Good afternoon,

My name is Anthony Nazzaro, I am the Principal and Owner of A.A. Nazzaro Associates. We are a Securities Lending Manager and Consulting Group in operation since 1987. I would first like to thank the Committee for the opportunity to appear before you today. It is a wonderful honor and a privilege for me to do so.

I believe I was invited to appear and give testimony because of my experience and the longevity of my career in the securities lending industry. My participation in this industry spans some 35 years, in roles ranging from an in-house lender at Yale University to a custodian agent lender for the pension funds of the Commonwealth of Pennsylvania, to our present status as an independent manager for university and foundation endowments. We currently manage the securities lending programs for Princeton University and The Robert Wood Johnson Foundation.

It is my hope that I can offer some perspective, insight and constructive counsel for pension funds which represent a large segment of the beneficial owners participating as lenders of securities.

Many large pension funds that participate in securities lending choose to do so through an agent lender such as their Custodian Bank. It is my sense that when a fund enters into an agreement with its agent lender, the fund may not fully appreciate or understand that it has also hired an investment manager. Many times the fund may be focused upon the lending of securities side of the equation and less upon the reinvestment of cash collateral. As a result, the focus or scrutiny is more heavily weighted toward the counterparty risk of the Borrower and overshadows or obscures the reinvestment risk. This may result in less scrutiny of the cash collateral investment guidelines proffered by the agent lender. In addition, given the wide ranging authority of the agent lender over all lendable assets and the reinvestment of cash collateral, the size of the assets held in the cash collateral portfolio may grow to become the largest portfolio in the fund's universe and the agent lender may become its largest investment manager.

The omission or failure to perceive the agent lender as an investment manager may result in a lack of sufficient reporting and oversight of the cash collateral portfolio and an assumption that the reinvestment of cash is part of the agent's custodial function in its management of the securities lending program. The danger and risk in this perception was brought to light and exposed during the recent financial crisis and brings us here today.
The reason I am highlighting this issue is because I believe there are some basic steps that can be taken to protect pension funds and limit their risk.

Step One: Documentation

In addition to the execution of a securities lending agency agreement which is standard documentation, pension funds should execute an investment manager agreement. This elevates the duty and standard of care by the agent lender/investment manager. The investment reports would receive a heightened degree of visibility and are more likely to come within the purview of those persons or committees with oversight at the pension fund.

Step Two: Investment Guidelines for Cash Collateral

Implementation of stringent guidelines for the reinvestment of cash collateral. An example would be guidelines that resemble those of a Rule 2a7 money market fund. This would limit holdings in the portfolio to only securities of high credit quality, high in liquidity and short in duration or weighted average maturity.

Step Three: Reporting and Valuation

Receipt of daily reports as to valuation of the cash collateral corresponding to the securities lending loan balances. The value of the cash collateral portfolio report should be equal to or close to the 102% collateralization required for loans and received from counterparty borrowers.

Step Four: Limits upon Program Participation

Implementation of a limit upon the amount or value of securities which may be loaned in order to reduce exposure of a portfolio. This can be done in a number of ways.

A. Set a certain dollar amount which acts as a ceiling or cap on the program. For example, a one billion dollar fund may set a limit of 150 million as the maximum value of its securities that may be on loan.

B. The limit may be expressed as a percentage of total assets. Using the above example, loan balances may not exceed 15% of the total value of the lendable portfolio.

C. A restriction may also be set as to the portfolios that may be eligible to participate in the lending program and made available for lending. In our example of the billion dollar fund, there may be ten different types of asset classes in separate portfolios whereby four are eligible and allowed to participate in the lending program and six are excluded or restricted from being loaned.

The above recommendations are four steps that pension funds can implement that I believe would be both constructive and prudent. It is my opinion that implementation of some or all of these steps could have mitigated the problems that funds experienced during the financial crisis.

Respectfully submitted by:
Anthony A. Nazzaro
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