eSecLending Statement for SEC Roundtable, September 29, 2009
Panel 3: *Improving Securities Lending for the Benefit of Investors*
Provided by: Chris Jaynes, Co-CEO

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Dear Ms. Murphy,

Thank you for the opportunity to share eSecLending's perspective on the state of the securities lending industry and the steps we believe necessary for the improvement of the process for the benefit of investors. A desire to provide a better solution for institutional investors was at the heart of eSecLending's founding nearly 10 years ago and remains our focus today as we manage programs for each of our clients. In the following letter, we discuss our history and approach as well as our specific views on transparency and other ongoing developments in the industry that we feel will benefit investors and the overall market.

History of eSecLending

eSecLending is one of the largest securities lending agents globally serving asset management firms, pension plans and other institutional investors in the US, Europe and Asia Pacific. Our clients have combined assets under management of approximately $2 trillion. We were founded in 2000 to provide an alternative approach to securities lending for institutional investors in an effort to address what we saw as the limitations of custodial lending programs which were the dominant route to market at the time. Our origins began in the late 1990's as part of an asset management firm where we were looking to establish a securities lending program for portfolios that we managed. During our review of the market we determined that securities lending should be treated as an investment management and trading discipline rather than an operational function, and that the embedded ties between securities lending and custody were there as a result of historical reasons rather than based on existing conditions in the market. When the securities lending market began several decades ago there were natural reasons why there was a close link to custody: i) securities lending was originally used primarily for sell fail coverage and other operational issues, and ii) custodial systems, electronic communication tools, and other operations and technology infrastructure was not yet robust enough to allow for efficient and effective support of securities lending outside of the custodial process. However, over the years the market has evolved dramatically and the historical reasons for the strong ties to custody were and are still no longer valid in our view. First, the demand side and reasons for lending has shifted from primarily an operational function to one driven by sophisticated arbitrage, investment management and hedging strategies. In addition, the improvements in custody systems, electronic communication tools, and settlement and reconciliation tools over the years have enabled securities lending to be efficiently and effectively separated from custody.

When looking at securities lending as an investment management and trading function however, we observed that many concepts that had been employed for years in the investment management industry were largely absent in the securities lending market. Concepts including "best execution", use of multiple managers, use of specialist providers based on core competencies, competition among managers, performance measurement and benchmarking, were not widely incorporated into the securities lending market. As a result, we developed a different approach to the market designed around what we wanted to see as an institutional investor including greater control so we could customize program activities around our specific assets, risk tolerances and objectives, and improved transparency over fees, returns and risks. In designing our approach, we incorporated what we viewed as the best features of existing custodial agency, third party agency and exclusive program structures and added concepts such as competition and best execution through the use of an auction process.

Our differentiated lending process utilizes a competitive auction process to provide institutional investors with greater transparency and control over their securities lending programs and provide them with more information to make better informed decisions regarding allocation of mandates between different counterparts and routes to market.

Below are several key themes that we see as important for continuing to improve the securities lending market for the benefit of investors today and going forward. Many of these themes have been gaining increased traction and acceptance in recent years but further progress in all these areas will benefit investors and the market as a whole.

- **Full Transparency** into all program activities including program structure, borrower exposures, lending process and approach, cash collateral holdings, risks, etc.

- **More Competition and Choice** including agent selection, lending securities based on best price, use of multiple providers and/or different routes to market. Having greater competition and choice in providers and routes to market benefits investors in multiple ways including better returns, improved service and reporting, enhanced accountability for all participants, and encourages innovation to continue to move the market forward

- **Unbundling of services** to provide pricing and fee transparency for each service, and the ability for investors to utilize "best of breed" firms where they can add value based on their core competency whether that is custody, securities lending or cash collateral management.

- **Improved Benchmarking and Performance Attribution** including improved transparency over returns, performance attribution, risk measurements, peer group and market comparisons, industry best practices, etc.

- **Fully Customized Program Structures –** individual programs should be designed around the specific needs and objectives of each client to incorporate their specific assets, guidelines, risk tolerances, objectives and requirements such as proxy voting policies, portfolio manager sensitivities, etc.

eSecLending's Differentiated Approach & Philosophy:

Auction Assets to Achieve Greater Transparency

eSecLending's approach is to begin each client's program with a competitive auction to determine the optimal route to market for different portfolios or asset classes whether it is via agency exclusives or traditional agency lending. See definitions below for additional clarity on the different routes to market.

Traditional Agency:

Daily trading/negotiating of securities to borrowers on a best efforts basis. Typically facilitated by custodial agents, third party agents and/or self-lenders.

Direct Exclusive:

A portfolio of securities or subset of a portfolio made available to lend to a borrower exclusively for a defined period of time, in exchange for a guaranteed fee payment. In the direct model, the beneficial owner lends directly to the broker/dealer without an agent in the middle managing the administration or providing indemnification.

Agency Exclusive:

Exclusive arrangement managed by an agent who provides full program management, indemnification and administrative oversight. Typically facilitated by custodians and/or third party agents.

The results of the auction allow eSecLending to make better informed decisions and allocations to counterparts with actual market data, based on the specific objectives and risk tolerances of each individual client. The rationale for the decisions can then be easily presented to the client's management, directors, auditors and regulators to show objective criteria for award decisions. This enables clients to better compare their returns and measure their performance based on their specific assets, program parameters, guidelines and risk tolerances.

Within either lending route, our clients maintain transparency and flexibility with regard to all portfolio management activity as well as the ability to restrict assets or recall them for proxy voting or other corporate governance purposes or any other portfolio flexibility that is important to a given client or portfolio manager.

Our approach accomplishes three primary goals that benefit investors:

1) Improved price transparency – Achieved through the auction process
2) Improved control – Achieved with complete program customization. Each client program is treated as a separate book of business and a strategy is designed to optimize returns based around each client's unique assets, guidelines, risk tolerances and objectives
3) Competition – A competitive process is critical to ensure that "best price" is a driver for loan allocations and to optimize program performance

eSecLending is the market leader in securities lending auctions, having auctioned over $2 trillion in assets since inception. The concept of providing greater transparency and control for institutional investors drove the formation of our business and remains at the heart of what we do today. The concept of transparency has a variety of applications and definitions and means different things to different market participants. Several forms of transparency within the securities lending market based on our view are described below.

Transparency in Securities Lending

Demand for greater transparency and best execution in the securities lending market is on the rise, fuelled by recent market events, increased regulatory scrutiny and changing views and expectations of investors. As institutional investors increasingly view securities lending as an investment management function rather than an operational one, they expect to have better data available for reviewing returns, performance attribution, risk factors and relative performance information in order to more fully understand and monitor their programs.

Price Discovery on Loan Pricing

How a lending agent allocates loans to approved borrowers is an area that has lacked transparency in the marketplace historically. This lack of transparency was one of the key drivers in the founding of our business and today investors are asking more questions about the lending agent's distribution philosophy and process. A number of firms including Data Explorers and SunGard's Astec Analytics have developed products in recent years that have significantly improved the information available to investors and other market participants and helped improve understanding of where trading prices are for a given stock or bond as well as providing comparative market and/or peer group data to allow participants to better compare their performance relative to others in the market.

Unbundling of Respective Functions (custody, securities lending, collateral management)

With more transparency and available options in the market comes the question of whether the different functions within securities lending belong as one mandate at one service provider. In our view custody, securities lending, and cash collateral management are each separate disciplines that should be reviewed and monitored individually. These functions have been tied together for historical reasons which are less valid today based on the evolution of the market. While each of these functions is critical to managing an effective overall lending program, the market has moved towards increased unbundling in recent years and we expect this trend to only accelerate going forward. Over the last 10-15 years, the practice of third party lending has taken a firm hold. Technology has made this development easier as electronic links into custodians for third party lending agents has become automated and seamless. Investors are increasingly evaluating their providers on an unbundled basis and requesting unbundled pricing quotes from custodians. This benefits investors since it brings transparency to the cost of each function and allows them to make better informed decisions on provider selection based on the true costs and merits of each individual service.

In recent years this trend has continued with a decision by more investors to also unbundle the cash collateral investment function from the securities lending activity. Close communication and coordination between the securities lending and cash collateral management providers is critical in order to effectively manage liquidity and the asset/liability function but investors are increasingly separating these two functions in an effort to gain greater control and transparency over fees, risk and performance for the respective areas. In addition, some investors are electing to manage the cash collateral in-house in cases where they have an internal capability. With in-house management of the cash collateral, certain investors feel they have better transparency and control over these activities and can therefore better manage the associated risks.

We strongly believe in the merits of unbundling and the concept of selecting providers based on their core competencies and strengths. This trend benefits investors since it increases transparency in many areas from fees, to performance, to risk management. Investors also benefit from unbundling because it introduces competition, drives innovation, and allows clients to gain the benefit of a “best of breed” program, incorporating core strengths and competencies of different providers.

Affiliated Lending Programs

Many mutual fund lenders have affiliated lending agents and/or borrower counterparties within the same ownership structure. An SEC exemption is necessary to transact with affiliated entities but the concept of transparency again comes up when investors engage an affiliate as a service provider. An organization may have a strong capability with an affiliated lending agent or borrower but Boards need to take steps to justify any affiliate relationships and ensure the underlying investors are getting the best “arms length” deal when transacting with an affiliate.

Our process can benefit asset management firms with affiliated agent lenders and/or borrowers since it allows the affiliates to still participate in a program but provides Boards and management with a transparent, arms length process to demonstrate that any awards to affiliates were made based on merits and objective criteria. For investors with affiliate providers we hold an auction that solicits both exclusive and traditional agency bids from the investor’s affiliated businesses as well as other approved counterparts. These bids are then evaluated and examined following a competitive auction process and if allocations are made to an affiliate, they are done so only after a transparent and competitive process and in accordance with the entity’s exemptive relief. The result is that the affiliated businesses are selected in areas where they show value and the mutual fund complex can rely on the auction as the “arms length” process that determined where the best value was for the underlying investors.

Reporting
In order for investors to have greater transparency over their programs lending agents need to provide robust reporting on all aspects of the program. This includes borrower exposures with collateralization levels, earnings with attribution to relevant performance drivers, as well as a full view into the holdings in any cash collateral portfolio that is utilized. Similar to other asset manager relationships, agents should review their programs with clients on a regular basis to review activity in the program, returns generated, compliance, risk areas and new market innovations and developments. Across the industry, the reporting and monitoring should use the same care and diligence that investors apply to other investment management mandates.

Benchmarking and Performance Attribution
Related to reporting is the concept of benchmarking and performance attribution so investors can determine not just what they are earning but how the earnings are being generated, what risks are taken to generate those returns, and how risk adjusted returns in their program compare against others in the market or peer group. As noted earlier, several firms have developed products that have increased the transparency for investors to provide improved context for reviewing the performance of their provider(s) and comparing to performance of others in the market. Although no two programs are exactly the same from an asset, risk and parameter perspective, the ongoing improvements in information available to investors have provided valuable data points to enable clients to better assess and monitor their programs. We support efforts to bring improved benchmarking and performance comparisons to the industry and also feel that our auction process itself is a valuable tool that can be used in conjunction with others to better assess lending demand based on each client's specific program parameters.

We are also supportive of other initiatives underway to improve transparency and overall market efficiency whether it is due to the development of securities lending indices, electronic trading platforms or central counterparties.

Thank you again for allowing eSecLending to participate in the SEC roundtable on securities lending. We look forward to discussions with other market participants to continue improvements in the industry for the benefit of investors.

Sincerely,

Christopher Jaynes
Co-CEO
eSecLending