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Salomon Brothers

Donald M. Feuerstein

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November 4, 1974

Alan Rosenblat, Esq.
Chief Counsel
Division of Investment Management Regulation
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

SEC Reference No. 74-638

Dear Mr. Rosenblat:

In an interpretive response of December 27, 1971, to State Street Bank and Trust Co. you enumerated certain guidelines under the Investment Company Act of 1940 for the lending of portfolio securities by registered investment companies. You further elaborated on these guidelines in responses of May 22, 1972, to State Street; of May 23, 1972, to this firm; and of July 29, 1974, to Standard Shares, Inc. We are probably the largest borrower of securities and have developed a somewhat different structure for securities loans. In addition, a number of additional technical questions have been raised with us by potential lenders. The purpose of this letter is to seek further interpretive responses concerning these matters.1/

1. Are marketable securities issued or guaranteed by the U.S. Government or its agencies acceptable as collateral? (Guideline (1))

The form of securities loan usually considered by the Staff involves a deposit of cash collateral, which the lender invests in "high yielding short term investments which give maximum liquidity to pay back the borrower when the securities are returned." Although this has been the usual structure for loans of corporate securities until recently, there is another structure, which has long been used for loans of U.S. Government and agency securities and is now most often used by Salomon Brothers for corporate securities also.2/ A form of loan agreement reflecting this type of loan is attached. In essence, the borrower deposits with the lender as collateral marketable securities, usually U.S. Government and agency securities, and pays the lender a "loan premium" computed as a percentage of the daily market value of the loaned securities. Any yield on the deposited collateral belongs to the borrower. Thus, the collateral is looked to solely for security not for compensation.

1/ For convenience, we refer to the guideline numbers in your first response when pertinent.

2/ The largest lender of securities is probably the Board of Governors of the Federal Reserve System, which lends U.S. Government securities to recognized dealers against U.S. Government collateral as part of its open market operations.

We see no reason to require the delivery of cash as collateral to the exclusion of the very securities in which the investment company would be permitted to invest the cash immediately upon its receipt, so long as the securities delivered as collateral have a market value at least equal to the amount of cash that would otherwise have been deposited. Indeed, it may be preferable for the lender to have securities as collateral rather than cash. We have retained special counsel to investigate, among other things, the position of a lender of securities in the event of the insolvency of the borrower. We have been informed by such counsel that, although the better view is that a valid security interest may be perfected in cash collateral, the matter is not free from doubt.

Recently, permission has been granted for the use of U.S. Treasury bills as 10-15 per cent of the collateral. If marketable securities are acceptable in principle as collateral, a second reach of our inquiry is whether all marketable U.S. Government and agency securities, whether long or short term and whatever their yield, would qualify for 100 per cent of the collateral. If the sole purpose of the collateral is as security, then the sole test for selecting the collateral should be whether it "gives maximum liquidity." Since the yield on the collateral is reserved by the borrower, its level should not be relevant. All public issues of U.S. Government securities and almost all public issues of U.S. agency securities are highly liquid, coming essentially from the same source as the cash itself. Moreover, the "high yielding short term" securities of other issuers would have considerably more risk than those of U.S. Government and its agencies whatever the latter's maturity or yield. Indeed, that would be the explanation for the former's higher yield.

2. <u>May the compensation for a securities loan be the payment of a loan premium by the borrower at the current market rates for comparable securities loans?</u> (Guideline (4))

As indicated in the previous point, when marketable U.S. Government and agency securities are used as collateral, Salomon Brothers compensates the lender by paying a loan premium negotiated with the lender on the basis of going rates for such loans. The rates are normally a percentage, expressed on an annual basis, of the daily value of the securities loaned. The aggregate amount of payment depends upon the duration of the loan. Thus, at the outset of the loan both the borrower and the lender know the price of the loan, and the compensation to the lender is not dependent upon its success in profitably investing in the short-term paper market. In addition to the possible advantage under the insolvency laws mentioned previously, the investment company avoids the administrative expense and burden of reinvesting cash collateral when it is compensated by such a loan premium. Obviously, the adviser to the fund who negotiates the loan premium would have a fiduciary obligation to obtain a satisfactory premium related to current market rates for comparable loans that would be equivalent to its obligation to select appropriate investments and obtain best execution. The payment of a loan premium by the borrower is in the nature of interest and would clearly seem to fall within the guideline if the rate is reasonably related to the current market.

3. Is the requirement of marking to the market limited to the market value of loaned securities? (Guideline (2))

Marking to the market to reflect changes in the market value of the loaned securities and, if securities are acceptable collateral, the collateral is a very simple procedure. It would also be theoretically possible to require such adjustment of the collateral to reflect changes in the obligations of the borrower to make payments in respect of dividends and daily interest accrual on the loaned securities and to pay the accrued loan premium. Since these amounts are small relative to the market value of the loaned securities and vary from loan to loan and from time to time for a single loan, computing these into the collateral coverage requirement would be difficult and cause an expense to the lender that is unnecessary to the security objective of the Staff's collateral requirement. In addition, registered investment companies would be less competitive than other potential securities lenders. A lender, of course, could require something in excess of the minimum collateral requirement set by the Staff. The lender, and indeed the borrower, might choose to do this to avoid the expense of numerous additions to, or deletions from, the collateral as the daily market values fluctuate. The attached form of loan agreement calls for 102 per cent coverage in securities. We submit, however, that this is best left to negotiation, since a 100 per cent coverage requirement effects complete security for the basic obligation of the borrower.

4. May the return of loaned securities be made on 6 business days' notice? (Guideline (3))

A broker-dealer borrows securities because it needs them to make delivery to a third person; the borrower does not usually retain them for any appreciable time. When a loan is terminated, securities identical to the loaned securities, but probably not the same certificates, are returned. These must be obtained by the borrower when notice of termination is given by the lender. When the borrower purchases them in order to make a return to the lender, the borrower's seller normally has five additional business days within which to make delivery to the borrower. The ability of the borrower to redeliver them to the lender in the same five business days depends upon its seller's making delivery to it early enough, certainly no later than the early morning of the fifth business day, for the borrower to turn them around and make redelivery to the lender by the end of the fifth business day. More often than not, however, such deliveries are made late enough on the fifth business day to preclude, as a practical matter, redelivery to the lender that same day. Thus, there is little real likelihood, as distinct from a hope, that the requirement contained in Guideline (3) could be met in most cases. We submit that allowing a one day turn-around is practically necessary and creates no material additional risk to the lender. Nor would a sale by the lender be materially delayed, since it need not have physical possession of the securities to make a sale.3/ We should prefer that a securities loan contract be written in a manner that reflects what can actually be required.

3/ See Rule 10a-1(c)(2) under the Securities Exchange Act of 1934.

5. May an investment company's board of directors delegate to the investment adviser the authority to negotiate particular securities loans? (Guideline (4))

In order to be competitive with other lenders of securities, investment companies must be in a position to respond almost immediately to requests from broker-dealers for securities loans. It would not be practicable for the adviser to delay entering into a securities loan until the directors approved the terms of a particular loan. The risk involved in collateralized securities loans is at least not substantially greater, and possibly less, than the risk involved in open contracts with broker-dealers for the purchase and sale of securities. The board of directors is clearly able to delegate to the adviser the selection of securities for purchase or sale and the negotiation of price and commissions. The same should be possible with respect to securities loans, so long as the borrower is not affiliated with the adviser. While it may be appropriate for the board of directors of the investment company to give prior approval to the general form of contract used for such lending, the board should be able to delegate to the adviser the selection of particular securities for lending and the negotiation of particular terms for securities loans to unaffiliated borrowers. All such lending transactions would be subject to review by the board of directors as is the case with respect to portfolio purchase and sale transactions. The adviser has a fiduciary obligation to obtain the best terms in lending transactions comparable to its fiduciary obligation to obtain best execution in purchase or sale transactions. We assume, of course, that securities collateral for securities loans would be held by the investment company's custodian or otherwise in compliance with Section 17(f) of the Act, and that the company's fundamental policies include the general right to make loans and contain no prohibition against the lending of portfolio securities.

6. May the lender enter into an alternative arrangement with the borrower that would have like effect to the lender's voting the loaned securities? (Guideline (6))

Terminating a loan is not the only way for a registered investment company to exercise its statutory responsibilities with respect to voting on material events affecting the investment. When it can be assured by other means that securities on loan will be voted in accordance with its wishes, we submit that this should be an acceptable way to carry out any fiduciary obligation to vote proxies, without requiring what might otherwise be an uneconomic decision to call the loan. For example, the third person to whom the borrower delivered the loaned securities and who holds record ownership might provide the borrower with an executed blank proxy, or an executed proxy voted in the manner which the lender wishes, which the borrower would then transmit to the lender for submission to the company whose securities were being voted. Thus, the borrower would be in a position to have its loaned securities voted as it determined while continuing to obtain income from the securities loan.

3/ See Rule 10a-1(c)(2) under the Securities Exchange Act of 1934.

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7. Does an investment company's obligation to return collateral on termination of a securities loan create a senior security under Section 18 of the Act?

Although we believe that a negative answer to this question is not only clear but also implicit in your prior interpretative responses, some investment companies would like a specific interpretation to this effect. A "senior security" is defined in the Act to mean "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." The obligation of the lender during the period of a se-securities loan to return collateral upon termination of the loan does not fall within this definition. Were an obligation to return collateral considered to be itself a loan by the secured party, every form of pledge loan would thereby create two indebtednesses: the borrower's promise to pay contained in the note, and the lender's promise to return the collateral securing the money obligation. It would produce the incongruous result that a lender receiving protection for its loan would be hurting its own financial condition.

8. How much of the portfolio may be loaned?

We understand that the Staff has previously expressed the view that not more than 30 per cent of the investment company's total portfolio may be out on loan at any one time. Although some limitation seems prudent, we have no basis for selecting any particular percentage. We should, however, appreciate confirmation if this in fact is the Staff's position.

* * *

Based on the above analyses I am of the view that under the Act, if an agreement substantially in the form attached is used by a registered investment company (with appropriate modifications in the case of cash collateral) for securities lending:

(1) Marketable U.S. Government and agency securities are acceptable collateral.
(2) Compensation for lending securities may be the payment of a loan premium by the borrower at current market rates.
(3) Six business days' notice for the return of the loaned securities is permissible.
(4) The investment company may enter into alternative special arrangements for the voting of loaned securities.
(5) Marks to the market are required only for net increases in the market value of the securities loaned and/or net decreases in the market value of the collateral relative to each other.
(6) The board of directors may delegate to the investment adviser the authority to select and negotiate particular securities loans to the same extent that it may do so with respect to particular purchases and sales.

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(7) A securities loan does not create a senior security under Section 18 of the Act by virtue of an investment company's obligation to return collateral to the borrower upon termination of the loan.

(8) No more than 30 per cent of the investment company's total portfolio may be out on loan at any one time.

I should appreciate your response as to whether the Staff agrees with these opinions.

Sincerely,

Donald M. Feuerstein

General Partner and Counsel

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT REGULATION

Our Ref. No. 74-638
Salomon Brothers
File No. 132-2

The following is a response to your eight questions concerning the terms and conditions under which registered investment companies may lend their portfolio securities.

1. Are marketable securities issued or guaranteed by the U.S. Government or its agencies acceptable as collateral? (Guideline (1))

We would not object to the use of securities issued or guaranteed by the United States Government or its agencies as collateral for such loans, provided that the other guidelines concerning collateral set forth in my previous interpretations in this area are satisfied. In order to avoid confusion, we would like to comment on your statement that, "although the better view is that a valid security interest may be perfected in cash collateral, the matter is not free from doubt." This doubt apparently stems from the fact that the original Uniform Commercial Code did not specifically include cash in any of the categories of collateral in Section 9 of the Code. However, the Code never specifically excluded cash, and, in any event, has been revised to provide for the perfection of a security interest in money. Although most states, including New York, have not yet adopted this revision, the revision is nevertheless strong evidence of an intent to include money as a form of collateral a security interest in which can be perfected by possession. Moreover, we are not aware of any judicial determination that money could not be used as collateral. (For a persuasive argument that a security interest in money can be perfected through possession under the original Code, see Coogan, Kripke, & Weiss, The Outer Fringes of Article 9: Subordination, Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements, 79 Harv. L. Rev. 229, 261-3 (1965)).

2. <u>May the compensation for a securities loan be the payment of a loan premium by the borrower at the current market rates for comparable securities loans?</u> (Guideline (4))

We would have no objection if the compensation to the investment company took the form of a loan premium so long as the intent of Guideline 4 is satisfied. To satisfy the Guideline the loan premium should give proper weight to prevailing interest rates, dividends, interest or other distributions on the loaned securities, and any increase in the market value of such securities.

3. <u>Is the requirement of marking to the market limited to the market value of loaned securities?</u> (Guideline (2))

We would not object if, as a matter of general practice, adjustments in collateral were not made to reflect changes in the obligations of the borrower to make payment in respect of dividends and daily interest accrual on the loaned securities and to pay the accrued loan premium, provided that the amount of the original collateral is reasonably calculated to account for such changes and that, if at any time it appears that the original collateral is inadequate, appropriate adjustments are made.

4. <u>May the return of loaned securities be made on 6 business days' notice?</u> (Guideline (3)).

It is our present view that permitting a six-day notice period for the return of loaned securities would appear to sanction possible fails to deliver if an investment company sold loaned securities on the same day it called for the return of such securities. You have stated that an investment company could sell loaned securities because Rule 10a-1(c) under the Securities Exchange Act of 1934 provides that securities may be sold even if the seller does not have physical possession of them. However, we note that Rule 10a-2(a) under the 1934 Act contemplates possible fails in such circumstances. In our view, extending the notice period in Guideline 3 to six days would substantially increase the chances for such fails, and, in fact, would assure fails if the full six days were actually used. Moreover, permitting a six-day notice period might raise problems under the NASD Rules of Fair Practice, if an investment company wanted to sell loaned securities. In an interpretation of Article III, Section I of the Rules of Fair Practice, the NASD's Board of Governors has stated that no member shall execute a sell order for a customer unless (1) the member has possession of the securities; or (2) the customer is long in his account with the member; or (3) the customer gives reasonable assurance that the security will be delivered within five business days of the execution of the order; or (4) the securities are on deposit with certain types of depositories and instructions have been given to deliver the securities against payment (see NASD Securities Dealers Manual, p.2037). Finally, the present five-day notice period in Guideline 3 is consistent with New York Stock Exchange Rule 160 which requires the borrower of securities, after notice, to redeliver borrowed securities within the normal settlement time of five days. In view of these factors, we do not consider it advisable to alter Guideline 3 at the present time.

5. May an investment company's board of directors delegate to the investment adviser the authority to negotiate particular securities loans? (Guideline (4))

Assuming that the fund's board of directors first approved the lending of its portfolio securities and the general limitations on such lending, including a general form of contract for such lending, we would not object if a fund's board of directors delegated to the investment adviser the authority to negotiate particular loans, provided that such a delegation would be consistent with the terms of the advisory contract. However, our taking this view should in no way be considered as relieving fund directors of their fiduciary duties.

6. May the lender enter into an alternative arrangement with the borrower that would have like effect to the lender's voting the loaned securities? (Guideline 6))

We would not object to the use of any practicable and legally enforceable arrangement to ensure that fund directors are able to fulfill their fiduciary duty to vote proxies with respect to loaned portfolio securities.

7. Does an investment company's obligation to return collateral on termination of a securities loan create a senior security under Section 18 of the Act?

The creation of an obligation on the part of an investment company to return collateral upon the termination of a loan of portfolio securities may involve the issuance of a senior security within the meaning of Section 18 of the Act. However, we would not recommend any enforcement action for violation of Section 18 because of the creation of such an obligation, so long as all the Guidelines we have established for securities loans are satisfied.

8. How much of the portfolio may be loaned?

It is our view that no investment company should have on loan at any given time securities representing more than one-third of its total asset value. In permitting the loaning of portfolio securities, we recognize that there are substantial differences between a secured loan of securities and a borrowing of money secured by a pledge of securities. However, there are similarities as well. One significant similarity is that, whether an investment company loans it securities or pledges them, to some extent it sacrifices control over its portfolio. A company which pledges securities for a loan obviously loses control of those securities. A company which loans portfolio securities loses control to the extent that, if the borrower defaults, the investment company may not be able easily to replace the securities at advantageous prices. Of course, the risk of default is reduced in view of the collateral and the right to terminate the loan. However, as indicated, there is no guarantee that the lending company will be able to restore itself to _status quo ante_ in case of a default. Section 18 effectively limits the extent to which an investment company can relinquish control over its portfolio by pledging securities, and we believe that it is appropriate to use the Section 18 limitation as a model for such conditions in the case of loaned securities.

Alan Rosenblat

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