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## Service Solutions for Short-Enabled Portfolios

### Elements to Consider for 130/30 and Other Hybrid Funds

Given the rising demand for short-enabled investment strategies, The Bank of New York Mellon was pleased to commission Service Solutions for Short Enabled Portfolios – Elements to Consider for 130/30 and Other Hybrid Funds.

### Preparing for Growth

Numerous portfolios have been launched by leading fund managers for retail and institutional investors alike, and many industry pundits predict that short enabled strategies, and their total assets under management, will grow exponentially throughout the decade. BNY Mellon is focused on meeting the rapidly evolving needs of the asset management community, and has devoted the attention and capital needed to ensure our clients can successfully launch new products and implement emerging investment strategies in a cost-effective and risk-mitigated manner.

### Adopting the Optimal Service Solution

This paper is aimed at fund sponsors preparing to launch a short-enabled strategy who seek to understand the key characteristics of the optimal service providers before the launch of their new products. The target audience includes investment managers, fiduciaries for pension funds, and other managers of institutional portfolios, as they consider investing in the “shorting world” for the first time. Adoption of the optimal service solution, before the product is launched, will enhance the likelihood that your short-enabled portfolios will enjoy maximum returns and achieve their potential for growth in the years to come.

*Our partner in developing this research paper...*





# Executive Summary: Selecting Service Providers for Short-Enabled Strategies

The interest surrounding short-enabled strategies over the past year has gathered significant momentum. Whether you refer to these strategies as 130/30, active extension, or more generically as long/short, it does not matter – they have been, and still are, hot topics for the industry. This paper begins by examining the background to the short-enabled strategy, and where it fits along the investment continuum. Is the strategy a “light” version of a hedge fund? Or is it more akin to a traditional long allocation?

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Traditional long-only asset managers facing the borrowing conundrum for the first time should recognize the importance of finding the right service provider, or combination of service providers, to achieve maximum success.

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There are many interested players across the financial spectrum who would like to allocate a portion of their cash to the strategy, as well as those who hope to increase management fees by managing the strategy and including service providers who support it. The regulators have also responded to these developments—short-enabled strategies, at least in the structured form we see today, have grown in the United States; however, European regulators are gradually considering changes that will allow the increase in European-based funds, too. This interest will continue to fuel the growth of the short-enabled strategy.

Traditional long-only asset managers who may face the borrowing conundrum for the first time should recognize the importance of finding the right service provider, or combination of service providers, to achieve maximum success. While most custodians or prime brokers have strong product suites, working with a partner who also brings comprehensive business solutions, such as tools to allow for greater operational efficiency and technology solutions, is a plus. Managers should consider partners with solid collateral management experience and strong risk management. Cost implications and pricing options also play a big role, and with price highly affected by the service solution chosen, how will the fund determine the best service solution for its needs?

## Overview of Short-Enabled Investment Strategies

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Short-enabled investment strategies are effectively a hybrid of traditional and alternative investment techniques.

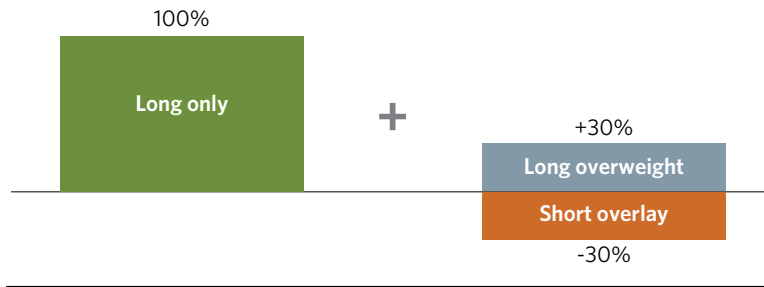
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Unconstrained long/short strategies have been utilized by hedge fund managers for years. Only in the past two years, however, have short-enabled strategies become mainstream, as they have become more structured.

These strategies offer the investor a combination of a traditional long-only portfolio exposure with an overlay of a short exposure to unattractive securities and a further long overlay of attractive securities (of equal weight). The overlay is set at a fixed proportion of the overall portfolio value—typically 20%–40%. A 130/30 portfolio is 130% long (100% + 30%) and 30% short. The net equity exposure is maintained at 100% and distinguishes these strategies from those that are opportunistically short or attempt to be market neutral. The 130/30 name has been adopted because these are the most common percentages currently used.

This is effectively a hybrid of traditional and alternative investment management techniques and is attracting interest from both segments of the market. The traditional fund managers welcome the opportunity to offer their clients services that attract higher management fees, while successful hedge fund managers welcome the opportunity to extend their services into long-only fund management to complement their alternative strategies.

Figure 1: Structure of a 130/30 Portfolio



Source: Spitalfields Advisors Limited

### The Investment Continuum

Continuum theory relates to anything that goes through a gradual transition from one condition to a different condition, without any abrupt changes or discontinuities. Our proposition is that the growing phenomenon of short-enabled strategies, which represent a logical evolution of existing investment strategies, are poised to become a more important part of the investment landscape.

	Beta	Continuum		Alpha
<b>Strategies</b>	Index Fund / ETFs	Traditional Long-only Funds	130/30 Strategies	Hedge Funds
	- Retail and Institutional	- Retail and Institutional	- Retail and Institutional	- Institutional and Qualified Investors
	- Liquid and Transparent	- Liquid and Transparent	- Liquid and Transparent	- Illiquid and Opaque
	- Low Management Fee	- Moderate Management Fee	- Moderate Management Fee	- High Management Fee
	- Low Operating Expense	- Moderate Operating Expense	- Moderate Operating Expense	- High Operating Expense

Source: Bank of New York Mellon

Two fundamental drivers of short-enabled strategy growth are: the search for additional alpha outside traditional asset management techniques; and the potential high level of transparency that is applied to short-enabled strategies. This is closer to that provided by traditional asset classes for which the prospectus provides an absolute guideline as to what is happening with the investor's funds.

Specifically, the index funds and exchange-traded funds (ETFs) that track an index are the ultimate transparent investment and this indexation approach is likely to be a fundamental aspect of short-enabled strategies.

There is a natural point on the investment continuum for short-enabled strategies, offering an alternative solution between the traditional long-only asset management strategies that provide complete transparency, and alternative strategies, such as hedge funds and private equity investments. For the first time, beneficial owners, including insurance companies and pension funds, have a real option to take a step into a strategy that embraces the concept of shorting, but in an easy-to-understand way. This additional confidence is the key—in the past an allocation to an alternative strategy, if made at all, would be a small percentage of total assets. Investors seem to be more confident in allocating more to short-enabled strategies, and it is this dynamic that is fueling potential interest in the strategy. The investor is able to utilize the services of an asset manager with whom they already have a relationship, or certainly with a name with which they are familiar.

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The search for alpha, along with the need for increased transparency, are the two fundamental drivers of short-enabled strategy growth.

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Specifically, investors have been attracted to the strategy in their search for higher risk-adjusted returns. Many believe that they can make their traditional equity investments work harder and smarter by giving their investment managers the freedom to extract higher returns by leveraging off their full investment insight on both the long and short side of the market. This is proving to be an attractive option with some commentators projecting as much as 25% of U.S. active large-cap core equity allocations will be designated to short-enabled strategies in three to five years.<sup>1</sup>

In addition, the asset management community has been attracted to a strategy that has the potential to offer attractive risk-adjusted returns and fees typically above those associated with traditional active investment. The fees associated with this kind of management are not as high as those charged by hedge funds, but are significantly higher than fees in the highly competitive traditional long-only space. The concern is that any formula or limitation imposed on managers will constrain performance and inhibit results; and that if an investor wants short-side exposure they should embrace experienced hedge fund managers rather than employing managers with less short-side experience. The market, as usual, will be the arbiter of this debate. The projected explosive growth of the short-enabled strategy will only occur if asset managers deliver credible results in line with investor expectations.

<sup>1</sup> JP Morgan Asset Management, Insights – The Buyer’s Guide to 130/30 Equity Strategies, April 2007

# Market Impact

## Securities Lending Market

Projected growth of short-enabled strategies is impressive. The strategy is currently estimated at about US\$140 billion AUM globally, and predicted by some to grow to more than US\$2 trillion AUM in the next several years.<sup>2</sup> If this is indeed the case, then an additional US\$600 billion is projected to be borrowed. This growth in borrowing has significant implications for the asset managers and the securities lending market.

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The projected growth of short-enabled strategies is impressive. AUM is estimated to grow from US\$140 billion today, to over US\$2 trillion several years from now.

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It is important for asset managers to understand the short side of the market and factor the appropriate information into their models or investment process. Many long only asset managers who have had no exposure, or limited exposure, to the short side may struggle to get the information required. They will need to understand which securities are already extensively shorted and monitor those securities in their index that are seeing spikes of shorting.

While there is a significant amount of information available on the "long" side of the market, there is correspondingly little on the "short" side. Securities lending activity is not synonymous with short selling. However, it is a reasonable and practical proxy for the scale of short selling activity in the absence of full short sale disclosure.<sup>3</sup>

Key challenges facing the Asset Manager new to borrowing securities to support short selling include:

- Understanding the capacity to execute short sales—many securities that might form part of the short exposure are already in high demand in the securities lending market and may be difficult to access
- Understanding the cost of borrowing—the cost of borrowing securities varies considerably and the pricing reflects many factors

An example of how this information helps us to understand how borrowers will pay a premium for in-demand securities is shown below. This UK listed company suffered during the 2007 credit crunch. When the market became aware of its issues in September 2007, demand grew leading to utilizations in excess of 80% and at one point over 20% of the company's market capitalization was on loan.<sup>4</sup> As the shares became difficult to borrow, fees soared in excess of 1,000bps.

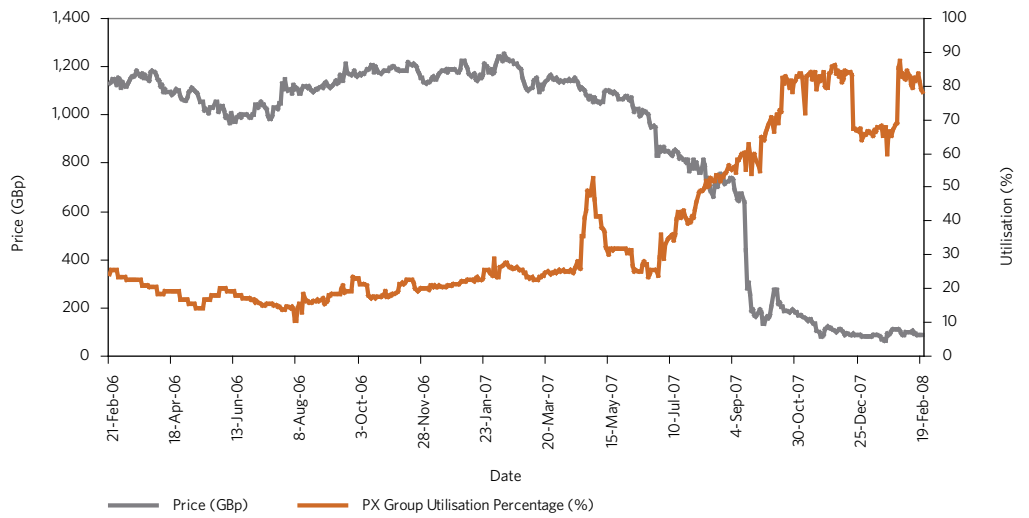
<sup>2</sup> TABB Group, "Alternative Investments 2007 - The Quest for Alpha", September 2007

<sup>3</sup> Short selling data can be difficult to obtain in many markets, but there is some short selling data available from stock exchanges in the following countries: Australia, Brazil, Canada, Denmark, Greece, Hong Kong, Japan, Spain, Sweden, USA.

<sup>4</sup> Utilization - The total value of assets on loan over the total value of holdings, expressed as a percentage

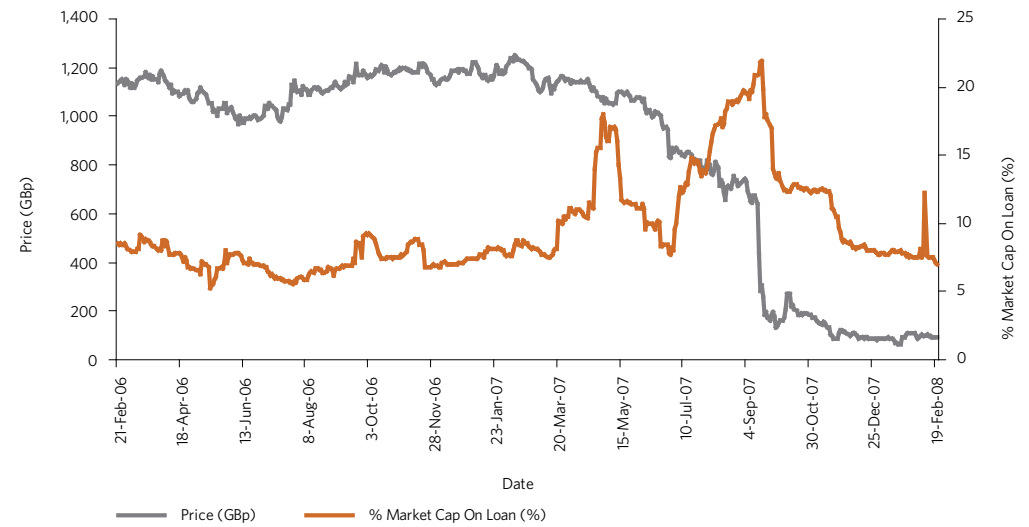
# The Case of a UK Listed Company

**Figure 2: Paying a Premium: Utilization vs. Price**



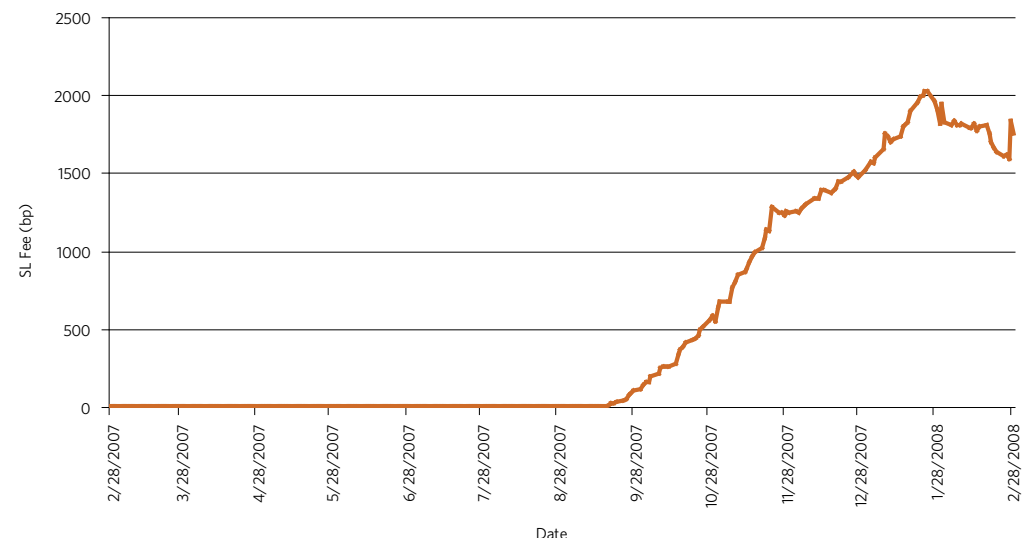
Source: Index Explorer

**Figure 3: Market Cap on Loan vs. Price**



Source: Index Explorer

**Figure 4: Securities Lending Fees Soar**



Source: Performance Explorer<sup>5</sup>

Fees on emerging market and specific sector funds are also generally higher as borrowers seek exposure to these indices. The ability to short an index, particularly where alternative market access products are unavailable, makes them particularly popular. We are aware of an index fund that tracks an emerging market index where lenders enjoyed major revenues in 2007. Utilization was over 90% for the majority of the year although as utilization dropped off in October 2007, the lending fee started falling from 350bps to below 200bps.

The examples above demonstrate that when liquidity is tight, borrowers will have to pay more to access their chosen securities. These price pressures exist today as a result of existing demand, predominantly from hedge funds. If the growth of the short-enabled strategy achieves the scale that some observers expect, then the price pressure will only intensify. The examples we see in certain assets today will spread to other assets in the same index and gradually, as short-enabled strategies move to other asset classes and indices, become a common sight in specific securities elsewhere. The ability to access quality and timely information on the scale of securities lending will become increasingly important.

### Service Providers

The strategy has attracted the interest of both traditional stock pickers and quantitative investors. The quantitative investors have reacted more quickly and established funds easily as the approach is very much in line with their stock selection process. The funds established to date typically have been set up to follow mainstream indices such as the S&P 500<sup>®</sup> or FTSE 100. We believe that, over time, the short-enabled strategy will follow along the lines of the ETF market and expand to include less liquid, lower-market capitalization indices and sectors.

Many of the asset managers involved in short enabled strategies previously were long-only managers and the first obvious discussion for them was to talk to their custodians about the services they could offer. Custodians are definitely in a position to provide many of the required services, but need to move swiftly to identify a full-service offering—only a small number so far have provided any guidance as to how they will service this strategy.

The specific requirements of the short-enabled fund represent a major opportunity to further develop relationships with existing clients as they expand into this strategy, and provide leads into a new client segment. Both global custodians and prime brokers now have an audience who are seeking a combination of key services for the first time. Many asset managers may now consider additional elements besides lending long positions and receiving collateral as they have traditionally done, including:

- Appropriate source for borrowing securities
- Appropriate provider for utilizing long inventory for lending and collateral purposes
- Ability to record and provide reporting on all elements required including fund administration
- Linking custody, lending, borrowing, collateralization, and cash reinvestment
- Provision of transparent pricing for all elements
- Ability to benchmark all transactions for best execution

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We believe that, over time, the short-enabled strategy will follow along the lines of the ETF market and expand to include less liquid, lower-market capitalization indices and sectors.

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### Emerging European Issues: The Move towards Shorting as an Alternative

The possibility to create short-side exposures for investors has not been limited to the hedge fund managers. In Europe, the Undertakings for Collective Investments in Transferable Securities directive (UCITS III) fund structure has encouraged fund managers to use synthetic structuring, such as swaps and contracts for differences (CFDs), to support strategies that require short-side exposure. The European landscape, until recently, has viewed that such synthetic structures would be the only way to support short-enabled strategies. This played nicely to the services that are provided by prime brokers who are more obvious synthetic or derivative partners for asset managers.

However, recent guidance from the Irish Financial Regulator has suggested that regulated offshore investment funds may be able to physically short stocks. This would allow Ireland-domiciled funds structured under UCITS III the right to short stocks outright, in addition to using derivatives to express negative positions, providing they make appropriate disclosures in their prospectuses.

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Regulators in Europe are now considering policies to facilitate shorting in cash markets.

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The Luxembourg regulator, the Commission de Surveillance du Secteur Financier (CSSF), is now looking into this issue and may also adapt its regulations to facilitate shorting in the cash markets. As Ireland and Luxembourg are the largest offshore fund centers in Europe, these potential changes in regulations are likely to provide added impetus to the growth of short-enabled structures. Other regulators will also start looking at the impact on their Fund community, such as those in the United Kingdom.

### Summary

The current market for short-enabled strategies is being fueled by both investor confidence and familiarity, as well as an asset manager's ability to leverage existing investment management expertise for product delivery purposes. In addition, there is potential that regulation in Europe may change to allow physical shorting. It is apparent to us that short-enabled strategies are here to stay—they form an obvious part of the investment continuum and are attractive to investors and asset managers for many reasons. What are the important points for an investment manager in identifying a service provider who can support their long/short strategies? What is the role of the global custodian and prime broker?

# Operational and Control Considerations

## Service Provider Capabilities to Consider

The choice of service providers is a key decision in supporting the short-enabled Asset Manager. The goal is to partner with a custodian and/or a prime broker that will work closely together to provide as seamless a solution as possible.

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Custodians have gradually added capabilities to support derivatives and alternative investment processing, demonstrating their ability to develop their product bases as the marketplace evolves.

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- **Custodian.** Custodians will need to make investments in their service suites to handle the complexity of short strategies. In recent years, most custodians have gradually added capabilities to support derivatives and alternative investment processing, demonstrating their ability to develop their product bases as the marketplace changes; however, supporting short-enabled strategies requires a further step. They need to connect with a prime broker to most effectively service the short side of the strategy.
- **Prime Broker.** Prime Brokers will have the capabilities to deliver the borrowing and collateral financing required, but must be able to effectively work with the custodian regarding custody, accounting, and consolidated reporting. When choosing a prime broker, one must not only evaluate their service capabilities, but also understand how they manage their own risk exposure. The Asset Manager should be comfortable that their assets will remain safe and free from encumbrance while at the prime broker.

The key points to address are:

- **Execution/Connectivity.** It is clear that quick execution is imperative, so a service provider must be able to provide a variety of methods to ensure quick execution. This should include the sharing of available positions in the fund's index, the ability to receive and acknowledge requests to borrow securities, an automated process for sourcing the borrowed securities at the best price, and the capability to execute the borrow in the shortest possible timeframe, plus confirm this back to the fund in order to allow the short sale to be executed. The level of automation incorporated in this process could ultimately prove critical if the period from request to confirmation is to be kept to a minimum.
- **Securities Borrowing.** The service provider should have an adequate pool of assets to support the short activity. How is that asset pool accumulated?
  - **Other clients in their securities lending program.** It is important to understand that other clients, which may include in-house investment management assets, are able to lend to your fund either directly, or via an infrastructure that the service provider has put in place (such as by using a broker to "cross" the transaction).
  - **Proprietary assets.** For those service providers who have a brokerage capability, it is likely that the service provider will have access to further inventory, either in custody or by virtue of their connecting relationships with other prime brokers and broker-dealers.
  - **Borrowing externally.** The capability to borrow, as principal, to access other assets from other dealers will be extremely beneficial.
  - **Exclusive supply.** This could apply to any of the sources discussed above but a big advantage to any service provider will be the proof that they have access to assets that a fund requires by virtue of an exclusive arrangement.

It should be noted that while these points are all important for the initial source of assets, they also are as important to protect the fund's short position. The reason that the prime broker relationship is so important to hedge funds is because of their ability to protect the fund from recalls. A fund will have little success if it is able to execute a strategy only to have to close out the short sale unexpectedly because of a recall.

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Effective custody services will ensure deliveries are made, corporate actions are accurately administered, and books and records are correct.

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- **Financing and Leverage.** The ability to assist the fund in providing cash and other securities, in the event that the fund needs to execute a borrow, is likely to be a core requirement. Delays in finding, and delivering, suitable collateral could negate all the benefits of efficient automation and execution. The size of the facility that will be made available, along with clear pricing of this service, will be important to a fund and should be considered in relation to the anticipated growth of AUM.
- **Collateral Management.** This is potentially the more challenging area for service providers and should not be underestimated in assessing a service provider. The ability to utilize the fund's long assets as collateral should be the first facility. If the fund sells a long asset currently being used as collateral, then the provider will need to have a process that efficiently switches the collateral to another of the fund's assets and have the collateral returned so they can satisfy the sale. Can the service provider work out if a long asset currently utilized as collateral is actually in demand from a stock lending perspective? The ability to substitute for different collateral in this situation is also beneficial. Perhaps more important, is sourcing collateral on the fund's behalf in the event that the long assets are not satisfactory for the borrower. Most short-enabled funds will be running equity index strategies as fixed income short-enabled strategies are in their infancy. Equity collateral, however, still represents a very small percentage of collateral utilized in securities lending; therefore providing a financing service becomes a key component of the service offering.
- **Custody.** Custody is an often forgotten element when dealing with the more exciting business of lending, borrowing and shorting. Custody, however, is the piece that holds the arrangement together. Effective custody services will ensure deliveries are made, corporate actions are accurately administered, and books and records are accurate. Traditional asset managers will be familiar with a custodian who is able to custody and settle transactions—they probably lend assets too, but in a short-enabled situation there are other questions to consider:
  - How do they reflect assets that have been lent as collateral?
  - How do they reflect short sales on their systems and in their reporting suites?
  - Can they support collateral substitutions and re-use of collateral?
  - Can they effectively work with the prime broker to efficiently process movements?
  - Is the relationship between back offices good?
  - In terms of interactions with other important vendors, what reporting and services will be important to the fund's trustee and fund accountant?
- **Reporting.** There are going to be a variety of processes that tie together to bring consolidated reporting. Custody reporting will need to show short positions, assets out on loan, assets being used as collateral, and collateral positions. How many of these are processed on different systems? Will the provider be able to produce the standard of consolidated reporting that will be required? Reporting for compliance and regulatory reasons will also need to be part of the core package, including Unrelated Business Taxable Income (UBTI) reporting, as required.

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As the number of funds and AUM dedicated to short-enabled strategies rise, the importance of selecting a high-quality provider with access to deep securities lending pools, cash and execution will increase.

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- **Accounting and Fund Administration.** Can your service provider pull together all the necessary information feeds required for accounting and fund administration purposes? As well as being able to provide these services themselves, they may need to work with a third-party provider of these services who will not understand the overall service provision. The ability to forge an effective partnership to produce the relevant information will be essential. Can the service support daily valuation of loan, collateral, and borrowed positions? Can the relevant financial statements be produced?
- **Securities Lending.** Most custodians and all prime brokers already will have a lending program. It is important to ensure that the securities lending program is competitive—a short-enabled fund will actually have a larger long-only component than a typical index fund, therefore the securities lending capabilities should be considered.

### Summary

As the number of funds and AUM dedicated to the strategy rise, the importance of selecting a high-quality provider with excellent access to deep securities lending pools, cash, and execution will increase. Service providers who are successful in adapting their service models will strengthen their positions with existing clients and create major opportunities with the growing short-enabled client base.

### Regulatory Requirements in the U.S. and Europe

The short-enabled structure will vary, depending upon the composition of the underlying investors and their regulators. Below, is a summary of the regulatory issues to consider. This is not an exhaustive list and not intended to be a substitute for detailed regulatory analysis conducted with expert advisors, but we believe it highlights the key items.

	Issue	Impact
<b>U.S.</b>		
<b>Registered Investment Companies ('40 Act funds)</b>	Assets must be held by a qualified custodian	Long assets, pledged as collateral against short sales will typically be held in a tri-party account at a custody bank
	Daily Net Asset Value must be calculated	Reporting from custodian and prime broker must be timely
<b>UBTI-sensitive Funds</b>	No debit balances allowed without tax consequences	Accurate and timely cash management is critical
<b>ERISA Funds</b>	Compliance Requirements	Generally applicable ERISA compliance, not specific to short-enabled strategies
<b>Europe</b>		
<b>UCITS III</b>	Assets must be held at a custodian bank	Long assets, pledged as collateral against short sales, will be held in an account at the custody bank
	Limitations on shorting in cash markets	Only Ireland has considered shorting in the cash market; other countries may consider similar changes
	Regulatory Reporting	Daily monitoring of risk management metrics

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## Summary

Local laws and regulations have required providers and investment managers to construct solutions to meet their very specific standards—an important consideration when selecting a fund structure and service provider. The structure chosen needs to both comply with the relevant regulations and be practical and efficient to manage.

## Best Practice Standards

The selection of provider(s), who can offer seamless operational solutions using a scalable integrated approach, is not only logical, but is essential. The introduction of operational risk in the development of the short-enabled strategy is all too possible, but the selection of the right provider will all but eliminate these risks. Components include: Custody and Asset Servicing; Prime Brokerage and Financing; and Collateral Management.

Three models are prevalent in the rapidly developing marketplace:

- **Ad Hoc Solutions.** The fund selects a custodian and a prime broker independently and constructs a service level agreement between the three parties, which hopefully will support the fund efficiently. This solution is the one least likely to provide the fund with operational efficiency, and may be a higher risk solution than strategic partnerships or integrated solutions.
- **Strategic Partnerships.** Based upon the successful experience gained from ad hoc solutions and reflecting some strategic coincidence, there are a growing number of strategic partnerships developing in the field. The fund can select providers with a proven track record of having worked successfully together and be reassured that some commitment to the necessary operational interfaces has been made. This is a step in the right direction regarding operational efficiency.
- **Integrated Solutions.** The current “state of the art” in this evolving marketplace is the integrated provision of the comprehensive service required by funds establishing a short-enabled strategy. There are relatively few organizations in the world that can call upon all of the necessary capabilities and have the resources to combine them in a credible service. Combining low capability services does not help the funds at all—high capability combinations are a major step in the right direction. Such solutions present funds with an excellent low-risk operational outcome. In the event that something does go wrong (as it nearly always does) they are not left looking at service level agreements and working out who to call first—they know exactly who to call.

**Cost Management.** The provider with the economies of scale on their side, offering a comprehensive solution, will be in a strong position to offer the funds the service that they require, at a price they will find attractive. Pricing points to be considered include bundled or unbundled Custody, Clearing, Securities Lending, Leverage, Risk Management, Collateral Management, Reporting, Fund Administration and Accounting.

As the allocations of capital to the strategy may grow, the pricing might change to reflect the scale of funds. There is no one established pricing model at present but the high level of competition combined with the growing volume of funds looking to enter the space suggest that a highly competitive pricing model will emerge.

It is important to note that the total cost of running a fund includes not only the fees of the providers, but also must factor in the time and costs associated with dealing with any operational issues such as failed trades, recalled securities, and corporate actions. These additional costs should not be material unless something has gone wrong. However, this is just another factor to keep tabs on, and if the operational costs of running the fund are too high, it will make sense to consider an alternative provider. Low operational costs will assist fund performance and could help differentiate funds from one another.

**Risk Mitigation and Management.** It is worth noting that the adoption of an operationally efficient model in combination with a strong IT environment has a material risk reduction implication. Key considerations are processes related to Normal Settlements; Corporate Actions; Securities Lending; Cash Management; Margin Financing; Reporting and Compliance. Selecting a provider capable of providing risk management support might be a major consideration unless the fund has access to that support in house. In the same way that compliance support is important to an investor choosing an asset manager to manage its short-enabled strategy, it is also important that the service provider chosen is able to provide the right level of compliance and regulatory support to the manager. The growth of short-enabled strategies and its reliance on short selling and borrowing will all ensure that regulators keep a close eye on the industry that supports these asset managers.

**Collateral Management Capabilities.** The efficient use of capital and the deployment of collateral requires efficient collateral management and the seamless movement of assets to the appropriate accounts in compliance with the relevant regulations. The operational, technological and compliance capabilities of the established triparty players are an excellent starting point for the offering of such a comprehensive service. The ability to allocate, settle, segregate, and report on a volatile pool of assets with a full understanding of regulations, margins, and fiduciary responsibilities is challenging and requires a significant commitment to operational and technological efficiency.

**Technological Efficiency.** Comprehensive solutions for Custody and Asset Servicing; Prime Brokerage and Financing; and Collateral Management on a multi-asset class, multicurrency system are significant. To coordinate the three core services into a fully integrated solution covering the entire trade cycle is the ultimate technological objective. Achieving such an objective will eliminate the inconsistencies that result from separate margin, portfolio, clearance, custody, and cash management systems that need to feed position information to clients.

### Summary

Service providers will compete to support short-enabled strategies based on the provision of a scalable and efficient solution that is fairly priced. The current state of the art is the integrated solution that offers to deliver operational, technological and risk management, as well as pricing benefits to the funds.

## Conclusion

Short-enabled strategies are growing in popularity and, irrespective of whether some of the more aggressive estimations of the short-term potential will be achieved, growth beyond the current levels is ensured. As the world capital markets continue to remain highly volatile, the attractiveness of a strategy that facilitates a short exposure and reduces portfolio volatility, while adding alpha, continues to grow.

As demand for the strategy increases, the competition from providers, such as custodians, prime brokers, and integrated providers, will intensify. As this happens the level of service will rise and the pricing will remain highly competitive too.

The key issues for a fund exploring this area is to find a provider that fits the requirements from a regulatory, operational, technological, risk and collateral management perspective. It is challenging enough for a fund manager to select which securities to buy and sell, so as much of the post-trade work as possible should be given to the experts.

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A key issue for a short-enabled strategy is to find a service provider that fits the requirements from a regulatory, operational, technological, risk and collateral management perspective.

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The experts will differentiate themselves by the way in which they structure, deliver and price their solutions, and the funds will need to be aware of the different approaches to make informed decisions. The choice of partner(s) that the fund makes will be critical to the success of the fund. Access to securities lending supply will become increasingly important as the assets allocated to the strategy increase.

If the US\$2 trillion of assets that TABB has estimated will be allocated to the strategy in several years is achieved, then an additional US\$600 billion of securities will be borrowed. Given that the majority of securities that funds will short will be common across many funds, the increased level of demand will potentially lead to high levels of demand in concentrated pools of securities. To be able to short these securities and keep short (i.e. to avoid recalls) will become critical and the impact upon the securities lending market will be significant.

An additional US\$600 billion of demand will alter the dynamic of the securities lending market and raise interesting issues regarding the pricing and allocation of loans. As competition for supply increases, the cost of borrowing will rise and agents and principals will face difficult allocation decisions—do they offer the securities to their in-house proprietary traders, their established and longstanding hedge fund borrowers, or the new short-enabled client base? A fund needs to understand how scarce securities lending positions will be allocated and recalled before they select their provider.

Finding, selecting, and managing a provider to support a short-enabled strategy is more complicated than a custody decision and much like the process followed by the numerous hedge funds. It is an important decision and will impact the success of the fund and its performance. It is a partnership, and the selection of the right business partner deserves careful consideration. The good news is that there are already some excellent solutions on offer and if the decision is thoughtfully approached, the right answer will emerge as part of the process.

# Appendix

## Service Provider Checklist

### Service Requirements

Custody

Clearance

Collateral Management

Securities Lending

Leverage Provision

Execution

Cross Margining

Fund Administration

Fund Accounting

Transfer Agency/Shareholder Recordkeeping

Risk Management

#### Custody

- 24/7 global operations
  - Global coverage
  - Asset servicing
    - Corporate actions
    - Income collections
    - Full tax reclaim
    - Proxy services
  - Multicurrency cash management (If applicable)
    - Availability
    - Reporting
    - Forecasting
  - Comprehensive foreign exchange capabilities
  - Cash securities and derivative securities processing
- 

#### Clearance

- Automated trade processing and reconciliation
  - Straight-through processing
- 

#### Collateral Management

- U.S. and international capabilities
  - Collateral eligibility screening and margining
  - Concentration limits
  - Rehypothecation capability
- 

#### Securities Lending

- Depth and breadth of supply
    - Mature markets
    - Emerging markets (If applicable)
  - Exclusive access
    - Scale
    - Distribution
  - Recall protection
  - Allocation policy
  - Collateral flexibility
  - IT infrastructure
    - Broadcasting
    - STP
    - Benchmarking
  - “Synthetic Lending” capabilities (If applicable)
-

### Leverage Provision

- Margin lending
  - Credit balances
- 

### Execution

- Cash markets
  - Derivative markets
  - Money markets
  - Direct market access where required
- 

### Cross Margining

- The ability for multi-strategy funds to receive centralized margining across all activities and asset classes
- 

### Fund Administration

- Periodic financial reporting to shareholders and regulatory filings
  - Fund expense budgeting and payment services
  - Statistical reporting to information services
  - Tax reporting and filings
  - Distribution calculations and preparation of shareholder tax information
  - Calculation of investment partnership and master/feeder partnership tax allocations
  - Post-trade compliance testing
  - Regulatory and fund prospectus compliance testing
  - Preparation of Board of Director meeting packages
  - Maintain minute books and general corporate records
  - Maintain corporate calendar, organize and run meetings
- 

### Fund Accounting

- Maintenance of books and records
  - Daily NAV calculation/multiple pricing points/daily reporting
  - Support of varied structures: Master Feeder/Fund-of-Funds/Multi-Manager/ETF
  - Real Time, Internet-Based Access to Fund Accounting Data
    - Extensive, Flexible and Customizable Reporting
    - Data Available in Exportable Format
  - The Accounting System Features:
    - Multi-currency accounting general ledger
    - Comprehensive online complex securities and derivatives processing
    - Multiple amortization/accretion and tax lot relief methods
    - Short position liability accounting
    - Dividend expense tracking on short positions
    - Rebates and fees recorded separately on general ledger
    - Provides flexible interfaces to support client specific applications
  - Robust business continuity
- 

### Transfer Agency/Shareholder Recordkeeping

- Document fulfilment
  - Maintenance of shareholder registers
  - Anti-money laundering (AML) compliance
  - Investor services
  - Processing and confirming investor subscriptions and redemptions
  - Shareholder communications
  - Distributing valuation statements and performance reports
- 

### Risk Management

- Performance Measurement
  - Performance Attribution
  - Investment Analytics
  - Peer Group Comparisons
  - Value - at - Risk
  - Reporting
-

# NOTES

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## The Bank of New York Mellon

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