Center for the Study of Financial Market Evolution
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October 30, 2009

Ms. Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Comment Letter on SEC Securities Lending Roundtable, September 29, 2009

Dear Secretary Murphy,

The Center for the Study of Financial Market Evolution[*] ("CSFME") appreciates this opportunity to comment on the very important issue of systemic risk management in the securities lending community, which was raised by Chairman Schapiro at the Roundtable on September 29, 2009. This letter supplements our position paper, as submitted on September 28, 2009.

Situation Analysis: Do systemic risks exist in securities lending?

During the Roundtable, Chairman Schapiro asked several times whether systemic risks exist in securities lending. Although that question was not asked during Panel Two, when the CSFME participated, several participants on other panels seemed to assure the Chairman that there were no systemic risks. The CSFME believes such assurances require amplification and modification.

Normally, securities lending programs operate as an extension of the trading and settlement markets, posing no systemic risk to the capital markets at large. Indeed, securities lenders provide beneficial support to market liquidity and price discovery, as was documented in a 1999 BIS/IOSCO study and subsequent research. Lending programs are also an important income source for institutional investors and their beneficiaries, shareholders, and constituents.

Nevertheless, systemic risks can evolve over time within a community of securities lending programs, primarily with regard to the consequences of a sudden collapse of lenders' cash collateral pools ("SL cash pools"). The conditions which can impair the ability of securities lending to act as a benevolent force can be brought on by the convergence of portfolio strategies in an opaque market, as well as by well-meaning but misguided regulatory actions.

Such a situation existed in September 2008.

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[*] The CSFME was created in 2006 to help provide transparency in opaque market sectors without revealing trade secrets and proprietary strategies or intruding on confidential relationships.

When proposed shortly after the Lehman bankruptcy, an apparently minor rule change very nearly triggered the forced sale of assets within SL cash pools which would have shredded NAVs for those investment funds and others with similar assets. Only an emergency weekend response by SEC Chairman Christopher Cox, with support from senior SEC and Federal Reserve officials, senior members of the Risk Management Association ("RMA") and Securities Industry Financial Markets Association ("SIFMA"), and facilitation by the CSFME, averted a 'Black Monday'-like crisis of massive sell orders at the market open in an already unstable global system.

September 2008 was admittedly a unique time. Still, many institutions today lend securities and manage collateral in all developed and many developing markets, creating the possibility that rule changes affecting the securities lending markets, as well as communal portfolio actions can foster the onset of conditions which may well contribute to systemic contagion during market instability. Furthermore, it is important to remember that while SL cash pools may appear very similar to retail and institutional money market funds, there are fundamental differences[*] in how pool liabilities drive lenders' cash management policies even during normal times, which are exacerbated during crises.

Unlike money market funds, the liquidity pressures on SL cash pools generally *increase* as securities market values *decline*. That is because money funds receive cash from investors seeking safety during falling markets, while SL cash pools, by contrast, pay out cash as the value of loaned securities falls. Lenders must repay excess loan collateral margin to many of the same borrowers who are also redeeming collateral by returning loan securities after closing out and taking gains on their short positions. To aggravate matters further, the compounding stress of these redemption forces can also force SL cash managers to pay higher rebates on existing loans to borrowers in an effort to stabilize cash balances, just as the lenders' own asset values and returns are also falling.

Prescriptive Assumption: Regulation of all SL cash collateral pools is unnecessary.

Despite the potential for systemic risk acceleration, we do not believe that it is necessary to require all cash reinvestment pools of securities lenders to be registered under the securities laws. The vast majority of institutions engaging in securities lending do not need the protections implied by regulation, since most lenders are sophisticated investors fully capable of understanding and managing the contractual risk profiles in their collateral pools. As a practical matter, the imposition of intrusive regulation can have the consequence of discouraging lending by institutions, thus reducing market liquidity. Ill-defined disclosure rules can also confuse and distort monitoring efforts, thereby disrupting the market's ability to self-correct. That said, recent experience strongly suggests that the ability of lenders and cash managers to anticipate the onset of stresses to their cash pools

[*] Futher discussion of the normal pressures on lenders' cash managers may be found in "Managing Liquidity Risks in Cash-based Lending Programs", by E. Blount and A. Gerdeman, *Securities Lending and Repurchase Agreements*, Frank Fabozzi ed., published by Wiley, 2006.

would benefit greatly from the availability of more information about latent risks in the lender/pool community. Similarly, broker-dealers should have the ability to know the degree to which cash collateral deposits are at risk due to lenders' risky portfolio strategies.

Discussion: New disclosures are desirable.

We call the Commission's attention to the section in our previously-submitted position paper entitled, "Trends in Cash Collateral Management by Securities Lenders." As noted therein, any analysis of the forces affecting securities lending programs and the reactions by their managers, especially during stressful conditions, is of necessity limited today by the current lack of market-wide disclosure of the precise composition and distribution of the assets and, just as significantly, of the liabilities which influence the management of lenders' cash collateral pools.

As a result, certain additional disclosures would be beneficial to all market participants. For example, it would be highly desirable for lenders' cash managers to know whether the evolving volatility of their own redemption liabilities, defined as the relative turnover of borrowers' collateral deposits, was comparable to that of their peers with similar asset holdings. Disclosures of the dynamics of relative program and market liabilities would help lenders (and borrowers) evaluate the risks associated with the asset-liability gaps in their own cash pools. These gaps are particularly sensitive in securities lending programs since all loans, by definition, are strictly overnight, subject to T+0 returns by borrowers (vs T+3 recall by lenders). Any reinvestment of cash collateral into assets maturing beyond one day creates an asset-liability gap, with cumulative liquidity stresses. For that reason, additional market disclosures would aid in providing transparency that would improve risk management and lower systemic exposures for the capital markets.

Solution: Incentives for enhanced market transparency on a voluntary basis.

We recommend that a voluntary, but incentive-based disclosure regime be created to allow regulators and market participants to monitor the growth of concentrations, turnover volatilities, excessive asset-liability gaps, and other contributors to systemic risk, so that defensive measures may be positioned in advance of deteriorating market conditions. The incentives could be structured in such a way that those cash managers or pools that do not participate in a voluntary disclosure regime would be subject to liability composition and/or size restrictions, counterparty concentration limits, liquidity constraints or asset diversification controls, all of which would be designed to curtail the risk of toxins within opaque SL cash pools infecting other capital market sectors.

Any voluntary disclosure regime for cash collateral reinvesting pools should be built upon the Quarterly Composite produced for the past fifteen years by the RMA. Consistency with this data model would allow agent banks to leverage existing reporting processes, as well as enable analysts to monitor long-term trends. Yet, although useful and necessary, adoption of this framework alone would not be sufficient. The evolution of market practices and instruments has rendered certain RMA reporting categories to be less than descriptive, and perhaps dangerously obsolete in the current environment. For example, the pool asset category "Other Corporate" must be used by agent banks today to report their holdings of customized instruments. The inherent ambiguity of a miscellaneous category is not conducive to risk management precision. In addition, the reporting of medians and means for pool composition categories is not as helpful as, for instance, a full dispersion histogram of assets and liabilities. For these and other reasons, an update to the RMA composite is highly desirable. Unfortunately, this is unlikely to happen without regulatory indulgence and encouragement, as the RMA's trade group reporting model is subject to limitations that are due to antitrust considerations. Therefore, another entity or institutional framework must be employed to collect, compile, scrub, validate, analyze, and report on the risk dynamics in these pools.

Conclusion: Disclosure administration should be not-for-profit and trans-jurisdictional.

We recommend that any voluntary disclosure regime be established and maintained by a not-for-profit entity which can not only manage the technical issues, but can also avoid the constitutional conflicts which will arise when the reports are used for dispute resolution by state-regulated investment funds whose securities lending programs are administered by federally-regulated banks and brokers, with operational interfaces to international settlement facilities. For the same reason, an objective, not-for-profit entity will be essential for providing the necessary data and analytics that will be required for any dispute resolution involving trans-border counterparties in multiple sovereignties, operating in a global capital market system.

We appreciate this opportunity to offer our comments on this important issue. If you have any questions concerning our views, or would like to discuss these further, please contact me at 202.581.1188, extension 101, or at ewblount@csfme.org.

Respectfully,

Edmon W. Blount
Executive Director

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