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A legal update from Dechert's Financial Services Group

Overview of Fund Securities Lending Programs

Introduction

In light of the recent interest in mutual fund securities lending programs spurred by the recently announced results from the 2004 sweep examinations conducted by the Securities and Exchange Commission's ("SEC") Office of Inspections and Examinations ("OCIE"), and recent SEC staff comments, this update identifies and explores key areas of consideration for fund securities lending programs.

Specifically, this update discusses appropriate topics for an annual compliance review of a securities lending agent, questions and issues to consider in selecting a securities lending agent, and policies and procedures for fund securities lending programs.

Compliance Review of Securities Lending Agent

Rule 38a-1 under the Investment Company Act of 1940 ("1940 Act") requires the chief compliance officer ("CCO") of a fund to review, no less frequently than annually, the adequacy of the fund's policies and procedures and the effectiveness of their implementation. This requires that the CCO review the policies and procedures of each of the fund's service providers. Rule 38a-1 explicitly designates the adviser, principal underwriter, and transfer agent as service providers, but representatives from the SEC have recently suggested that the CCO also should include the securities lending agent in the annual review.

As a result of OCIE's 2004 sweep examinations of fund complexes and their securities lending programs, certain fund complexes recently received deficiency letters regarding such programs. The deficiency letters focused on a vari-

ety of issues, including the rebate rates paid to borrowers, the income to the funds, and the process of determining whether an affiliated securities lending agent's fees and services to the funds were at least equal to those from an unaffiliated securities lending agent.

At a recent conference on securities lending, Gene Gohlke, Associate Director of OCIE, discussed the staff's findings from OCIE's 2004 sweep examinations. He noted that the staff uncovered further deficiencies with respect to securities lending programs involving affiliated lending agents, including failures by funds to comply with conditions of SEC orders permitting the use of affiliated lending agents and inadequate supervision of such programs and the inherent conflicts by the boards of such funds.¹

In light of these letters and the more recent comments of SEC staff members, we suggest including the securities lending agent in the CCO's annual review of service providers. We believe that the CCO should review at least the following areas with the securities lending agent:

- the industry standard for fee splits between the fund and the lending agent;
- the operating procedures between the fund, the lending agent, and the custodian, including any areas for improvement in the procedures;

¹ See Gene Gohlke, unpublished remarks at the Mutual Fund Directors' Forum Conference: "Securities Lending: The Board's Role," *Micromanagement v. Effective Oversight* (Jan. 25, 2007). See also Tom Lauricella, SEC Discovers Breaches in Lending Securities, *The Wall Street Journal* (Jan. 29, 2007), at <http://online.wsj.com/article/SB117002900817890633-search.html?KEYWORDS=mutual+fund+directors+forum&COLLECTION=wsjie/6month> (last visited March 15, 2007).

- the process for monitoring proxy voting;
- the process for monitoring qualifying fund income;²
- the types of reports provided to the funds;
- the process of monitoring loan income to the fund on a daily basis;
- the process of monitoring collateral on a daily basis; and
- the process of monitoring portfolio management decisions for the funds (e.g., the process between the portfolio manager and the securities lending agent to notify the agent regarding sales of portfolio securities and securities no longer eligible for lending).

Selecting a Securities Lending Agent

Perhaps the most important decision that a fund board will make in establishing a securities lending program is the selection of the lending agent. The fund and lending agent are literally partners in the enterprise because they generally split the revenues generated from the program. While the agent negotiates the loans and manages the day-to-day program, the SEC staff has made it clear that they do not want a fund, particularly a fund with an affiliated lending agent, to act as a “silent partner.” Below is a discussion of various issues that a fund board should address to demonstrate effective oversight over the lending process.

- *Consider hiring a consultant to manage the process.* One way for the board to fulfill its oversight responsibilities is to hire a third-party consultant to assist in selecting the lending agent. A knowledgeable consultant could bring expertise to the process that

² Typically, if an equity fund lends a portfolio security over a dividend payment date, the borrower will remit to the lender fund a payment in lieu of dividends. These payments do not represent qualified income and may not be eligible for the lower capital gains rate generally available to dividends. Therefore, the fund and the lending agent must monitor these payments to determine when the fund should discontinue lending because of the detrimental impact to the fund's income.

may not belong to the fund's adviser. Before going forward with a consultant, fund management and the board should consider the costs of hiring a consultant against the expected benefits. Some small fund groups have hired consultants that have developed state of the art Request for Proposal (“RFP”) processes, but the returns from a lending program may not necessarily justify this type of expense. If an outside consultant is not hired in connection with the RFP process, a fund board may still wish to consider a consultant in reviewing the program periodically, or in subsequent years when considering whether to retain its current lending agent.

- *Consider the ramifications of selecting an affiliated lending agent.* Whether or not the board hires a consultant, the board may be asked to consider hiring the advisor (or an affiliate) as lending agent. In certain cases, there may be compelling reasons to select a fund affiliate or the custodian as lending agent. For example, the fund's affiliate may be a leading player in the lending marketplace and there can be synergies with its relationship with the fund's advisor. If an affiliate of the adviser serves as the custodian, there may be benefits in managing the operational risk relating to settlement and monitoring of securities loans, and the clients of the custodian generally are eligible clients of the securities lending agent. If an affiliate is hired, the fund will either need to obtain an exemptive order from the SEC, or otherwise meet the requirements of the Norwest no-action letter.³ Also, it is important to realize that the selection of an affiliate will likely bring increased regulatory scrutiny.
- *Consider both economic and non-economic factors in hiring a lending agent.* In most cases, lending agents get paid a portion of the return on the cash collateral not rebated to the borrower. While it is tempting to focus exclusively on the fee split, the

³ Norwest Bank Minnesota, N.A. (pub. avail. May 25, 1995).

board should also look at non-economic factors. As noted above, one reason to select the fund's custodian is because of the operational advantages. In addition to the fee split, directors should consider the fees on the collateral vehicle used to maintain the collateral underlying the loaned securities. It is important to select a lending agent that has the operational capabilities to settle trades promptly, to effectively recall securities on loan where necessary to vote proxies, to value the securities on loan, and to ensure that collateral is marked to market daily, as well as adequate knowledge of the marketplace to negotiate the most favorable terms for the fund. It is possible that a less favorable split with a lending agent may be offset by an agent better able to optimize the fund's lendable securities. Looking at the agent's other clients and its relative position as a securities lending agent is a useful starting point. Also, make sure that the lending agent handles securities lending for mutual fund clients that have some different operational and legal requirements than other institutional lenders.

"Negative loans" are another area of SEC concern that can occur when the return from the cash collateral invested is insufficient to pay the rebate (usually based on the federal funds rate) that goes to the borrower when the cash is returned. While negative loans can and do occur in certain interest rate environments, an effective process to monitor and minimize them should be in place.

- *Consider Treating the Lending Agent as a Fund Service Provider.* Whoever is chosen as lending agent should be subject to the review and oversight of the fund's CCO. As noted above, while lending agents are not specifically mentioned in the SEC's Rule 38a-1 release, the SEC staff has indicated that they expect the lending agent's policies and procedures to be part of the fund's compliance program.
- *Make sure that the Fund continues to get the best available terms when the lending agent's contract is up for renewal.* A fee split that was attractive three years ago may no longer be

"market," or a fund's growth may have made it a more attractive lender than the initial terms reflect. Also, a fund that has an affiliated lending agent may no longer be getting attractive bids from competing agents after initial approval of the program due to a concern that the business is "locked up" and is not worth the time and effort for competing agents to do the type of analysis that is necessary to provide a competitive bid. There are a number of ways a fund board could address these issues, including hiring an outside consultant as described above, but the important thing is to have a process in place that is designed to ensure that the funds continue to get a good value from the lending agent. Where an affiliated agent is being used, this is even more crucial.

Securities Lending Policies and Procedures

Consistent with the requirements of Rule 38a-1, a fund that engages in securities lending must have in place written policies and procedures reasonably designed to prevent violations by the fund of federal securities laws relating to securities lending, and provide for oversight of the fund's service providers and compliance by the fund's service providers and other entities with federal securities laws in connection with the fund's securities lending activities. The 1940 Act generally permits a fund to lend portfolio securities, provided that the fund has adopted a fundamental investment policy permitting the making of loans to other persons. In addition, the SEC staff has developed guidelines regulating the securities lending activities of funds, which guidelines are set out primarily in a series of SEC staff no-action letters.⁴

⁴ See, e.g., State Street Bank and Trust Co. (pub. avail. Jan. 29, 1972); State Street Bank and Trust Co. (pub. avail. Sep. 29, 1972); Salomon Brothers (pub. avail. Sep. 29, 1972); Norman F. Swanton Associates (pub. avail. Oct. 13, 1973); Standard Shares, Inc. (pub. avail. Aug. 28, 1974); Adams Express Co. (pub. avail. Oct. 9, 1974); Salomon Brothers (pub. avail. May 4, 1975); Merrill Lynch Capital Fund, Inc. (pub. avail. March 9, 1978); Adams Express Co. (pub. avail. Oct. 20, 1979); SIFE Trust Fund (pub. avail. Feb. 17, 1982); Twentieth Century Investors, Inc. (pub. avail. Nov. 26, 1982); Northwest Bank Minnesota, N.A. (pub. avail. May 25, 1995); Morgan Guaranty Trust Co. of New York (pub. avail.

The guidelines developed by the SEC staff relating to securities lending activities are summarized below:

- **Collateral.** With respect to each loan, the fund must receive eligible collateral equal to at least 100% of the market value of the securities loaned.⁵ Collateral must be marked to market daily to account for any increases in the market value of the securities loaned and/or decreases in the market value of the collateral.
- **Termination.** The fund must have the right to terminate the loan at any time and recall the securities within the normal and customary settlement time for the loaned securities.
- **Returns.** The fund must receive a reasonable return on the loan.
- **Fees.** With the approval of the board, a fund may pay reasonable fees to entities engaged in securities lending activities on behalf of the fund.⁶
- **Voting Rights.** A fund must be able to exercise voting rights with respect to material matters for issuers of securities loaned.
- **Loan Limit.** A fund may not loan securities with a value in excess of one-third of its total asset value.

A fund's written policies and procedures relating to securities lending must be reasonably designed to ensure compliance by the fund, service providers and

April 17, 1996); Division of Investment Management, Generic Comment Letter of Chief Financial Officers (pub. avail. Nov. 7, 1997); The Brinson Funds (pub. avail. Nov. 25, 1997). See also In the Matter of Montgomery Street Income Securities, Inc., IC No. 9,686 (Notice of Application) (March 21, 1977) and IC No. 9,726 (Order) (April 19, 1997).

⁵ Industry practice is to provide for 102% collateralization for domestic securities that are loaned and 105% for foreign securities. Generally the additional collateral required for foreign securities provides some protection against currency fluctuation between the currency of the loaned securities and the U.S. cash collateral.

⁶ Absent an order from the SEC, a fund may not pay to an affiliated person a fee based on revenue or profit from securities lending activities.

other entities engaged in securities lending on behalf of the fund with:

- disclosure requirements relating to its fundamental policy and securities lending activities;
- the SEC staff's guidelines; and
- the conditions of any applicable SEC order.

In addition, a fund's policies and procedures should address risks and provide for controls relating to counterparty risk, reinvestment risk, operational risk, and legal/contractual risk. For example, as discussed above, the SEC staff has focused recently on conflicts inherent in affiliated lending arrangements. In addition, recent news reports have identified proxy voting as an area of particular concern.

A fund is required to disclose its proxy voting record annually on Form N-PX,⁷ and various financial publications and corporate governance groups have been scrutinizing funds' voting records recently.⁸ As a result, the financial press has also focused on funds' policies and procedures relating to compliance with the SEC staff's guideline regarding voting loaned securities on material matters and funds' ability to comply with that guideline, including issues relating to loan agreement termination terms and identification of material events.⁹

⁷ See Rule 30b1-4 under the 1940 Act.

⁸ See Kara Scannell, How Borrowed Shares Swing Company Votes: SEC and Others Fear Hedge-Fund Strategy May Subvert Elections, *The Wall Street Journal* (Jan. 26, 2007), at <http://online.wsj.com/article/SB116978080268188623.html?KEYWORDS=proxy+voting+securities+lending&COLLECTION=wsjie/6month> [hereinafter Scannell, Borrowed Shares]; Big Players Vote with Management: Study, Ignites (March 2, 2007), at http://www.ignites.com/articles/20070302/players_vote_with_management_study [last visited March 15, 2007]; Beagan Wilcox, Voting Shares and Securities Lending: Boards Weigh Choices, BoardIQ (Feb. 20, 2007), at http://www.boardiq.com/articles/20070220/voting_shares_securities_lending_boards_weigh [last visited March 15, 2007] [hereinafter Wilcox, Voting Shares].

⁹ See Scannell, Borrowed Shares, *supra* note 8; Wilcox, Voting Shares, *supra* note 8.

Following is a list of general topics to consider in developing policies and procedures relating to a registered fund securities lending program:

- collateral requirements, including eligible types, required amounts, and valuation of collateral;
 - monitoring and reporting of tax characterization of substitute payments;
 - investment of cash collateral, including investment guidelines on permissible investments, diversification, credit quality, liquidity, and joint accounts;
 - eligible counterparties and/or counterparty guidelines on credit review and creditworthiness, diversification, exposure limits, and indemnification;
 - standardized documentation;
 - voting of loaned securities, including monitoring corporate events and actions, and identification of material matters triggering termination of a loan;
 - settlement of loan transactions;
 - constraints on lending agents' activities;
 - supervision of service providers to ensure compliance and performance;
 - monitoring of securities lending activities and results;
 - conditions imposed by applicable SEC orders;
 - periodic reporting to the fund's board regarding securities lending activities, including information regarding borrowers, terms, fees, profitability, and compliance with policies and procedures;
 - annual review and approval of all elements of the securities lending program by the board, including lending agents, fees, eligible borrowers, permitted parameters of loan terms, loan documentation, collateral vehicle, and policies and procedures (of the fund and entities engaged in securities lending activities on behalf of the fund); and
 - record retention.
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