

Analysis of the effect of the SEC's special order on the securities lending market

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In his 1932 book, *Short Selling*, James Meeker, then the chief economist at the New York Stock Exchange, documented centuries of attempts by governments in every corner of the world to restrict the practice of short selling. He attempted to show that these rules, which seem always to follow stock market declines, are generally repealed because they prove to be ineffective or have unintended – and undesirable – consequences. Now, more than 75 years later, we may have another example of unsuccessful short selling regulation that reminds us, yet again, that history repeats itself.

In the middle of the credit crisis, as banks were being especially hurt by falling share prices, SEC Chairman Christopher Cox used his emergency powers to issue a special order on Tuesday, July 15, to add new requirements to short sales of 19 financial stocks. These included Fannie Mae and Freddie Mac, as well as 17 primary dealers in Treasury securities, only 12 of which have significant markets for their shares in the United States. The rule went into effect the following Monday, July 21, and expired this week, after 23 days, on Tuesday, August 12.

In a nod to Meeker's thesis that restrictions on short selling often backfire¹, it was reported in *The Wall Street Journal*, *The New York Times* and elsewhere that the share prices of the protected bank stocks did not fare as well as those of many other large financial companies during the period in which the special order was in effect. What was not reported in those articles, however, is how the emergency order affected share borrowing, which, after all, was the primary focus of Mr. Cox's new rule.

According to data tracked by SunGard Astec Analytics, a leading provider of market data and performance analysis to the securities lending industry, the SEC's special order did, in fact, have a significant impact on the securities lending market. During the first few days after Mr. Cox announced the temporary measure, the number of shares borrowed in order to short these 19 stocks doubled to more than 815 million on July 21. However, two-thirds of these newly borrowed shares were subsequently returned, apparently as short sellers and their prime brokers became better informed as to the extent of emergency rule.

Before Mr. Cox announced the new restrictions, only 7 of the 19 stocks (and 2 of the 12 stocks with a major U.S. market presence) were considered 'special' in the securities lending arena, meaning that the cost to borrow those shares exceeds 30 basis points, excluding the borrower's own cost of funding the collateral requirement. Even Fannie Mae and Freddie Mac, the two stocks at the heart of this order, were not very difficult or costly to borrow at this time, with barely half of the shares at the lending institutions already taken and borrowing costs less than 20 basis points. In other words, very few of these stocks were hard to borrow at the time of the order.

In the days following the announcement of the rule, however, prime brokers moved to double the number of shares in these companies that they had borrowed. During the dash to borrow more shares,

¹ "Stocks Under 'Short' Order Fell During Protection Period" by JUDITH BURNS. *Wall Street Journal*. August 13, 2008; Page C6. <http://online.wsj.com/article/SB121859398601235661.html>

the cost to borrow these stocks rose to an average of 266 basis points from just 56 basis points as supply became increasingly scarce. Borrowers had to pay up to 1,000 basis points for Fannie and Freddie shares, and about 300 basis points to get shares of Lehman Brothers, twice as much as they were paying before.

Some securities lending desk managers explained that they initially increased their borrowings in mid-July because of the uncertainty of how far-reaching the new rule would be. For example, it was not until Friday, July 18, that the SEC decided that market makers would be exempt from the temporary order to pre-borrow shares in these 19 issues. But by then, the huge increase in securities lending volumes had already occurred. By July 21, 16 of the 19 issues (11 of the 12 with a major U.S. market presence) saw their loan volume increase more than 33%, and 13 of these 19 stocks (8 of the 12 with a major U.S. market presence) were considered special or hard-to-borrow.

After the new rule went into effect on July 21, things settled down in the securities lending market after participants had a few days to digest the impact and limits of the SEC's special order. Much of the initial increase in shares on loan was apparently borrowed as a precautionary measure, to guard against overly stringent interpretations of the rule, a possible lack of exemptions for market makers, and a potential dearth of shares within a market governed by a new paradigm.

In addition to the obvious exemptions, it also appears that the well did not run dry in the securities lending market at all. In fact, two-thirds of the shares borrowed after the rule was announced were returned to their original owners by August 12, because the prime brokers did not need to hoard them. In fact, some have observed this as a sign that there could not have been much naked shorting in these shares if the brokers actually returned shares en masse after the rule went into effect. The SEC warned brokers to borrow enough shares to cover all short sales on their books, but as soon as the rule went into effect, those brokers returned about 30% of all the shares they had on loan, apparently because there were no naked shorts hiding and in need of shares for covering.

So after all of the excited frenzy of borrowing activity in the days after Mr. Cox announced the temporary measure, the securities lending market appears to have slowly but surely reverted to a fairly normal state of affairs in the shares of these 19 companies. On the day the special order expired, shares on loan in these issues were still one-third higher than they were before the rule was announced. Borrowing costs were also 28 basis points higher, on average, but that was down a significant 182 basis points from a peak on July 21.

This huge volatility in the securities lending market was probably not part of the SEC's plans. But one notable aspect of the Mr. Cox's approach to rulemaking for short selling has been thoughtful and detailed reviews of empirical evidence. Based on the SEC's deliberative track record throughout the Reg SHO revisions, it is a good bet that the Office of Economic Analysis will take a close look at the effects of this recently expired emergency order. Their careful analysis will hopefully enhance the SEC's ability to regulate with a deft touch, and will add to our understanding of how markets reacted during these challenging times in our financial history.

Supporting Tables

On an average day during the week before the July 15th announcement (i.e. July 7-14)...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	420,053,784	375,971,955
Value of shares on loan	\$11,024,648,279	\$10,071,738,132
Average cost to borrow a new loan	56 bp	15 bp
Average cost to borrow based on all open loans	48 bp	11 bp
Number of stocks that were 'special' (based on new loans)	7	2
...as a percent of the sample stocks	37%	15%
Number of stocks that were 'special' (based on all loans)	6	1
...as a percent of the sample stocks	32%	8%

By the first effective date of the special order, Monday, July 21...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	815,091,565	753,243,468
Value of shares on loan	\$23,713,128,000	\$22,117,783,909
Average cost to borrow a new loan	266 bp	238 bp
Average cost to borrow based on all open loans	118 bp	99 bp
Number of stocks that were 'special' (based on new loans)	13	8
...as a percent of the sample stocks	68%	67%
Number of stocks that were 'special' (based on all loans)	12	6
...as a percent of the sample stocks	63%	50%

The change in loan activity and costs from the week before the announcement to Monday, July 21...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	94%	100%
Value of shares on loan	115%	120%
Average cost to borrow a new loan	210 bp	223 bp
Average cost to borrow based on all open loans	69 bp	88 bp
Number of stocks that were 'special' (based on new loans)	86%	336%
Number of stocks that were 'special' (based on all loans)	100%	500%

These significant changes occurred across most stocks...

	All 19 stocks	The 12 "US-market" stocks
Number of stocks whose loan volume increased by more than 33%	16	11
...as a percent of the sample stocks	84%	92%
Number of stocks whose new-loan borrowing costs increased by more than 45 bp	12	7
...as a percent of the sample stocks	63%	58%

As of August 12, when the special order expired...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	577,031,179	539,871,576
Value of shares on loan	\$16,748,895,376	\$15,477,093,247
Average cost to borrow a new loan	84 bp	31 bp
Average cost to borrow based on all open loans	84 bp	41 bp
Number of stocks that were 'special' (based on new loans)	10	7
...as a percent of the sample stocks	53%	58%
Number of stocks that were 'special' (based on all loans)	11	5
...as a percent of the sample stocks	58%	42%

These levels on August 12 are this different from the levels on July 21...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	-29%	-28%
Value of shares on loan	-29%	-30%
Average cost to borrow a new loan	-182 bp	-208 bp
Average cost to borrow based on all open loans	-33 bp	-59 bp
Number of stocks that were 'special' (based on new loans)	-23%	-13%
Number of stocks that were 'special' (based on all loans)	-8%	-17%

These significant changes occurred across most stocks...

	All 19 stocks	The 12 "US-market" stocks
Number of stocks whose loan volume decreased by more than 25%	14	9
...as a percent of the sample stocks	74%	75%
Number of stocks whose new-loan borrowing costs decreased by more than 45 bp	10	6
...as a percent of the sample stocks	53%	50%

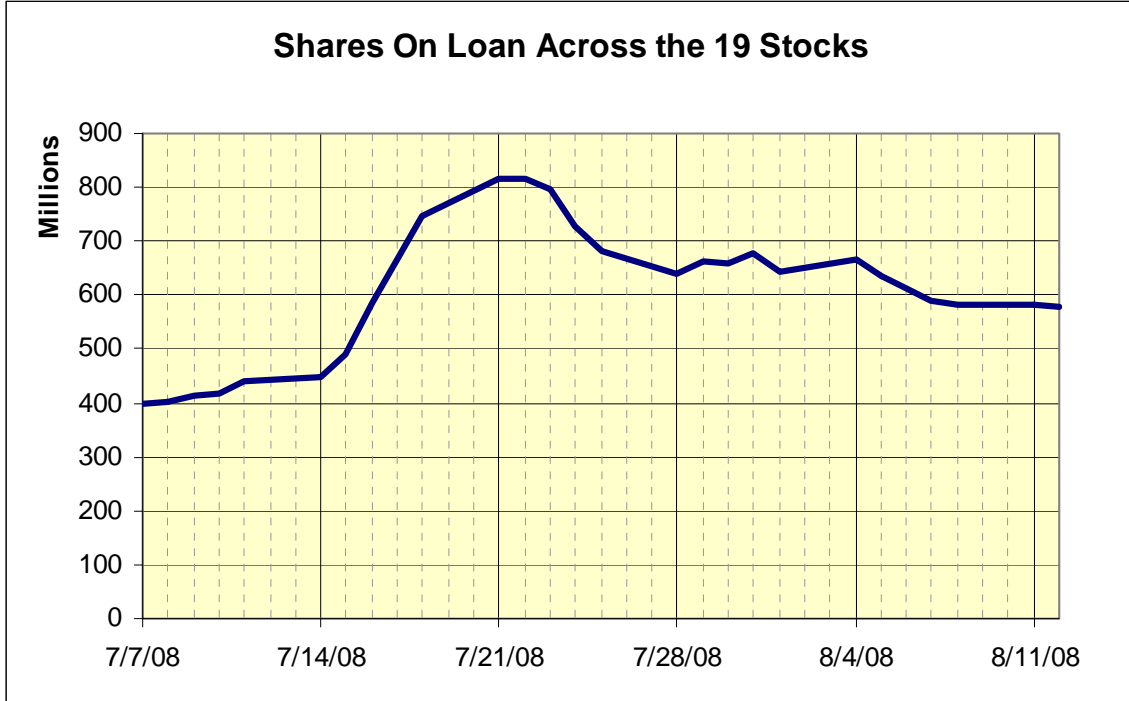
These levels on August 12 are this different from the levels in the week before July 14...

	All 19 stocks	The 12 "US-market" stocks
Number of shares on loan	37%	44%
Value of shares on loan	52%	54%
Average cost to borrow a new loan	28 bp	15 bp
Average cost to borrow based on all open loans	36 bp	29 bp
Number of stocks that were 'special' (based on new loans)	43%	282%
Number of stocks that were 'special' (based on all loans)	83%	400%

Ultimately, not many stocks ended the special order period with significant increases in loan activity or costs...

	All 19 stocks	The 12 "US-market" stocks
Number of stocks whose loan volume increased by more than	9	6
...as a percent of the sample stocks	47%	50%
Number of stocks whose new-loan borrowing costs increased by	6	3
...as a percent of the sample stocks	32%	25%

Supporting Charts



About SunGard Astec Analytics

SunGard Astec Analytics is a research company specializing in market information services for the global securities lending industry. Established in 1980, Astec Analytic's benchmarking tools help securities lending professionals effectively measure and manage performance.

Find out more about how Astec Analytics is suited to your particular business needs by visiting www.sungard.com/astec or contacting an expert on +1 (802) 383 0660