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OFFICE OF THE SECRETARY

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

Re: Securities Lending Follow-up

Dear Ms. Murphy:

JPMorgan Chase & Co. is pleased to submit these comments on the securities lending market as a follow up to our meeting with the U.S. Securities and Exchange Commission (the "Commission") staff. This letter discusses the importance of standardizing securities lending cash collateral investment strategies and the proposed use of a central counterparty for securities loans. We support the Commission's over-arching goals to increase transparency and to reduce systemic risk. Our objective in this letter is to enhance understanding of current risks in the securities lending industry and to provide specific ideas for addressing some of these risks.

Cash Collateral Investment Strategies

Securities loans are transacted on a collateralized basis-either by cash or securities. Intrinsic value returns are generated by demand for a specific security. If the collateral is in security form a spread is earned. If the collateral is cash, the lender earns not only the intrinsic value but also a return on the reinvestment assets. The European market is predominantly collateralized by securities; the US market is generally collateralized by cash.

There are a broad range of investment strategies and vehicles employed by participants in the securities lending market, including some that present different portfolio characteristics and significantly higher levels of risk with substantially less liquidity. In some cases less conservative investment strategy portfolios may have had a detrimental impact on lenders during the recent financial crisis, including actual losses, driven by some lenders' need to sell assets in an illiquid secondary market, and gating of funds by some lending agents to protect liquidity.

It is our view that cash collateral investment strategies should seek to balance in a rational and consistent way risk return and liquidity. Reinvesting securities lending cash collateral in the short term credit markets has systemic importance both in that it contributes substantially to the liquidity of the short term investment market and can lead to highly concentrated exposures to issuers of short term debt. Given the broad range of

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risk strategies that had been taken, establishing industry-wide credit quality, maturity, and liquidity limits applicable to investment guidelines applicable to a securities lending cash investment portfolio would provide a useful, common understanding amongst investors and the market in general.

Lenders who would like to invest cash generated by securities loans more aggressively than such guidelines would permit should be able to do so, but only if they meet certain criteria, including having appropriate oversight and risk management capabilities. Additionally these investment activities should not be categorized as "securities lending reinvestment portfolios".

Central Counterparty

Using a clearing house and central counterparty (CCP) structure to engage in securities lending transactions has been raised as a way of reducing systemic risk. In this type of structure, presumably lenders would lend to a CCP which would on-lend to end borrowers. Borrower and Lender participants would share the risk (through a guarantee fund, loss sharing arrangement, etc.) of any borrower or lender default. The securities lending market did not create systemic risk during the Lehman insolvency; therefore, we do not believe that a CCP structure would have much impact. The benefit of a CCP structure generally is that it provides a mechanism to net transactions, resulting in lower exposures for each participant by allowing it to participate in a loss sharing arrangement or contribute to a guarantee fund to cover any other participant's default. Securities lending transactions intermediated by agents are not susceptible to bilateral or multilateral netting. Large lenders in agency programs typically are not also end borrowers and could face a potentially large cash exposure to a CCP, while retaining exposure to individual borrowers for the return of the loaned securities. Additionally most agency programs indemnify against broker dealer default. Finally, all securities loans are fully collateralized today at either 102% or 105% of the value of the loan, marked to market and margined daily, and in the U.S. the collateral is primarily either cash or government securities (US or OECD, including agency securities and debentures). We understand that as a general matter in the wake of Lehman's insolvency, agents were able to unwind positions and restore securities (or cash where necessary). Lenders are also generally indemnified by their lending agents against the borrower's failure to provide sufficient collateral in the event of default.

Given this backdrop, the benefits to the system of a central counterparty for securities loan transactions are not clear, and significant questions and issues would need to be resolved in the development of any CCP. First, because of the typical risk profiles of Lenders participating in an agency lending program, indemnification by the agent is a prerequisite to participating in a lending program. It is not clear that either agents or Lenders would be willing to commit to contributing to covering the losses of other

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participants in the event of another participants default or to indemnify against losses related to market infrastructure. Second due to the ancillary nature of this business for them, lenders prefer to lend securities on an overnight basis. End users of borrowed securities (i.e., hedge funds, proprietary position takers and other funds), given the term aspects of most portfolios, typically desire to keep their open borrow positions on longer than overnight for hedging and other purposes. The management of the different tenors is currently performed by the agent lender through its ability to reallocate loans to different customers when the original lender requires the return of the loaned securities, providing stability to market flows. It is unclear how this critical component of the securities lending market would be addressed through a CCP. Third, the central counterparty would reduce transparency in the system, particularly if the CCP acted to reallocate loans among its borrowing members. Today, broker/dealers and underlying beneficial owners approve each other, and both have the right to restrict or eliminate activity with the other. The central counterparty would eliminate this transparency and some of our lending clients have specifically told us that they would rethink their commitment to securities lending if they lost this ability directly to control counterparty transactions. Fourth, lower-credit borrowers could gain greater access to the market through the CCP and would add risk to the overall system, not reduce it. Fifth, the agent lending market has traditionally settled loans on a strict DVP basis, with settlements occurring throughout the day to accommodate the operational needs of both parties. It is not clear that lenders would prefer to give up the flexibility and protection this process offers in exchange for the end of day cash settlement typical in the CCP environment.

Securities Lending Impact on the Market

Securities lending provides critical liquidity in both the securities financing and the money markets. We also think it is important to note that the Lehman's default on its securities borrowings did not itself appear to pose a significant systemic risk to the market. This is largely because the collateral standards used by the securities lending industry have generally been both conservative and rigorously applied. In the wake of the credit crisis, agent lenders were able to liquidate collateral, buy in securities and return securities to lenders in a manner that did not cause disproportionate risk or exposure to be borne only by a small number of participants. In cases where the liquidated collateral was insufficient to meet the buy-in costs, the agent lenders immediately stepped up to their obligations under the indemnification provisions of the agreement - without stressing their own balance sheets or liquidity. As a result, Lehman's default on its securities borrowing had at worst a limited affect on the liquidity of either the markets in the borrowed securities or the agent lenders

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On the other hand, as noted above, we believe that the broad range of cash reinvestment strategies on the back of securities lending resulted in unanticipated liquidity risk to some lenders. This risk can be mitigated by establishing industry standard parameters that apply to cash reinvestment guidelines.

Sincerely,

Judith Polzer

Judith Polzer
Managing Director