INVESTMENT COMPANY INSTITUTE

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May 25, 2012

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Comments on Interim Report on Securities Lending and Repos

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on the interim report (the "Report") by the Financial Stability Board's Workstream on Securities Lending and Repos (the "Workstream").[2]

Registered investment companies in the United States ("funds" or "U.S. funds") have a number of perspectives on this topic. Some funds may lend portfolio securities to earn incremental returns for their shareholders or borrow securities to cover short positions. Fund lenders frequently use money market funds to reinvest cash collateral. Those, and other, money market funds often enter into repurchase agreements ("repos") with high quality counterparties as a collateralized short term cash investment. Given the extent of their participation in these markets, U.S. funds have a strong interest in the FSB's recommendations on securities lending and repo financing.

As the FSB is clearly aware, securities lending and repo financing in the U.S. are subject to a number of regulatory requirements designed to protect investors. We believe that many of these requirements also serve to allay the financial stability concerns highlighted in the Report. In the pages that follow, we describe the activities of U.S. funds lending securities and U.S. money market funds participating in repo financing. We then discuss certain of the financial stability concerns raised in the Report, including concerns over transparency, collateralization (including valuation of collateral), indemnification, and procyclicality.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

[2] *Securities Lending and Repos: Market Overview and Financial Stability Issues*, Interim Report of the FSB Workstream on Securities Lending and Repos (April 27, 2012), which is available at http://www.financialstabilityboard.org/publications/r_120427.pdf.

Securities Lending by U.S. Funds

Like many other types of institutional investors, mutual funds, closed-end funds, and exchange-traded funds ("ETFs") may engage in securities lending.[3] U.S. funds may lend securities only if it is permitted by its organizing documents, disclosed to investors in the fund's prospectus or statement of additional information ("SAI"), and subject to approval and oversight by its board of directors.

In addition, the Securities and Exchange Commission ("SEC") staff has established guidelines for securities lending activities for funds registered under the Investment Company Act of 1940. Among other things, these guidelines restrict the types of collateral that are permissible and how that collateral may be treated, impose limitations on the amount of lending, ensure the ability of a fund to recall securities in a timely manner, and address potential conflicts of interest.

U.S. Funds in Repo Financing Markets

Many money market funds[4] participate as cash investors in tri-party repos, the most prevalent form of repo contract in the U.S. The Federal Reserve Bank of New York's white paper on tri-party repo provides a comprehensive description of the repo market and the role money market funds play in it as cash investors.[5]

The Report highlights several concerns with repos that may be considered from a financial stability perspective. As the Workstream is clearly aware, many of these same issues have also been considered at length by a special Task Force on Tri-Party Repo Infrastructure (the "Task Force"), which was formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the Federal Reserve Bank of New York (the "FRBNY"). ICI participated on the Task Force along with several representatives from ICI member firms. The Task Force recently concluded its work, highlighting a number of areas in which significant progress was made to

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[3] A unit investment trust ("UIT") is a fund with an unmanaged fixed portfolio of assets. It does not have an investment adviser and may only change the composition of the fund under limited circumstances (e.g., a UIT that replicates an index may adjust its portfolio when that index is rebalanced). It may not select or lend securities or otherwise engage in activities that require an investment adviser.

[4] Money market funds are subject to extensive oversight and regulation under the Investment Company Act of 1940 and the rules thereunder, particularly Rule 2a-7. This comprehensive set of regulations includes investor protections, extensive disclosure requirements, and broad financial reporting and recordkeeping requirements. These rules were strengthened in 2010, with new maturity, diversification, credit quality, and stress testing requirements, tighter liquidity requirements, and enhanced disclosure obligations. For a summary of money market fund regulatory requirements, including the SEC's 2010 amendments to Rule 2a-7, *see* http://www.ici.org/mmfs/sec/11_mmf_reg_summ. These additional restrictions are important to note in the context of evaluating some of the financial stability concerns highlighted by the Report.

[5] See Tri-Party Repo Infrastructure Reform (May 17, 2010), available at http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf.

meaningfully reduce both the potential for systemic risk and the magnitude of the risk associated with the tri-party repo infrastructure.[6]

Financial Stability Concerns

1. Transparency

The Report suggests that it may be appropriate to consider, from a financial stability perspective, whether transparency could be improved in either securities lending or repo markets.[7] We recognize that U.S. funds may have a somewhat unique perspective on the appropriate level of transparency in these markets. As highly regulated, highly sophisticated institutional investors, U.S. funds have not found the level of transparency in the U.S. relating to securities lending or repo activities to be problematic in any of the following contexts:

- ***Market Data for Securities Lending.*** There is a substantial amount of market information available to securities lenders. Agent lenders in the secured lending market provide funds with daily transactional information and periodic reports (typically monthly, quarterly, and annually) that facilitate oversight and reporting to the fund's board. Data vendors compile proprietary market information for their clients, which can assist funds in assessing the terms of their securities loans, and the Risk Management Association compiles macro-market data from prime brokers and other securities borrowers.

  While we understand the Workstream's concerns over the availability of securities lending market data, we would caution against requirements for a real-time "ticker" or "consolidated tape" of securities loans. It would be difficult for any ticker to capture the information relevant to each securities loan, as the economic terms of each loan are unique to the parties involved and their particular relationship. A ticker likely would be limited, therefore, to certain fields of information and could prove more confusing than informative. As a result, we believe the potential benefits of a securities loan ticker would be marginal, and in any event would be outweighed by its costs.

- ***Market Data for Repos.*** There also is a substantial amount of market information available to cash investors, dealers, tri-party repo clearing banks, and regulators. Beginning in May 2010, the FRBNY began publishing market data on the tri-party

[6] See Task Force on Tri-Party Repo Infrastructure Payments Risk Committee, Final Report (February 15, 2012), available at http://www.newyorkfed.org/tripartyrepo/pdf/report_120215.pdf.

[7] As the Workstream is likely aware, the SEC also is examining this topic. Section 984 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to adopt rules designed to increase the transparency of information available to brokers, dealers, and investors with respect to securities lending. The SEC has not yet issued a rule proposal.

repo market on its web site.[8] This data highlights the overall size of the market, collateral, concentrations, and margin requirements that exist within the market. This reporting has provided greater transparency into the broader market, giving all market participants and regulators the ability to monitor repo exposures and highlight repo market trends.

Moreover, in response to a Task Force recommendation, dealers, cash investors, and tri-party repo clearing banks are now fully implementing three-way trade confirmations. These added operational enhancements allow the tri-party clearing banks to monitor "real-time" credit exposures. It also provides the tri-party repo clearing banks an additional level of transparency within the repo market and reduces the risk of the occurrence of failed or intraday defaulted repo trades for all market participants.

- ***Corporate Disclosure.*** U.S. funds are required to provide a high degree of corporate disclosure to investors about their securities lending and repo activities. A fund must disclose that it may lend securities or engage in repurchase transactions. This disclosure appears in the fund's prospectus and SAI, both of which are available to investors, the SEC, and the public. Twice a year, funds also prepare financial statements that are filed with the SEC and sent to shareholders. The fund's financial statements identify securities out on loan, investment of cash collateral received, a liability reflecting the obligation to return the cash collateral at the conclusion of the loan, and income earned from securities loans.[9] In addition to the semi-annual financials in these shareholder reports, funds also file Form N-Q after the first and third quarters, which includes a detailed listing of the fund's portfolio. The filings on Form N-Q identify those securities out on loan.

  In addition, money market funds are required to post their portfolio holdings on their websites each month within five business days after month end. Money market funds also are required to file Form N-MFP with the SEC on a monthly basis. This provides details on the fund and its portfolio holdings (including detail on each security held as

[8] *See* http://www.newyorkfed.org/tripartyrepo/margin_data.html.

[9] Under applicable accounting standards, the loaned securities are reflected in a fund's financial statements as a fund asset and reported in the schedule of investments along with disclosure indicating that the securities have been loaned. When a fund has effective control of the collateral received, the collateral is also recorded as a fund asset, with a corresponding liability. In the rare instances where the fund does have not effective control, such as if the collateral is in the form of securities and the fund does not have the ability to dispose of such assets except in limited circumstances, the collateral is not recorded as a fund asset. Any securities or instruments purchased with cash collateral are recorded as fund assets. *See e.g.,* Letter from John S. Capone, Assistant Chief Accountant, Division of Investment Management, U.S. Securities and Exchange Commission, to Frank Maresca, Managing Director, Bear Stearns & Co., dated Sept. 16, 1997.

collateral), and has given regulators in the U.S. and the public significantly enhanced transparency with respect to money market funds' role in tri-party repos.

2. Collateralization

The Report states that there are "financial stability risks associated with collateral re-use, whether arising from repo, securities lending, re-hypothecation of customer assets or margining of OTC derivatives."[10] We assume that the Workstream's concerns in this regard do not stem from U.S. funds, because of the many regulatory requirements pertaining to collateralization in connection with securities lending and repo transactions.

SEC guidelines require that funds lending securities or involved in a repo transaction receive at least 100 percent of the value of the loaned securities or the cash invested, as the case may be, as collateral from a borrower. As a practical matter, securities lending agreements typically establish a somewhat higher collateral amount, usually 102 percent for loaned domestic securities and U.S. dollar denominated foreign securities and 105 percent for loaned foreign securities. Consistent with this approach, repo transactions are typically over-collateralized at levels ranging from 102 percent to 110 percent, demonstrated by the collateral haircut data published monthly by the FRBNY. The value of the collateral must be marked-to-market daily and adjusted so that the obligations are fully collateralized at all times.

For securities lending, the SEC guidelines set forth the types of collateral that funds may accept. These include cash, U.S. government and agency securities, and, subject to limitations, certain bank guarantees and irrevocable bank letters of credit. As the Report notes, as a practical matter, U.S. funds almost always receive cash collateral. The cash collateral is typically reinvested in very high quality, highly liquid investments.

With respect to repo, the Task Force considered collateral and counterparty concerns at length, making several notable risk reducing recommendations, which have now been implemented:

- ***Delaying the "Unwind."*** Changes have recently been implemented to cause the daily "unwind" of most tri-party repo transactions to move from early morning to mid-afternoon, greatly reducing the duration of intraday credit extensions by the tri-party repo clearing banks to the dealers. Work on this front continues, with the ultimate goal of reducing credit extensions by the tri-party repo clearing banks to the dealers to no more than 10% of a dealer's notional tri-party book.

- ***Collateral Substitution/Collateral Management.*** Both tri-party repo clearing banks have recently implemented automated collateral substitution capabilities as a result of

[10] Report, at 17.

recommendations from the Task Force. The introduction of such automated systems has allowed cash investors and other industry participants to monitor and manage their intraday collateral positions and ensure that their repo exposures are adequately collateralized on a "real-time" basis. Industry participants continue to actively work with the tri-party repo clearing banks to build out the capabilities of this technology and improve the transparency and the efficiency of this important monitoring system. The ability to efficiently substitute collateral helps to prevent disruptions to regular market activity as dealers have full access to their positions throughout the day.

- ***Counterparty Concerns.*** Money market funds are distinct from other lenders in the repo market in that they are required to determine that counterparties present "minimal credit risk," assuring that the funds are only dealing with the highest quality counterparties.

  Moreover, as a result of the recommendations from the Task Force, the repo markets are better prepared to deal with potential dealer defaults. The tri-party clearing banks are working toward adopting "waterfall" recommendations of the Task Force that will mandate the priority of payments or distribution of assets in the event of a default. In addition, various industry groups continue to work with the tri-party repo clearing banks and industry participants to develop a process for the orderly liquidation of collateral. For example, ICI has prepared a checklist designed primarily to detail the steps that a fund would take in order to liquidate securities subject to a repurchase agreement with a dealer that becomes insolvent after entering into the repo transaction.[11]

Along with the implementation of three-way trade confirmations as discussed above, all of these changes have introduced additional restrictions to mitigate systemic risk, improve the quality and transparency of the collateral in secured finance transactions, and allow market participants to be better positioned to withstand potential defaults.

3. Risk of Insufficient Rigor in Collateral Valuation

The Report states that during the 2008 financial crisis, a number of financial institutions that held mortgage-backed securities as collateral either did not mark-to-market those holdings or valued them based on overly-optimistic models. Arguably, the decline in the prices of mortgage-backed

[11] *See* Investment Company Institute, Checklist for Fund Investors of Repurchase Agreement in the Event of Dealer Insolvency, available at http://www.ici.org/policy/current_issues/11_mmf_repo_checklist.

securities would have caused less disruption in financial markets if such changes had been reflected more gradually through continuous marking-to-market.[12]

As noted above, any securities or instruments purchased with cash collateral are recorded as fund assets.[13] As required by the Investment Company Act, the reinvested collateral must, in all cases, be marked-to-market daily. The Investment Company Act generally requires U.S. funds to use market values to value portfolio securities for which market quotations are readily available. When market quotations are not readily available, funds must value portfolio securities by using their fair value as determined in good faith by the board of directors of the funds.[14]

On the tri-party repo platform, the tri-party clearing banks are required to price the collateral on at least a daily basis using various independent pricing sources, which ensures centralized and consistent valuation across all market participants. The clearing banks continually review the pricing sources to ensure that the repo transactions remain fully collateralized at all times.

4. Potential Risks from Indemnification

The Report notes that many agent lenders indemnify their customers against the risk of borrower default. It further suggests that such indemnification could incent the lender to look to its agent as the effective counterparty and avoid screening and monitoring the borrower.[15]

While it is true that lending agents in the U.S. typically provide indemnification to the fund in the event of default by a borrower, that indemnity is unlikely, in our view, to cause funds to be any less rigorous in screening, monitoring, and approving borrowers. In part, this is because the indemnification is of limited practical value, given overcollateralization of the transaction with collateral that is marked-to-market daily and rebalanced as appropriate.

More importantly, SEC staff guidelines require that the fund's board approve specific borrowers to whom the fund may lend shares. This responsibility may be delegated to the fund's adviser subject to board supervision. In practice, fund advisers and/or their lending agents typically perform a thorough credit review of all potential borrowers and develop a list of "approved borrowers" to whom the lending agent may loan the fund's securities. These borrowers are usually limited to well-established broker-dealers and major banks.

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[12] Report, at 18.

[13] *See* n.6, *supra*.

[14] For links to relevant statutory provisions and SEC interpretations relating to the valuation of fund assets, *see* http://www.sec.gov/divisions/investment/icvaluation.htm.

[15] Report, at 17.

The preparation of such lists, populated by quality borrowers, and subject to board oversight, evidences the seriousness with which counterparty creditworthiness is taken. While an indemnification is an important feature of many lender-agent relationships, we do not believe that it causes U.S. funds to be any less attentive in selecting counterparties.

5. Procyclicality of System Leverage

The Report expresses a concern that there is potential for securities lending and repo financing to influence the level of risk-taking within the financial system in a procyclical way. It notes that the procyclical behavior of securities financing markets depends on three underlying factors: (i) the value of collateral securities available and accepted by market participants; (ii) the haircuts applied on those collateral securities; and (iii) collateral velocity (the rate at which collateral is re-used).

While we note that many of the reforms recently put in place in the repo market were explicitly meant to offset procyclical trends, including the delay of the daily unwind on the tri-party platform and the added transparency of repo haircuts and holdings, we do not believe that U.S. fund participation in securities lending or repo played a significant procyclical role in the financial crisis. As noted above, U.S. funds typically take cash collateral for securities lending and reinvest in highly liquid money market funds or similar collateral investment vehicles that are marked-to-market daily and maintained for the fund. U.S. money market funds participating in tri-party repo similarly mark-to-market repo collateral daily, and are making regular assessments of the credit quality of their counterparties and only dealing with the most stable and highest quality partners.

We caution the Workstream to carefully consider the potential for unintended consequences that might come from policy recommendations designed to limit procyclicality. For example, restricting the ability of market participants to adjust margin haircuts might have the opposite effect—if lenders cannot adjust haircuts to account for deteriorating credit quality, their only option would be to terminate the loans to reduce their exposure. This may well be more procyclical than simply demanding more collateral.

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ICI strongly supports the FSB's efforts to identify and investigate potential causes of systemic risk and commends the Workstream for its work on securities lending and repo thus far. We urge it to keep in mind that the extensive regulation of securities lending and repos in the U.S., enhanced by the many developments since the 2008 crisis, addresses and mitigates many of the potential financial stability concerns raised in the Report by reducing intraday credit risk, increasing transparency in the broader market, and mitigating counterparty credit, liquidity, and credit quality risks.

We look forward to continuing this important dialogue as the Workstream develops its recommendations later this year. If you have any questions about our comments or would like additional information, please contact me at 202/371-5430, Dorothy Donohue, ICI's Deputy General Counsel – Securities Regulation, at 202/218-3563, or Brian Reid, ICI's Chief Economist, at 202/326-5917.

Sincerely,

/s/ Robert C. Grohowski

Robert C. Grohowski
Senior Counsel