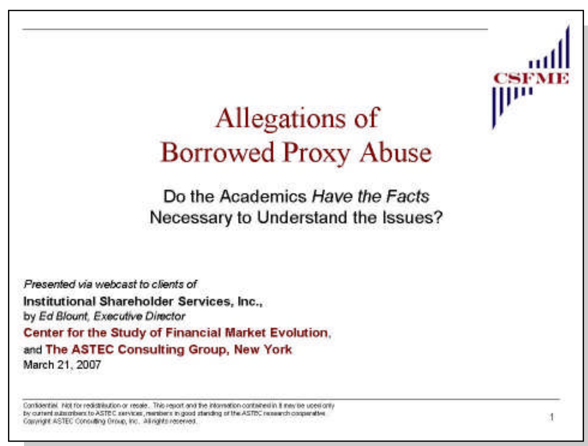
TRUE OR FALSE: SECURITIES LENDERS ENABLE "EMPTY VOTING"... AN ABUSE OF THE PROXY PROCESS

An edited transcript of a response by Ed Blount, Executive Director, Center for the Study of Financial Market Evolution, and ASTEC Consulting, New York, in a webcast with Professor Henry Hu, University of Texas Law School, Austin, Texas, and Mr. Christopher Kunkle, Vice President of JP Morgan Chase Bank, New York, on March 21, 2007, as moderated by Ms. Diana Bourke, Executive Vice President of Institutional Shareholder Services, ISS Governance Forums.

Thank you, Diane, and thank you Professor Hu for that fascinating summary of your groundbreaking study. As someone who has been involved in the business of securities lending for over three decades, I have to say that I regard it as a mixed blessing when we get the kind of attention from academia and media that we've gotten in the last couple of years.

Normally, we would be very pleased to have that attention. Unfortunately, most of the attention that has sprung from recent academic studies, of which Professor Hu's is just one, have been of a very negative cast. And, unfortunately, most of those studies are based on what I regard as a very incomplete, and, in some cases, very biased sources.



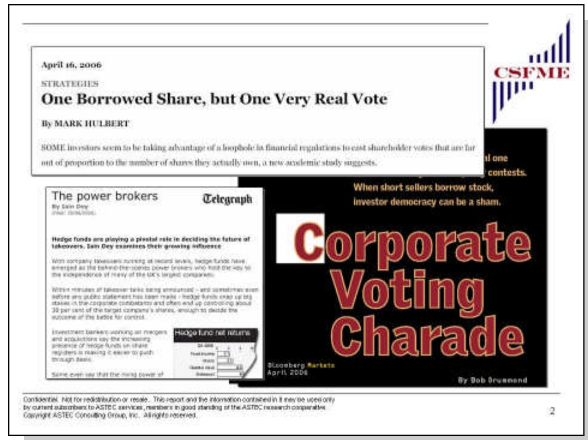
Professor Hu's thesis is that there is "the possibility" of widespread abuse of the proxy voting system using borrowed votes, as evidenced by the examples given in his paper. Thus, <u>something must be done</u>, either in the form of additional disclosure or regulation.

I propose a possible anti-thesis:

- What if there is nothing wrong?
- What if the market is adequately policing itself through the forces of supply and demand, by making securities in contention generally unavailable to borrowers through recall or other processes?
- What if the securities in contentious votes become so scarce and the cost of borrowing so dear that the very strategies the Professor cites -- in the process of indicting the securities lending industry -- are rendered impractical?
- What if, in fact, nothing should be done?

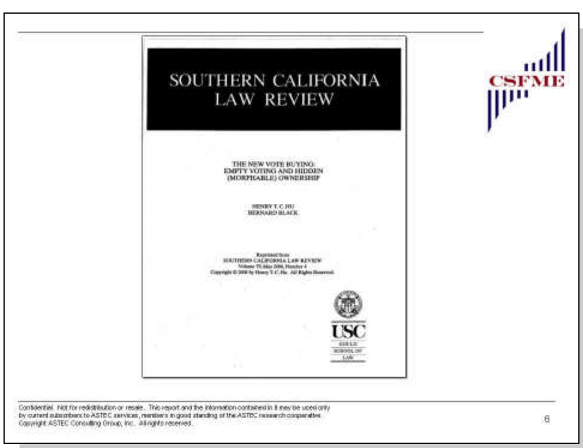
That doesn't mean that we shouldn't look at it; doesn't mean that we shouldn't talk about it. But perhaps nothing is wrong and the market is functioning properly...

Why interfere with a market that not only provides billions of dollars in income to institutional lenders, but also helps maintain stability and liquidity in the capital market system?

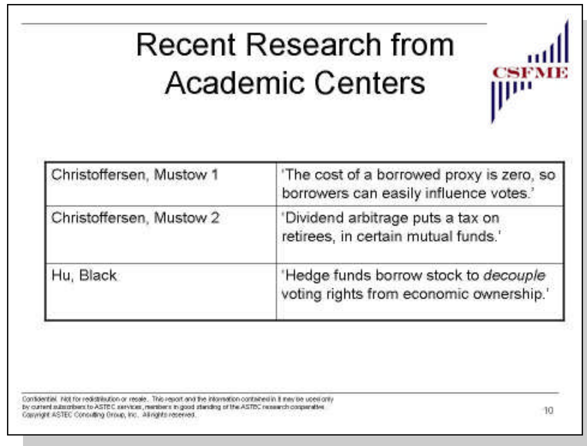


This isn't "just" an academic study. This research has been picked up by the media and extended from fairly conservative findings to something much more dramatic. Sad to say, the impressions in these headlines are being given to regulators, board members and others with the ability to change the direction of lending programs. And if those lending programs are important; are operating as they should, then these are dangerous impressions. The fires are being further fueled by other studies.

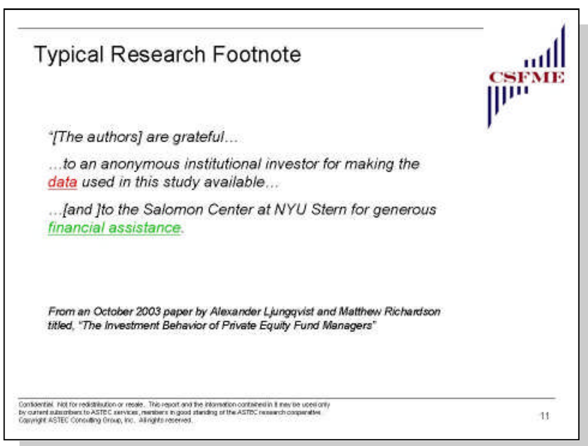
In particular, a Wharton study about securities lending by Professor Susan Christoffersen of McGill and her co-authors was picked up by the Wall Street Journal to suggest that proxy voting problems are related to the securities lending industry. Yet the data used in that study was eight years old, derived from only a single bank and a single broker. Although that is neither a representative nor a timely sample, the media has used that study to create the impression that there are pervasive, current problems within the securities lending industry.



The support for the allegations in Professor Hu's Southern California Law Review article are two dozen or so cases and cross-references to other studies, including the Christoffersen paper. The Wall Street Journal has interpreted these findings as a condemnation of the securities lending industry. And, you know, it's awfully hard not to think that this is cosmic in its significance when the Wall Street Journal commits a page 1 story to these allegations. And it's hard to believe this is merely an academic discussion when the Council of Institutional Investors invites Professor Hu to present his paper at its fall conference. This could lead to any number of changes in securities lending, some of which could be quite destructive.



I'm here as a "quant", so let me turn to some of the quantitative issues. At the risk of distorting these papers (like the media) let me try to summarize the essential findings in three of the most accusatory. The first Christoffersen paper alleged that stocks were being borrowed to influence proxy votes -- and there was no additional cost to borrow. In effect, the borrowers had unlimited power to influence the outcome of the vote. The second study concluded that the service fee on a yield enhancement trade was actually a tax on pensioners, even though it accelerated the dividend cash flow to those entitled, nonresident investors. The third study, by Professor Hu, expresses a hedge fund strategy in the form of decoupling shareholder rights and economic interests. For all of these, as a consultant, I find it illogical when financial engineering is criticized without accompanying methodological support and a robust discipline. You can't criticize this business based on anecdotes. You'd need broadly-based data.



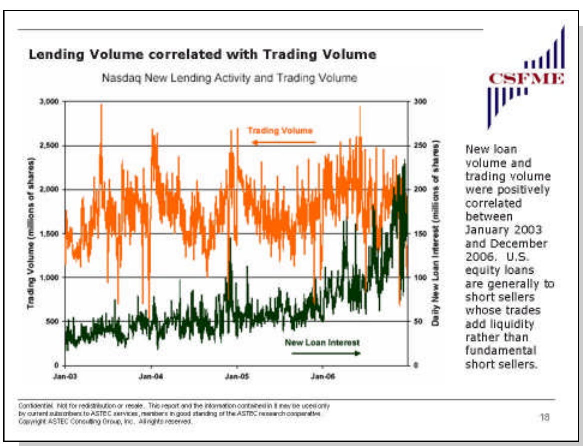
Sadly, the one or two studies that have relied on data are not replicable. As you see in this example footnote, the data is provided by anonymous sources. Even though the Center may be reputable, you can't obtain the data to replicate the study. There are many Research Centers that conduct studies like this.

In my opinion, any study that is going to allege a connection between vote buying and securities lending must rely on quantitative data, not anecdotal support. And, to underline the point, the only studies that are quantitatively based rely on data which is seven or eight years old and comes from one or two anonymous sources.

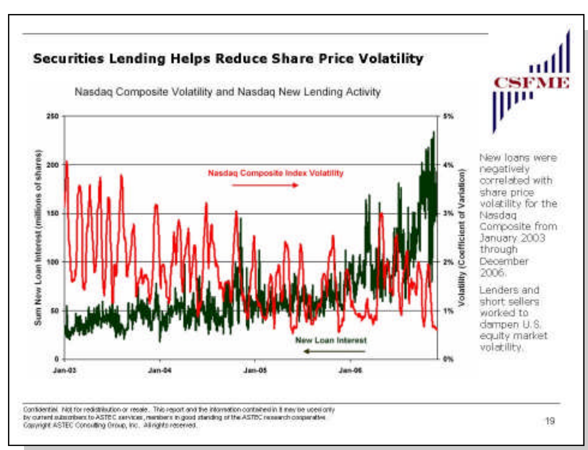
Interestingly, the securities industry is among the first to support studies such as these. I believe that the industry is prepared to get behind this research and continue the studies that you and your colleagues have presented, but I believe they want it held to a very high quantitative standard. In a sense, one could say that the industry in the past has paid for its own gallows. In any event, it's clear that the financial industry is quite willing to pay for the educational effort to illuminate its processes and markets. I have first-hand experience with some of these studies.

My firm, ASTEC Consulting, completed a study with J.P. Morgan in 2000 that concluded short-sellers and securities lenders provide an extremely useful service to the market. By purchasing securities to return to lenders when markets turn down, in order to take profits, short-sellers cushion a price break. Far from being evil doers, securities lenders are helping to provide an extremely valuable cushion and support for market corrections.

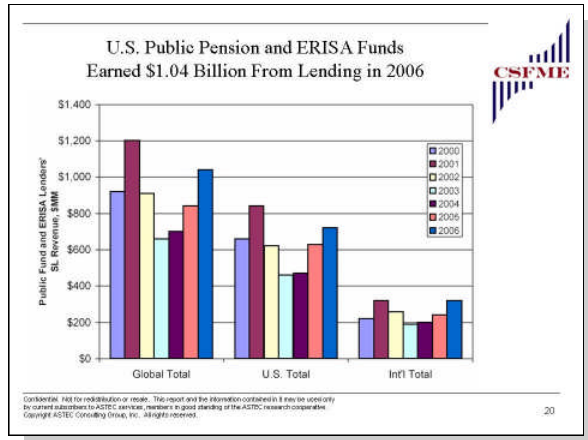
We found the same dynamic was true after 9/11 and again during the summer of 2002, when global equity markets fell 25%. I will be presenting an updated version of that study in Moscow at a World Bank IMF conference in two weeks. My message is this: securities lending and shortselling are extremely positive forces, not just for developed markets but also for developing markets. (These studies are available to any listener, especially any board members who might question the value of securities lending programs.)



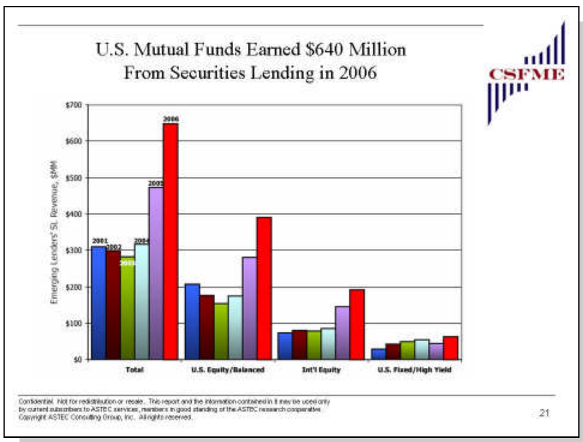
Correlations between lending volume and trading volume show that most loans go to short-sellers who are not taking the kinds of positions that are being criticized by Professor Hu and others in these academic studies. In fact, they are generally following statistical arbitrage, long-short and other market neutral strategies that contribute more to market liquidity than to any malevolent effort to influence the outcome of a proxy vote. Furthermore, strategies that are supported by securities lending contribute to market stability. Again, correlations show that the strategies followed by short-sellers (and even those evil hedge funds) are really good for markets. Indeed, part of my intent in Moscow is to convince developing market regulators that securities lending should be permitted in order to provide a more efficient capability in their own systems.



We can conclude that securities lending is good for markets, but there are also real dollars and cents benefits for the institutional lenders. Based on our own surveys, U.S. pension funds earned over $1 billion in 2006 from lending their securities. In many funds, that was enough to pay for the entire annual administrative cost of supporting the beneficiaries. And it's a growing business.

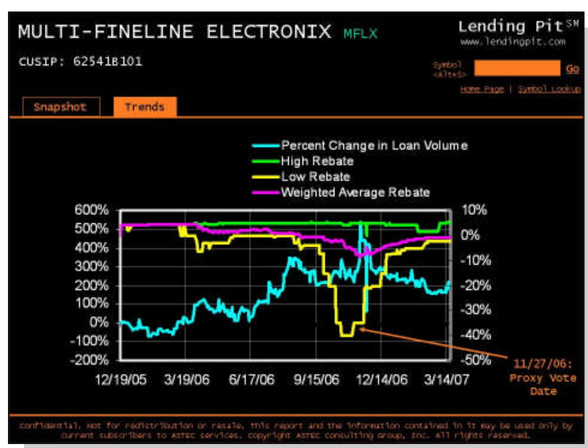


Mutual funds, which started lending their securities only recently, earned over $600 million in 2006. That money goes to the shareholders. In many cases, those earnings can offset transaction costs necessary to execute the portfolio managers' strategies.



In conclusion, I agree that academic studies are important and they help us understand what has to be improved or fixed. But if something isn't broken, don't fix it. The cost of intrusion that comes from additional regulation can work against the contribution made to pricing efficiency, as well as market stability that comes from lending.

Ultimately, these academic findings should only be used as a basis for changing policies, protocols and procedures, not to mention regulations, if they can be corroborated by sound -- I'm a quant -- and broad research, not just by a handful of selected case studies. Because we may well find -- and this is my point -- that market forces are already at work to prevent widespread abuse by making the securities unavailable through recall and other regulatory processes that Chris Kunkle is about to describe, or by making those loans so expensive that traders just can't put on the strategies claimed to be so destructive. And this is true not just of "hedge funds", but also of derivatives dealers who have to hedge their positions in the securities markets by borrowing the securities needed to cover their shorts.



If the loan is too expensive or the position unreliable, the purported evil-doers just can't do the trade. Let's find out the truth. Let's do a robust study to find out whether we have a legitimate concern here – but let's not rush off to the regulators trying to change the rules based on allegations founded on a few, carefully-chosen case studies.

Thank you.

About Ed Blount

Ed Blount is the founder and executive director of ASTEC Consulting, a research firm with offices in New York, London, and Zürich. During his 30+ years working with clients in the securities lending markets, Ed has seen the business evolve in a number of fascinating directions:

- On Wall Street in the 1970s, he managed the Citibank division that loaned American Depositary Receipts to brokers eager to make deliveries and get paid, sometimes weeks before receiving the underlying shares from their foreign counterparties.

- Then, as a consultant in the 1980s, Ed designed MIS programs for global custodians and dealers during the years that securities lending evolved out of operations and onto the trading desks.

- By the 1990s, his institutional clients were managing cash as collateral for loans, thereby adding an investment component to securities lending, so ASTEC began providing risk management analytics.

- In the last eight years, as fund managers and dealers stepped up demand for securities loans to cover the short legs of their trading and hedging strategies, Ed transformed ASTEC's research capabilities into an online pricing and risk management service, called Lending Pit, working from a database with over 500 million loans in 90,000 issues, and a current total of $2.5 trillion on loan.

- Last July, after several high-profile media and academic reports were published criticizing the securities lending industry, Ed created a nonprofit research center and recruited a team of independent academic researchers, offering free access to the ASTEC database in order to investigate the validity of the allegations.

- By December, the Risk Management Association of securities lending agents approved initial funding for a study to be conducted by an academic team from Fordham University's graduate school of business administration at Lincoln Center in New York.

Ed Blount, a former U.S. Marine fighter pilot, has received graduate finance degrees from New York University and Pepperdine University and an undergraduate degree in economics from Fordham University. He is contributing editor for the *Banking Journal* of the American Bankers Association and executive director of the *Center for the Study of Financial Market Evolution*. In two weeks, he will be an invited expert at the World Bank/IMF conference in Moscow presenting a new research paper, entitled "The Impact of Short Sales and Securities Lending on Capital Market Portfolios: 1990-2006".