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In Focus: Board Oversight of Securities Lending

Presentation to the Mutual Fund Directors Forum

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What is Securities Lending?

Securities Lending is an established investment strategy in which institutional investors make **short-term collateralized loans** of their securities to **generate incremental revenues** from their portfolios



Loan results in a **transfer of title/ownership** to the borrower who is obligated to **return the same type and amount of securities**



Loaned securities are **collateralized at 102%** of market value for **U.S. securities**, and **105%** of market value for **non U.S. securities**



The lender **retains the right to vote** proxies on securities on loan through recall

Lender retains economic attributes of loaned securities



Price movements in the original securities



Cash distributions on the loaned securities*



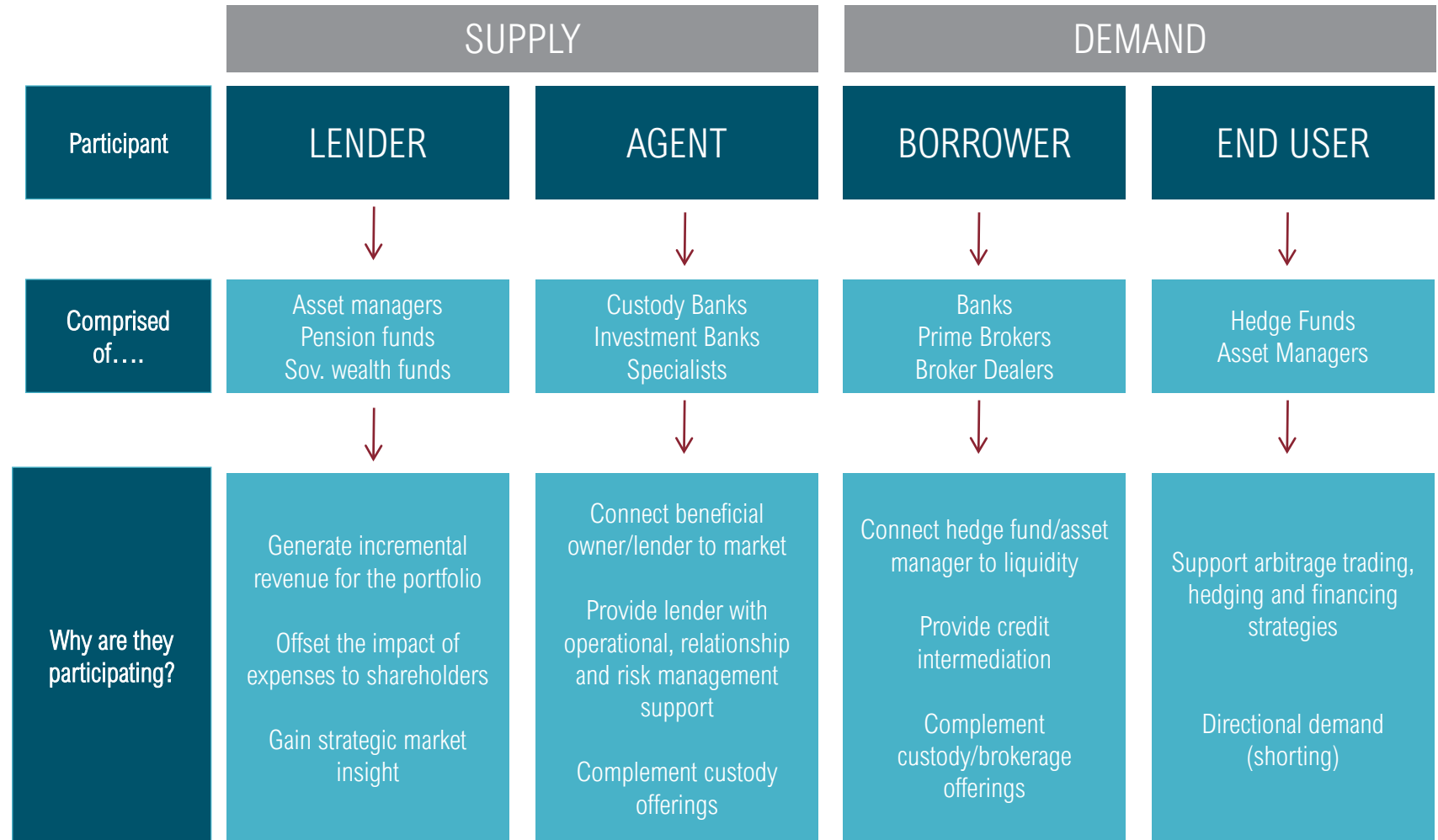
Non-cash distributions on the loaned securities**

* Examples include cash dividends and interest, for which the lender generally receives equivalent economic value from the borrower

** Examples include stock dividends, rights, splits, warrants, for which the lender generally receives equivalent economic value from the borrower

Who participates in Securities Lending?

Securities Lending stakeholders and decision makers



Industry landscape

\$7.6B in securities
lending revenue generated
over past 12 months

\$27T global assets available
for loan, **\$2.5T** global assets
on loan

90% of top global
asset managers engage
in securities lending

19 of 20 top US ETF
sponsors, representing **99%** of
\$4T US ETF market, engages
in securities lending



Potential Benefits of Lending

To the Lender

- Increase fund performance
- Minimize tracking error
- Enhance sales & distribution model
- Provide unique market insights

To the Broader Capital Markets

- Increase liquidity and reduced transaction costs
- Facilitate the hedging of risk
- Promote price discovery
- Improve settlement efficiency
- Increase collateral available in marketplace

Different approaches to Securities Lending

Value vs Volume

Value Lending

This strategy focuses on lending only those stocks with a scarcity premium combined with conservative collateral guidelines (e.g. reinvestment of cash collateral into a Government MMF or high quality sovereign debt non-cash collateral). This typically results in lower absolute total returns but higher risk adjusted returns, and less potential interference with the investment process due to fewer securities on loan.



Volume Lending

This strategy focuses on both lending securities with a scarcity premium and low margin “general collateral” securities, in combination with a generally higher level of collateral risk. This means either reinvesting cash into a higher yielding money market/short term fixed income vehicle (e.g. a Prime MMF) or taking lower credit non-cash collateral. The total returns from this strategy are frequently dictated by the clients’ tolerance for balances on loan, collateral risk and the amount of general collateral loans that can be absorbed by borrowers given the surplus of assets in the market.

Risks of Securities Lending

The primary risks associated with Securities Lending and how they can be mitigated

Risks

Borrower Default Risk. The risk that a borrower may not return lent securities in a timely manner or at all due to insolvency

Cash Collateral Reinvestment Risk. The risk that there could be a loss of principal or impaired liquidity in respect of reinvestment of cash collateral. The Agent's indemnification does not apply to the loss of cash collateral due to reinvestment risk.

Operational Risk. The risk that the operational mechanics of a securities lending program could cause a disruption to the investment management process or that the fund could suffer due to loss of voting rights, mishandling of a corporate action elections, or sell fails

Legal, Tax, Regulatory Risk. The risk that securities lending activities introduce complications with respect to taxation or regulation

Mitigants

- Highly creditworthy approved borrowers and robust and continuous oversight process in place
- Borrower default indemnification
- Agent has robust operational processes designed to maintain sufficient collateral margin at all times
- Appropriate oversight where lending occurs between affiliated entities, e.g. agent lending to affiliated prime broker

- Invest cash collateral prudently in a vehicle of sufficient scale that prioritizes principal preservation and liquidity, e.g. 2a-7 Government Money Market Fund

- Partner with a lending agent that has solid core technology infrastructure and proven straight through processing and automation capabilities
- Implement contractual protections with lending agent to help protect funds from operational risks.
- Ongoing due diligence of lending agent (site visits, SOC1 review, etc.)

- Partner with a lending agent that has in-house legal, tax and regulatory specialists to monitor ongoing securities lending industry developments
- Obtain independent tax and legal advice as necessary

Considerations for a Mutual Funds Board

- Reasons for participating in a securities lending program
- Risk reward profile of securities lending program
- Alignment with lending provider
- Oversight of securities lending program
- Program alignment with Fund governance principles

BBH Global Securities Lending

Revenue Optimization

- Risk adjusted return philosophy
- Integrated electronic trading and algorithmic pricing power
- Transparent execution



Specialized Securities Lending Solutions

Control & Transparency

- Tech driven client solutions through DealBoard® and SL Infuse™
- Multiple routes to market
- Alignment with Lender operations and investment strategy

Asset Manager Focus

- 90% of client base is registered funds
- Dedicated expertise
- Custody agnostic infrastructure

 **\$1.4tr**
in lendable assets

 **36**
Global Markets in which we are lending

 **Trading Expertise**
In Americas, EMEA and APAC

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