Exchange-traded Funds: Uncompensated Risks From Securities Lending

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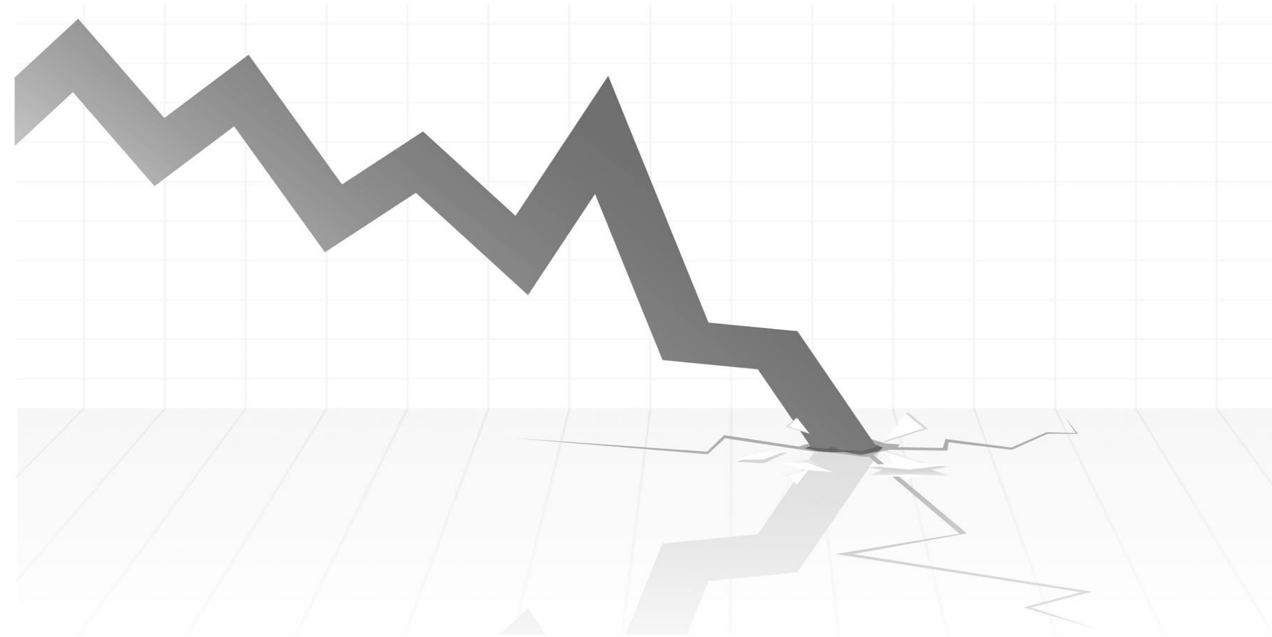

Investors and trustees often use exchange-traded funds (ETFs) to produce market or index returns at a low cost. Often, an ETF strategy is utilized to economically meet the obligations of diversification and to meet the prudent investor standard.

Recent analysis by the Kauffman Foundation and by Bogan Associates LLC raised significant questions about the risks associated with ETFs. Assessing and minimizing risk is a responsibility of trustees and all prudent investors. Common practices of ETF management present surprising risks, with the compensation for the risk kept, in part, by the fund sponsor.

While the articles identification of over subscribed short selling is surprising, far more troubling are the unmentioned hidden risks, conflicts of interest and overreaching by managers who loan out the underlying fund assets and then keep the proceeds.

Several risks related to ETFs are worthy of consideration for the careful investor and trustee.

Fund shares are shorted, sometimes more than five times the outstanding shares of the fund. While hard to grasp, this financial engineering generates substantial fees for various companies but nothing for the ETF investor. Generally, arranging the loans is done by authorized participants of the fund. Many financial professionals claim that short selling fund shares in excess of the outstanding shares is not significant because, at each step, the lender receives collateral. Nevertheless, it is impossible for all of the short sellers to cover their shares because there are not enough shares available.

Additionally, this argument ignores the reality that in the event of a short squeeze with the market rising, the collateral, if safely invested, will not increase in value. During 2008 to 2009, losses due to insufficient collateral resulted in litigation against pension fund managers because the collateral lost value while held in volatile investments. While the collateral should not rise with the market, cost of replacing the fund shares will increase. There is therefore no guarantee that the collateral is sufficient to replace the shares.

Risks exist even if the collateral is marked to market daily. Volatility of the market can exceeded 2 percent per day, which is often the amount of the collateral held in excess of the value of the fund shares.

For funds comprised of highly liquid assets, this risk may be mitigated by the ability to create new units. Illiquid funds are not able to create new units and the collateral would have to be seized. While this issue was discussed (and roundly dismissed by industry representatives), other types of lending to short sellers is even more distressing.

A separate practice should concern every careful investor led to believe that investing in ETFs is just like investing in company shares. All ETFs loan out some portion of the securities comprising fund assets. By law, unit investment trusts cannot receive income from loaned securities. Therefore, these trusts do not loan securities. For example, according to a 2009 article in Forbes, *"Securities Lending Meltdown,"* lending reached $5 trillion and generated $17 billion in total revenues of which investors only received about 1 percent.

So who benefits from the fees generated by loaning the securities? In the case of many fund sponsors, there is a split between the fund holders and the sponsor. Therefore, the fund owners (individuals, trusts or institutions) assume the total and complete risk of loss, but both the fund and the sponsor get part of the income. The sponsor receives these fees in addition to the disclosed management fee. By only enjoying the benefits, but not the risk of loss, the sponsor is more likely to take greater risks. Clearly, receiving two fees for the same work is double dipping.

There are also additional fees paid for arranging the loans and managing the collateral that may go to the sponsor, a related entity or a separate entity. No matter what, the sponsor wins. The investor may or may not get any benefit to go along with all of the risk.

What is the total amount placed at risk? Some sponsors lend a small percentage of the total value of the fund, others lend as much as 95 percent. Lending a large percentage of the fund may increase returns for the sponsor and the fund owners, but this also tacks on a risk of loss to unknowing fund owners.

A competent trustee would never loan stock — certainly not 95 percent of the stock. But thanks to ETFs, the stock is being loaned to short sellers who then bet against the stock positions of the fund.

And what is the counter-party risk? Funds use an authorized participant to sell and create new units. These organizations may well be the same ones that are involved in borrowing the underlying securities and shorting the fund. Therefore, in the event of a breakdown in the system, it is possible that the counter-party responsible for arranging all of these deals could be under extreme pressure due to market forces and fail. The fund owners could then be faced with losses due to loaning the underlying securities and the effects of the short squeeze on the fund shares themselves.

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Running throughout this discussion is the issue of the quality and sufficiency of collateral. Collateral is supposedly protection for both the strategy of shorting a fund's shares and the loaning of securities owned by a fund. Recent litigation and failures demonstrate that holding collateral does not prevent losses. For instance, the Lehman Brothers bankruptcy and other losses resulted in securities lending losses in the billions of dollars during 2008 and 2009. (Lambert, 2009)

For those trying to be prudent investors, as trustees in California must be pursuant to California Probate Code Section 16045, this situation is extremely difficult to address. Apparently, all ETFs engage in this practice and disclosure is extremely difficult to obtain and analyze. Even the industry suggests that greater transparency is necessary according to an Oct. 12, 2010 article in *Global Pensions* titled: *"Transparency Needed Over Securities Lending."*

ETFs have been marketed as an efficient means to purchase a diversified portfolio, but in fact, many practices in the financial industry introduce risks that are not disclosed and probably not fully understood either. In fact, systemic risk exists and can affect anyone's holding. Keeping a significant amount of the revenue increases risk without commensurate compensation.

Furthermore, the companies that are managing these investments are also betting against these investments — making money no matter what happens, which is a clear conflict of interest by the financial companies. Of course, a trustee cannot have such a conflict.

Since it is impossible to find an ETF that does not engage in securities lending, a prudent investor should take steps to minimize the risks that loaning of securities introduces into the ETF investment.

ETFs with the following characteristics present somewhat less risk: An upper limit of securities lending equal to 5 percent or at most 10 percent of total assets; return all of the revenue, less reasonable fees, to the fund owners; requirement of more than 110 percent collateral only in cash or U.S. Treasury instruments; and limits investment of the collateral to highly liquid assets such as cash or bonds.

Finally, if the above criteria cannot be met, limiting an investment in any one ETF may be the only way to limit the risks associated with the management of the ETF. Unfortunately, this approach is often hard to apply economically and efficiently.

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