

Securities Lending Viewed through the Sustainability Lens

Introduction

Securities lending is an important contributor to well-functioning capital markets and provides a number of benefits to asset owners. In a typical securities lending transaction, an asset owner lends securities — both stocks and bonds — to a third party, often one who needs to cover a short position. In return, the third party provides collateral for the loan and pays a borrowing fee which can enhance investment returns for the asset owner. Especially for long-term investors with a stable asset base, the returns that accrue can be meaningful over time if risks are managed effectively. BlackRock's ViewPoint Securities Lending: The Facts¹ explains these transactions in more detail, including how risks are managed.

Recently, questions have been raised about how securities lending aligns with sustainable investing. Some seek to portray short selling — and therefore lending securities which facilitates this — as incompatible with sustainability considerations. Others question how investors can still engage with companies whilst actively lending securities.

We firmly believe that short selling is a crucial contributor to efficient capital markets and that lending securities is not in conflict with effective engagement with companies. This Spotlight explores the intersection of securities lending with short selling and investment stewardship through the lens of sustainable investing.

Securities Lending – the silent contributor to market efficiency

Securities lending has been an established market practice for over 50 years and has evolved into a vital component of developed financial markets. It is a well-regulated practice that contributes to capital market efficiency and also enables end-investors to generate additional returns on their investments.

The lending of stocks, bonds and other assets is a straightforward concept with \$24tn of securities available to borrow and \$2.3tn on loan globally.² Lenders are typically large asset owners — pension plans, sovereign wealth funds, corporations and insurance companies, as well as managers of mutual funds and exchange traded funds (ETFs). A lending agent such as a custodian bank, asset manager or other third party often acts on behalf of the lender.

The borrowers are generally the larger financial institutions, such as some of the largest global banks³, which in turn lend the borrowed assets on to their end clients such as active funds and smaller banks. These borrowers typically use the loaned stocks or bonds to settle a trade, use as collateral in another transaction or facilitate a short sale to either hedge market risks or to implement negative views on a stock. In exchange for the loan, borrowers must post collateral with the lender.

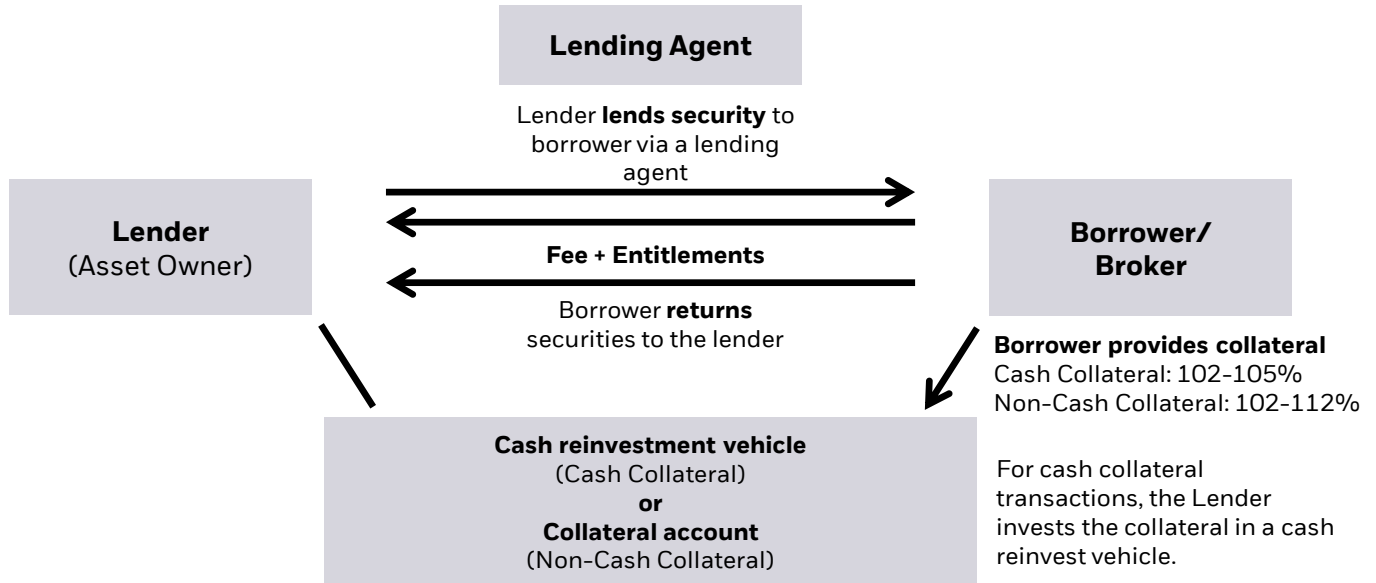
Who Engages in Securities Lending?

Most large asset owners, such as pension plans, sovereign wealth funds, corporations, insurance companies, charities and endowments, as well as managers of mutual funds, exchange traded funds (ETFs) and collective unit trusts do engage in securities lending. The returns over time can be meaningful and contribute to investment performance. For example, it has been publicly reported that the Florida Retirement System (FRS) Pension Plan earned over \$721m in aggregate from Securities Lending since 2001.

Source: SBA Florida Annual Investment Report, Fiscal Year July 1, 2018 - June 30, 2019, available at: https://www.sbafla.com/fsb/Portals/FSB/Content/Performance/Annual/2018_2019_AIR.pdf?ver=2020-01-23-114646-160
All figures in USD.

The borrower pays the lender a fee⁴ for the security — the more sought-after the security, the higher the fee — as well as the equivalent of any income generated by the lent security, such as bond interest or stock dividends. At the conclusion of the transaction, the securities are returned to the lender and the collateral is released back to the borrower. For more detail on the securities lending transaction refer to the diagram below.

Securities lending transaction explained



For illustrative purposes only.

Benefits of Securities Lending

Revenue earned from securities lending can contribute to enhanced portfolio returns. End investors can also view the increased returns as helping to offset the management fees associated with portfolio management activities. Certain portfolios tend to yield higher securities lending income compared to others based on the assets they hold. Securities lending returns are based on the demand to borrow them. The lower the lending supply and the more demand there is for a security, the higher the expected lending fee and in turn the return to investors.

Market efficiency is a tangible benefit for end investors: the added liquidity supports the price discovery process. It can help prevent pricing bubbles from occurring and contribute to reducing trading spreads that in turn can bring down trading costs for investors. In the next section of this Spotlight we will discuss these factors in more detail referencing third-party research.

Risk Management

From an investor's perspective, there are two primary risks in securities lending:

- the potential for borrower (counterparty) default, and
- losses in the reinvestment of cash collateral.

Lending Agents manage these risks by carefully selecting borrowing counterparties, overcollateralizing and prudent management of cash collateral. BlackRock has published several papers outlining our approach to risk management in securities lending.ⁱ

ESG integration and increasing quality of ESG data gives risk managers another tool to determine the long-term viability of counterparties and collateral instruments.

i. <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-securities-lending-the-facts-may-2015.pdf>

Securities lending and sustainable investing

With sustainable investing becoming mainstream, questions have arisen regarding whether securities lending is additive to or detracts from sustainability objectives. The questions we have received from clients in relation to the topic are mainly focused on short selling and voting.

Short Selling

Since securities lending transactions may be used by the borrower to facilitate short sales – where investors sell borrowed securities in anticipation of price declines – some have criticised securities lending as a risk to market stability.

Short selling as a concept is thought to have been invented in 1609, when Isaac Le Maire, a Dutch businessman entered into a transaction that enabled him to short sell shares in the Dutch East India Company. Over time short selling has evolved into a well-regulated mechanism of fully functioning markets. Importantly, short selling should not be confused with naked short selling or market manipulation, which is illegal.

Short selling is important for price discovery and the efficient working of markets. Despite these benefits, short selling at times receives negative press including concerns about whether short selling may have contributed to the 2008 global financial crisis. However, the empirical evidence⁵ shows that short selling does not drive down asset prices nor does it increase volatility.

The Federal Reserve has found that short sales improve market stability. Their research has shown that short selling does not systematically drive down asset prices, and that restricting short selling could actually lead to reduced liquidity and higher transaction costs for investors.⁶ Similarly, in the European Systemic Risk Board's (ESRB) January 2018 working paper on 'Short-selling bans and bank stability', the authors concluded that contrary to intention, stocks with short selling bans experienced greater probability of default and volatility⁷, leading to higher risk to end investors. Research done on the eight month long short selling ban on Australian stocks in the aftermath of the financial crisis also showed that stocks under the short selling ban suffered from decreased liquidity, higher bid-ask spreads and increased volatility leading to higher risk and costs to investors. Regulators in many developing markets are actively looking to establish securities lending and short selling to increase efficiency and promote wider participation.

Each of these papers similarly concluded that short selling contributes to efficient price discovery and liquidity in markets, reducing volatility and costs for investors and is not contrary to long term sustainable value creation.

Voting

When a security is lent, the voting rights and entitlements associated with the security transfer to the borrower. Entitlements (dividends, coupons, etc.), while on loan are paid back to the lender of the security as stipulated in industry standard legal agreements.

A common misperception is that securities lending transfers the voting rights to the short seller. Securities are typically borrowed in order to sell the security and create a short economic position. The short seller who borrows a security via a broker does this by selling the borrowed security in the market. The buyer of the security would then have the right to exercise voting rights with respect to the security, not the short seller.

Short selling does

- Improve Market Stability
- Increase Liquidity
- Reduce Transaction Costs for Investors

Short selling does not

- Drive Down Asset Prices
- Increase Volatility

CASE STUDY

Tesla the company hitting its all-time high valuation after many quarters of losses

On January 22nd 2020, Tesla's valuation surpassed \$100bn for the first time, after turning a profit of \$143 million in Q3 2019. On January 22nd, Tesla's valuation was sitting at more than the combined valuation of General Motors and Ford Motor. In recent years, many have been questioning the company's valuation due to its inability to turn profits in 9 out of the last 12 quarters between Q4 2016 and Q3 2019. Therefore, Tesla has been attracting significant short interest throughout this period and investors lending the security have generated incremental returns. After turning profits in Q3 2019, with the company's fundamentals improving, the stock price has recovered.

This illustrative case study demonstrates that over time, stock prices react to fundamentals and are not driven by short selling. Investors who participate in securities lending can benefit from lending revenues when there are questions about a company's valuation and independently of that, from stock price increases when the fundamentals of a company improve.

Securities lending is therefore consistent with the interest of long-term investors.

Source: <https://www.nytimes.com/2020/01/22/business/elon-musk-tesla-bonus.html>

Source: <https://www.bloomberg.com/news/articles/2020-01-03/tesla-appearing-to-turn-corner-sends-market-value-to-80-billion>

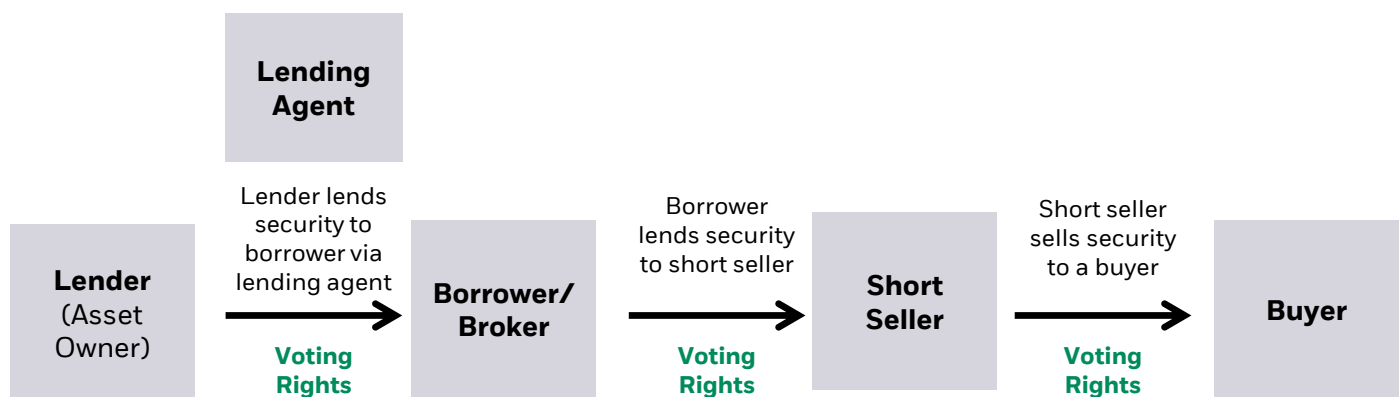
Tesla Q3 2019 Update, available at: <https://ir.tesla.com/static-files/47313d21-3cac-4f69-9497-d161bce15da4>

All figures in USD.

In relation to voting and securities lending there are two areas of discussion that arise; **borrowing to vote** and **proxy voting**.

With regards **to borrowing to vote**⁹, investors are protected in multiple ways. Outside the US, the industry standard legal agreement (Global Master Securities Lending Agreement) prohibits investors from borrowing shares for the primary purposes of voting. Additionally, in the UK, the Bank of England Money Market Code stipulates the same. In the US, as per the 'Permitted Purpose rule' our borrowers need to ensure that borrowing for the purpose of voting does not occur¹⁰.

Securities lending transaction explained continued



For illustrative purposes only.

Regarding **proxy voting**, it is important to note that the majority of lendable assets in the market at any time are not out on loan. BlackRock tends to see borrowing demand of around 10% of lendable assets across portfolios we manage¹¹. Therefore ~90% of securities are available to be voted on. A common misperception is that securities lending cannot coexist with an ability to vote proxies. However securities lending programs all over the world¹² balance the trade-off between voting and keeping shares on loan to generate additional return. BlackRock balances this by giving our Investment Stewardship team discretion on when to recall shares that are on loan.

At BlackRock, we view investment stewardship as central to our fiduciary duty to protect and enhance the value of the assets that asset owners have entrusted to us to manage on their behalf. That is why the Investment Stewardship team is positioned as an investment – not compliance – function, covering both active and index investment strategies. The text box on the right provides more information about the team. BlackRock's approach to the balance between securities lending and proxy voting is driven by our clients' long-term economic interests.

The decision whether to recall securities on loan to vote is based on a formal analysis of the anticipated revenue to the client from the shares on loan compared to the assessed economic benefit of casting votes.¹³

Generally, we expect that the likely long-term economic benefit to clients of casting votes would be less than the securities lending income. This is either because, in our assessment, the resolutions being voted on are routine and will not have significant economic consequences or because the outcome would not be affected by BlackRock voting the marginal holding of loaned securities. The vast majority of the proposals submitted to shareholder meetings deal with routine business and most shareholders overwhelmingly vote in one direction, either 'for' or 'against'. Recent analyses performed by BlackRock¹⁴ have shown that there is overwhelming support for company directors in director election, say-on-pay, and mergers and acquisition (M&A) proposals. For instance, in the Russell 3000 for the for the period of July 1, 2018 to June 30, 2019, approximately 94% of director elections were won by a margin greater than 30%, and fewer than 1% of director votes were determined by a margin of less than 10%. And, 86% of say-on-pay votes were won by a margin greater than 30%, and 95% were won by a margin greater than 10%. Likewise, 98% of M&A-related votes were won by a margin greater than 30%.¹⁵

BlackRock Investment Stewardship (BIS)

BlackRock views informed voting as central to our fiduciary duty. To do this, we have developed the largest global team in the asset management industry, consisting of over 45 multidisciplinary members working from seven offices in six countries around the world, voting at approximately 16,000 meetings a year across 85 markets.

Yet, investment stewardship is not only about proxy voting – it requires a meaningful commitment to engagement with investee companies. BIS conducts over 2,000 company engagements annually. In our experience, the long-term relationships we have built through having a local presence support more constructive dialogue with all market participants. **Engagement is an important aspect of developing informed voting decisions for those clients who have delegated their voting responsibility to BlackRock.**

We engage with management and boards of investee companies to encourage the governance and business practices, including managing material environmental and social factors, aligned with sustainable financial returns. We publish on our website annual [Engagement Priorities](#) that help company boards and management prepare for engagement with the team and provide clients with insight into how we are conducting engagement and voting activities on their behalf.

Committing time and resources to the engagement process is particularly crucial in complex or contested situations. In these instances – as the case studies highlighted in this paper demonstrate – we typically have multiple meetings with companies and, where relevant, dissident shareholders over many months as the situation evolves. BIS analysts frequently work closely with BlackRock's active portfolio management teams to leverage their expertise and perspectives.

While most voting items are routine, our global commitment to constructive and continuing dialogue with companies is particularly relevant in contested votes that could lead to an internal process of recalling shares for voting purposes.

Source: BlackRock, 31st December 2019

While most voting items are routine and the outcome would not be affected by BlackRock's vote, from time to time, the Investment Stewardship team may determine that the expected near- and long-term economic benefit of voting clients' entire holding is greater than the anticipated lending revenue. We do not recall shares on loan to vote unless we can make the case that the optimal voting outcome would be economically beneficial for clients and voting all eligible shares in BlackRock's portfolios would increase the likelihood of achieving that outcome.

Utilizing a model where portfolio management and securities lending is conducted in-house on our integrated technology platform gives BlackRock's Investment Stewardship team full transparency into lent positions. This provides a well-structured process for the recalling of shares, if needed.

The following illustrative case studies are intended to demonstrate two different instances in which BlackRock did and did not recall shares. BlackRock's approach will vary based on a variety of factors as described in the previous sections and either course of action may be accretive to long term sustainable value creation. However, there will be instances when BlackRock will not be successful in advocating for a particular position and we might revisit our approach.¹⁶

CASE STUDY

Dell engagements outside the voting cycle leads to value creation in a reverse merger transaction, reaching a resolution without having to recall shares

In the third and fourth quarters of 2018, we engaged with Dell regarding the company's offer to buy out DVMT shareholders in a ~\$22 billion deal, worth \$109/share with a \$9 billion cash component. Dell and Silverlake controlled all of the board seats, leaving Class C shareholders (such as BlackRock) with little say. BIS, in partnership with other active teams across BlackRock, engaged with management of the private company, various external advisors of the private company, and the two public companies party to the transaction. When we engaged with the private company, we expressed our reservations with its terms, citing in particular their 1) heavily diminished tracking stock price, and relatedly, 2) our view that the company had severely undervalued its potential worth in the public market. After months of discussion and continued concerns expressed by shareholders about the price of the private company tracking stock, new terms were proposed, which BlackRock supported. The revised deal provided a \$5 billion overall value-add when compared to the original valuation. Additionally, the company agreed to appoint a new independent board member. Our engagements and the resulting value-add to this contested situation underscores BIS' role as an investment function focused on delivering value for our clients.

All figures in USD.

CASE STUDY

Controversial vote at Telecom Italia where shares were recalled

In 2018, two Telecom Italia shareholders proposing different long-term corporate strategies fought for control of the board. At the annual general meeting, shareholders, including BlackRock, voted for directors proposed by an activist investor with a 9% shareholding. As a result, the largest shareholder with 24% of the shares, lost control of the board. In 2019, the largest shareholder attempted to regain control by seeking a shareholder meeting to remove the activist investor's five board members and elect five of its own candidates. BlackRock viewed this vote as financially material given the opposing strategies on asset mix, which could impact the value of BlackRock's clients' investments. Moreover, we expected the vote could be close. As a result, BlackRock restricted lending across the global fund ranges in order to vote the full holding. Ultimately, the incumbent board was retained.

KEY TAKEAWAYS

1 Securities lending and short selling contribute to efficient capital markets, benefiting all investors.

Securities lending generates additional income to investors and contributes to market efficiency via providing additional liquidity. Increased market efficiency and liquidity support the price discovery process, which can help prevent pricing bubbles from occurring and contribute to reducing trading spreads and lowering costs for investors.

2 Securities lending does not prevent effective investment stewardship.

Questions have arisen regarding whether securities lending is additive to or detracts from sustainable objectives, particularly in relation to short selling and voting. A common misconception is that securities lending transfers the voting rights to the short seller. However, the buyer of the security has the right to exercise proxy votes of the security not the short seller. Additionally, brokers are prohibited from borrowing shares for the primary purposes of voting. Securities on-loan can also be recalled to vote.

3 ESG and securities lending are compatible with each other.

Investors should seek to learn more about the investment stewardship activities surrounding their lending programme and how their lending provider manages ESG risks. At BlackRock, our integrated approach to investment stewardship and securities lending (including the use of BlackRock's proprietary technology platform) allows us to simultaneously manage and balance ESG risk and desired securities lending activity with the goal of optimizing client outcomes.

Endnotes

1. Available at <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-securities-lending-the-facts-may-2015.pdf>
2. Source: Markit, 31 December 2019, unaudited figures. All figures in USD.
3. The borrowing counterparties for BlackRock lending funds are published in the funds' annual statements.
4. In instances where the collateral posted is cash, the lender will earn a spread equivalent to the interest rate paid to the borrower (Rebate) and the rate that the lender is able to reinvest the collateral (Reinvestment Rate).
5. Please refer to publications under footnotes 6, 7 and 8.
6. Source: Federal Reserve Bank of New York Staff Report no. 518, 'Market Declines: Is Banning Short Selling the Solution?' September 2011.
7. Source: Beber, A., Fabbri, D., Pagano, M., Simonelli, S. (No 64 / January 2018) Working paper series: Short-selling bans and bank stability, European Systemic Risk Board.
8. Helmes, U., Henker, J., Henker, T. (2010) The effect of the ban on short selling on market efficiency and volatility
9. 'Borrowing to vote refers to borrowing a security in order to secure the voting rights.
10. Section 220.10 of Regulation T of the Board of Governors of the Federal Reserve System details the permitted purposes of borrowing a security.
11. In 2019, BlackRock had 9% of its lendable assets on loan globally with 6% on loan for equities. Source: BlackRock, 01/01/2019 – 31/12/2019, unaudited figures.
12. Examples include: Norges Bank Investment Management, California State Teachers' Retirement System (CALSTRS). Source: https://www.nbim.no/contentassets/fa779bdb63724b13a0b25fb976212a13/assetmanagerperspective_2-16_the-role-of-securities-lending.pdf, <https://www.calstrs.com/general-information/program-overview>
13. See [BlackRock Investment Stewardship's Global Corporate Governance Guidelines & Engagement Principles](#) for a discussion on the relationship between securities lending and proxy voting.
14. <https://www.blackrock.com/corporate/literature/publication/barbara-novick-remarks-harvard-roundtable-corporate-governance-the-goldilocks-dilemma-110619.pdf>
15. FactSet using U.S. Securities and Exchange Commission (SEC) Form N-PX filings for Russell 3000 companies for the period of Jul. 1, 2018 to Jun. 30, 2019
16. These case studies are circumstantial and not necessarily indicative of all instances.

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