United States Securities and Exchange Commission
Securities Lending and Short Sale Roundtable

September 29, 2009

Bruce G. Leto, Esq.
Stradley Ronon Stevens & Young, LLP

I appreciate the opportunity to express my views at this roundtable. I am going to address specifically the role of mutual funds and their boards in lending fund portfolio securities. Mutual funds are important participants in the securities lending market and comprise a significant percentage of lenders. Although I represent several fund families that engage in securities lending, my statement reflects only my own views.

The Investment Company Act of 1940 (the "1940 Act") does not directly address securities lending. It does, however, include broad provisions that require good custody of fund portfolio securities, that limit the leverage that funds can incur, and that protect funds against conflicts of interest with their affiliates. The staff of the Securities and Exchange Commission (the "SEC") has provided guidance on the application of these provisions to securities lending, primarily in a series of no-action letters beginning in 1972.[1] Securities lending by funds did predate those letters, though, and was an acknowledged practice when the SEC adopted the original version of Rule 17f-2 in 1941.[2]

---

1 The leading letters providing guidance are essentially considered to stretch from *State Street Bank and Trust Co.*, SEC No-Action Letter (Jan. 29, 1972), and *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972), to *The Chase Manhattan Bank*, SEC No-Action Letter (July 24, 2001).

2 Release No. IC-172 (July 31, 1941) (referring to "securities on loan which are collateralized to the extent of their full market value").

Overview of SEC and Staff Guidance

From a legal perspective, the lending of its portfolio securities by a registered investment company raises issues under Section 17(f) of the 1940 Act, which imposes strict requirements for the custody of portfolio securities, and potentially raises issues under Section 18 of the 1940 Act, which limits the amount and nature of leverage to which registered investment companies can be subject. The SEC staff in two 1972 no-action letters[3] originally set out guidelines under which a mutual fund could lend its portfolio securities:

1. The fund must receive 100% cash collateral from the borrower. The staff in later letters and the SEC in exemptive orders have expanded the types of permissible collateral. However, cash collateral remains the usual collateral for securities lending in the United States. Typically, securities loans in the United States are overcollateralized with 102% cash collateral for domestic securities and 105% for international securities.

2. The borrower must add to such collateral whenever the price of the securities rises (i.e., it marks to market on a daily basis).

3. The borrower must, after notice, redeliver the borrowed securities within the normal settlement time.

4. The fund must receive any dividends, interest or other distributions on the loaned securities, any increase in the market value of such securities, and a reasonable return (either from interest or from the fund's retention of part or all of the returns from the investment of the cash collateral).

---

3 *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972); *State Street Bank and Trust Co.*, SEC No-Action Letter (Jan. 29, 1972).

5. The fund may not be required to pay any service, placement or other fees in connection with the loan, with certain exceptions. The fund may pay reasonable custodial fees to its custodian in connection with the lending of portfolio securities. However, the fees to be charged should be negotiated, reduced to a contract, and approved by the fund directors. Later no-action letters also allow the payment of fees to loan brokers.

6. If fund management has knowledge that a material event will occur affecting an investment on loan, the directors are obligated to call such loan in time to vote the proxies. A later letter allowed the fund to use other methods to secure voting rights, such as an executed blank proxy from the borrower, but these are not typically used. Directors rely on fund investment advisers to satisfy this obligation (e.g. to identify material events).

7. The fund's fundamental policies must permit lending of portfolio securities.

8. Appropriate disclosures must be made in the fund's prospectus.

In addition, the staff has indicated that a mutual fund should not have on loan at any given time securities representing more than one-third of its total asset value. The fund may include the assets that it receives as collateral for purposes of this test, whether or not the collateral would be considered fund assets for accounting purposes.[4]

Assessment

For many years, mutual funds have been able to increase shareholder returns, sometimes materially so, by lending their portfolio securities. This has been accomplished while generally maintaining risk at quite a low level. Although some funds experienced difficulties within the past two years with respect to investments in securities lending cash collateral pools, many funds

---

4 *Brinson Funds*, SEC No-Action Letter (Nov. 25, 1997).

did not experience such losses, and for those that did, it does not appear that the losses were as dramatic as those experienced by other market participants. Thus, the suggestions and comments discussed below should be understood as addressing the margins of an essentially successful system in the mutual fund arena.

Role of the Board

In general, the current regulatory guidance is somewhat outdated and was drafted at a time when the securities lending process looked different from what it looks like today. Consequently, when new wrinkles to the process are identified, legal guidance must be drawn from no-action letters that were drafted before such wrinkles occurred. For example, the use of unregistered securities lending cash collateral pools is a relatively new phenomenon that has been addressed to some degree through the SEC's exemptive order and rulemaking processes. The older SEC staff guidance outlined above, however, predates the use of unregistered pools. In their oversight of securities lending arrangements, therefore, fund boards would benefit from updated regulatory guidance that takes account of current market conditions.

Fund boards also would benefit from a refocus of their efforts on policy decisions and overseeing conflicts of interest. Basic decisions, such as whether to engage in securities lending and the general manner in which a securities lending program will be conducted, should remain the province of the fund board based upon well-presented recommendations from management. Similarly, the board has the same obligation to oversee conflicts with affiliated securities lending agents that it has with any other affiliated service provider. But, as discussed below, when the lending agent is unaffiliated, it should be sufficient for board to set out broad guidelines. The board is ill-suited for the more detailed findings and reviews that they are currently called upon to make. Boards often find themselves reviewing pages of statistical data relating to securities lending, much of which is too detailed for an oversight role.

Updated interpretive guidance would respond to both of these concerns. Ideally, the updated guidance would be through a notice-and-comment process, resulting in an interpretive release or rulemaking that has received the benefit of comments from fund boards and other industry participants.

Proxy Voting

The SEC staff has expressed the view that, in the event management has knowledge that a material event will occur affecting securities on loan and in respect of which the holder of such securities will be entitled to vote or consent, the directors will call the loan in time to vote or consent, or otherwise obtain rights to vote or consent.[5] In practice, however, management often does not have knowledge of material events, because issuers typically do not give notice of the matters to be voted on until after the record date.

Even if the fund were aware of a material matter to be voted on, it is far from clear that it necessarily would be in the best interest of fund shareholders to recall the security in order to vote. A recall of the security, at the very time when lent securities are in greatest demand, will cause the fund to lose the income it otherwise would have received. Frequent recalls also mean that a fund is less desirable as a source of lent securities, since borrowers will be uncertain whether they will have to return the security prematurely. Thus, the fund and its board are placed directly in the crosshairs of two different responsibilities. Further, proxy voting of portfolio securities is generally considered to be part of the investment management process,

---

[5] *E.g., SIFE Trust Fund*, SEC No-Action Letter (Feb. 17, 1982); *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972).

rather than a Board role. It would be helpful if the SEC clarified the securities lending proxy voting guidance and, in particular, the board's role in that regard. It would also be helpful if regulators enhanced the proxy vote notice mechanism that exists so that beneficial owners that desire to vote the proxies of securities on loan had adequate notice to do so.

Lending Agents

Existing guidance contemplates extensive oversight of lending agents. For example, the staff has stated that the fees to be charged should be negotiated between the fund and the lending agent, reduced to a contract, and approved by the fund directors.[6] The staff has also suggested in a thirty-five year old no-action letter that fund directors, in carrying out their fiduciary duty to act in the best interests of the fund's shareholders, should make a comparative analysis of the fees charged by placing brokers.[7] These steps seem excessive for a relatively minor relationship, more akin to that of a broker trading in portfolio securities than that of an investment adviser or fund administrator. In the case of an unaffiliated securities lending agent, this level of oversight might not be necessary when management can effectively oversee the activities of the lending agent.

Affiliated lending agents present a different issue. The SEC staff has provided guidance on how affiliated lending agent arrangements can comply with the 1940 Act.[8] In that case, however, the staff took the position that the affiliated lending agent could not receive compensation based on a share of the lending revenues absent an exemptive order. In practice, however, sharing in revenues is the industry-standard method of compensation, preferred by both

---

6 *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972).

7 *Standard Shares*, SEC No-Action Letter (Aug. 28, 1974).

8 *Norwest Bank Minnesota*, SEC No-Action Letter (May 25, 1995).

lending agents and lending funds. The SEC has allowed affiliated lending agents to obtain revenue-sharing compensation through the exemptive order process.[9] In the past few years, the SEC has not issued those orders, presumably out of concern that the bargaining process with an affiliate may, in certain circumstances, present an insurmountable conflict. This may not have been a uniform problem for affiliated arrangements, and existing arrangements were permitted to remain in place. Such affiliated arrangements which permit revenue sharing may be beneficial for some fund groups. It should be possible for the SEC to provide an exemptive rule or other exemptive or interpretive relief that effectively would address the SEC's concerns.

Investment of Collateral

It is unclear exactly how much flexibility a lending fund has to invest cash collateral. While the SEC staff has at various times mentioned that collateral **could** be invested in various specified ways,[10] the only definitive statement is that the type of investment for cash collateral is a decision for directors of the fund.[11] The industry assumes, however, that the SEC requires that cash collateral must be invested in highly conservative, liquid investments.

Although liquidity is a clear requirement for the investment of collateral that may have to be returned on short notice, there may be circumstances where an investment company should not be limited to such conservative investments. Rather, where consistent with the fund's investment program, greater flexibility may be appropriate when such flexibility is adequately

---

9 For a recent example, see *U.S. Bank National Association*, Release No. IC-28238 (Apr. 16, 2008), 73 Fed. Reg. 21670 (Apr. 22, 2008) (notice).

10 *E.g., Chase Manhattan Bank*, SEC No-Action Letter (July 24, 2001) (investment in joint accounts that, in turn, would invest in fully collateralized repurchase agreements, commercial paper, and other Rule 2a-7 eligible securities); *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972) (investment in high yielding short-term investments which give maximum liquidity to pay back the borrower when the securities are returned).

11 *State Street Bank and Trust Co.*, SEC No-Action Letter (Sept. 29, 1972).

disclosed, and when there is the potential for higher returns for shareholders. Of course, in every case the investment of cash collateral should be consistent with the fund's stated investment policies and prospectus disclosures, including risk disclosures. Further guidance in this area also would be beneficial.