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Securities Lending And Governance

By: Rob Ferguson

One doesn't have to look any further than the business section of a newspaper to see what the changing standards for corporate **governance** have brought to the marketplace. Corporate **governance** is at the forefront of management affairs and guardianship of a corporation's stakeholders is an underlying theme. Accountability has been an issue with some critics of corporations including policymakers, labour leaders, and activists. To address this, management of public and private companies have assumed a greater responsibility to ensure that the actions of the corporation are transparent and available for existing and potential shareholders to review.

These same trends are equally applicable to **pension plans** and their corporate sponsors. As fiduciaries of the members of the **plan sponsors** are charged with, among other things, ensuring that the voting of proxies provides **benefits** to plan members. In many cases, voting proxies is a valued tool to show displeasure or support for management decisions. In other cases, voting on particular issues such as the re-election of a well-run board or the external auditor may not necessarily be seen as providing added value to the participants in the plan. For plans that have securities lending programs, concerns arise when shares are out on loan over a record date and cannot be voted by the **plan sponsor** (or its delegate). As a result, it is becoming apparent that **plan sponsors** require policies for securities lending and proxy voting.

Temporary Loan Securities lending is the temporary loan of a security from one party, the lender, to another, the borrower. The need to borrow is most often the result of trading strategies such as index arbitrage or hedge trading that see a party taking a short position in a particular security. In order to settle positions that have been sold short, the security must be borrowed from another holder of the security.

In return, the lender receives a fee from the borrower and also holds appropriate collateral for the loan. This collateral is typically a minimum of 102 per cent of the market value of the loaned security in the form of bonds, equities, or cash to ensure the safe return of their lent asset. When the borrower closes out its underlying trade and no longer requires the security, it delivers the shares back to the lender and its collateral is returned.

There are many benefits to participating in a securities lending program. From a lender's perspective, securities lending generates incremental income and is a material alpha contributor on positions that otherwise would have been idle. For the borrower, securities lending makes possible various hedge, short, and arbitrage strategies. The lending of securities is a practice recommended by the Group of 30 as an activity that brings efficiency to the overall markets. This offers the greater market added stability and price discovery. Both of these can be incredibly important during times of volatility.

In a securities lending arrangement, absolute title to the security passes to the borrower. While legal title is surrendered, Section 260 of the Canadian Income Tax Act allows for the lender to retain beneficial ownership of the security. From an accounting perspective, the security and all benefits of owning that security remain in the fund and will be credited to the fund as if the security had not been loaned. The rights to vote, and to receive dividends and interest payments, however, are not retained by the lender.

Financially Whole

The lender is typically made financially whole for the loss of dividends and interest payments as such payments can be, and often are, recovered through substitute payments that retain the characteristics of the original entitlement. However, as there are a finite number of votes available to shareholders based on the outstanding shares, there cannot be a substitute for a vote. Therefore, when a security is on loan over the record date, the right to vote is passed on.

There are three voting options for plan sponsors engaging in securities lending, each with its own benefits and costs:

- Vote none of the time – The plan sponsor could elect to vote only on securities that are not on loan over record date. In years past, this was a fairly common strategy. However, due to the increased focus on corporate governance, this option has become less popular.
- Vote all of the time – The plan sponsor could elect to vote all securities. The lending agent would require standing instructions to automatically recall (or reallocate to another lender) all securities prior to the record date. This ensures that all shares are in the lender's account and are available to vote. Agent lenders use systems that alert their lending

departments of upcoming votes and ensure that securities for these plan sponsors are returned prior to record date. The vote-all option is the least common among sponsors participating in securities lending programs.

- Vote selectively – Under the third, and most commonly practiced option, the plan sponsor (and its investment advisors) could take an active role in the corporate governance process and determine which votes are considered important or contentious enough to ensure that voting rights are retained. Plan sponsors who engage in this strategy may need their securities to be recalled from loan to ensure possession over the proxy record date. This requires notification to the borrower of at least a standard settlement cycle as the ability of the agent lender to get the securities back prior to the record date will be affected by the amount of notice provided by the plan sponsor. In addition, agent lenders who lend on behalf of many sponsors can have an advantage over smaller lenders as they may be able to re-allocate the loans to an account that chooses not to vote its securities.

Lending agents are a conduit to a valuable investment tool. While in many cases securities lending is already viewed as a revenue stream for plan sponsors, it can also be viewed as an aid to offsetting the costs of running a plan. Revenues generated by lending can lessen the impact to the plans of custody, transaction, and performance measurement fees. When recalling securities to retain the vote, there is the potential for a negative impact on the plan in the form of lost revenue. The costs of this strategy must, therefore, be measured against the benefit to the plan of continuing the loan.

Consider The Potential

To fulfill their fiduciary responsibilities while practicing good corporate governance, plan sponsors must consider the potential lost lending revenue versus the importance and impact of the underlying vote. This can be a challenging process in many cases and plan sponsors will need to carefully balance the reward to be generated from a securities loan versus the plan's corporate governance objectives.

Rob Ferguson is vice president, product and client service, global securities lending, at CIBC Mellon