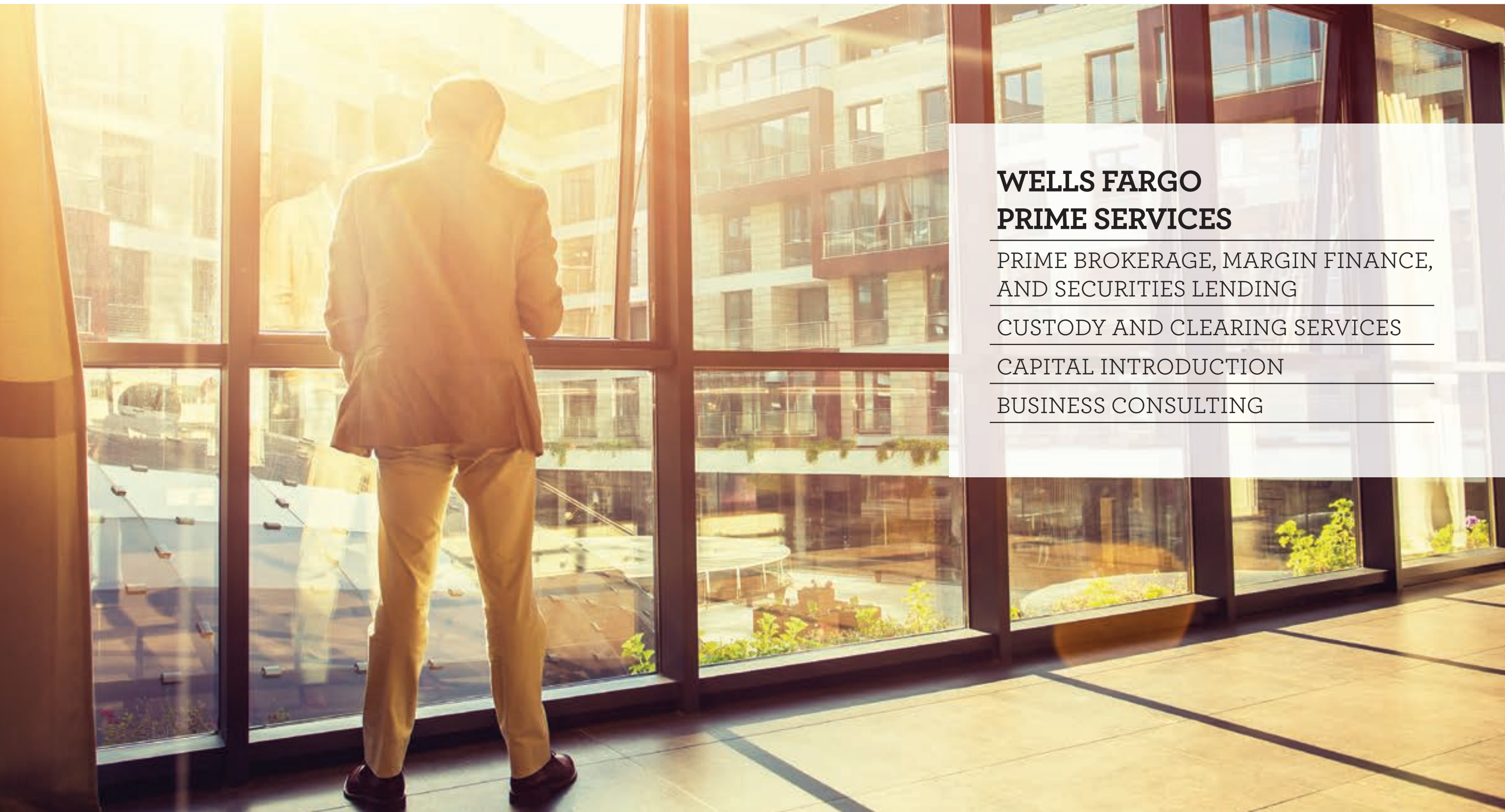

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