UNITED STATES SECURITIES AND EXCHANGE COMMISSION

SECURITIES LENDING AND
SHORT SALE ROUNDTABLE

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P R O C E E D I N G S

CHAIRMAN SCHAPIRO: Good morning. I'm sorry we're a few moments late. I want to welcome everyone to day one of the Securities and Exchange Commission's Securities Lending and Short Sale Roundtable. The Commission is very grateful that so many have agreed to participate in today's meeting, and I think I can speak for my colleagues on the Commission in saying that we look forward to the panelists' comments, insights and recommendations on these two very important, interconnected areas of the securities industry.

Today's focus will be on securities lending. Securities lending is a practice where an institution with a portfolio of investment securities temporarily lends out, on a collateralized basis, some of its portfolio securities that would otherwise be sitting idle.

Securities lending has existed in some parts of the world since at least the 19th century, if not earlier. In the 1970s, securities lending increased in the U.S. as custodian banks lent out the portfolio securities of their custodial clients, and registered investment companies began lending their securities.

In the 1990s and early 2000s, with the expansion of the global securities markets and investing, and the exponential increase in short selling and related strategies, the demand for securities lending also grew.

For a long time securities lending was regarded and described as a relatively low risk venture, but the recent credit crisis revealed that it can be anything but low risk. This was particularly the case with cash collateral reinvestment programs, which experienced unanticipated illiquidity and losses. Some institutions that lent their securities and the beneficiaries relying on those institutions were significantly harmed.

As a result, many questions have arisen with respect to the securities lending market, and whether it may be improved for the benefit of market participants and investors. We hope to explore many of these important questions in today's roundtable.

Throughout the day, we will hear from panelists on four different panels. Each panelist will take a few moments to share his or her thoughts on the issues being discussed, and when the opening statements are complete, the floor will be open to questions from the moderators and the Commissioners.

The first panel will in part serve to provide an overview of securities lending, its participants and processes -- a "securities lending 101," if you will -- to provide us with context for the ensuing panels. The panelists will describe the mechanics of securities lending, the major participants, its compensation structure, as well as the motivations for lending and borrowing securities. The panelists will also comment on the benefits and pitfalls of securities lending given their recent and past experiences in this arena.

The second panel will explore a number of topics relating to investor protection concerns, such as cash collateral reinvestment and the problems that many lenders and lending agents experienced when the credit crisis hit; alternatives to cash collateral and lending practices that could perhaps have mitigated the recent experience; default risk; lending agent compensation and fee splits; and proxy voting issues.

The third panel will discuss the issue of transparency: what it is, whether it exists in the current securities lending marketplace, and whether steps need to be taken to improve it. We're interested in hearing about transparency related to the pricing of securities lending transactions as well as transparency in any other area of securities lending the panelists may wish to discuss. The panel will also explore issues related to newly emerging electronic lending platforms, central counterparties and issues of accountability.

The fourth and final panel of the day will discuss the future of securities lending, what are the factors that are likely to drive its future evolution, and the risks going forward. In addition, that panel will assess whether there are any regulatory gaps in the marketplace, and finally what areas, if any, are in need of additional SEC action to enhance investor protection.

The panelists we will hear from today are leaders in their respective fields and represent a range of constituencies that includes beneficial owner lenders, agent lenders, borrowers, regulators, academics, consultants and others. We are truly privileged to have them here and to have them share their thoughts with us. We look forward to a spirited and substantive discussion.

Let me turn this over now to Jamie Brigagliano, co-acting Director of the Division of Trading Markets, who will introduce and moderate our first panel. Thank you.

MR. BRIGAGLIANO: Thank you, Chairman Schapiro. We will now begin the day's first panel, titled Overview of Securities Lending: Participants; Process; Benefits and Pitfalls. Following introductions, the panelists will each make a brief opening statement. Because we have a lot of information to cover in a relatively short amount of time, we ask that the panelists limit their opening statements to no more than three minutes.

During your prepared remarks, we will hold up a yellow card indicating that you have one minute remaining. Following opening statements, we will engage in discussion with the Commission. While responding to questions from the Chairman and Commissioners, panelists are encouraged to engage in dialogue with one another. We welcome discussion of other panelists' viewpoints, differing opinions and additional thoughts in response to other panelists' remarks.

Before we begin, I'd like to welcome and introduce our distinguished panel. Jerry Davis is the Chairman of the Board of Trustees for the New Orleans Employees' Retirement System. He's also the Employee Representative on the Board of Trustees.

David Downey is the Chief Executive Officer of OneChicago. Irving Klubeck is a Managing Director of Pershing LLC, where he is a member of the customer processing and services group, and is responsible for securities lending operations and global clearance and settlement.

William Pridmore is an independent consultant. He provides advice to large institutional investors on their participation in the securities lending and short-term investment markets. And Dr. Adam Reed is the Julian Price Associate Professor of Finance at the University of North Carolina's Kenan-Flagler Business School.

Jerry, would you like to start us off with your opening statement, please?

MR. DAVIS: Thank you very much, Mr. Brigagliano. I represent the City of New Orleans Retirement System. 2008 was not a good year, to put it kindly. We were a mid-sized pension fund, we're now flirting with the problem of being a small pension fund, as we struggle to recover from all that.

The carnage of last year was widespread enough among our stock and bond managers. We expect that. We expect stocks to fall and rise in accordance with what's happening in the overall global markets. What we did not expect was the kind of disaster in the securities lending program that we experienced.

This was sold to us as an idea some 20 years ago by what was then Chemical Bank. It was going to be free money from your idle assets. That was a very seductive concept, and it worked for a long time.

But then Lehman failed, then Sigma failed, and all of a sudden, in our securities lending program, we lost six years worth of revenues in a matter of weeks. So we're sitting here now owing the bank about $400,000 in collateral that the bank invested for us.

This raises some concerns from us about the possibility of the same kind of cross-contamination that affected the stock and bond markets last year. These huge, vertically and horizontally integrated financial institutions play in so many areas of the market that it's hard to imagine that they're not aware upfront of all the risks that can arise in a program like lending.

The suspicious part of me says maybe they did know and could have done something about it and perhaps did do something about their own level of risk and that of selected clients. This is part of the reason I'm here today, is to raise suspicions that I think are probably widespread, given the number of securities class actions that are beginning to take place on this issue.

The idea of cross-contamination in the markets is very troubling in an issue such as securities lending, where the banks typically, at least for smaller investors, have full discretion to do whatever they choose in terms of lending and borrowing -- their relationships with borrowers, their use of the cash collateral.

We had a very broadly written contract, which I've since learned is pretty typical for the industry for small investors. All the discretion fell with the bank, and the losses fell to us. We discussed with the bank the possibility of some kind of modified action or modified relationship to help us deal with the losses -- the bank has been non-receptive, and I think that's been pretty constant with all of my associates that I've talked to.

The overriding issue that has presented us with is that we desperately need to develop new due diligence checklists, not only for all of our investment practices, but for every relationship we've got, including the custodial relationship. We need checklists that will go down the line in terms of everything they're doing for us, what can go wrong, what can go right, and what are we going to do about each one.

We know that Washington cannot provide all the answers to this process, but I certainly am very happy that the SEC is bringing people together to discuss this in a very intense way so that we can hopefully arrive at some workable solutions. Regulations are a scary concept because they can have unintended consequences, but I think if we work together we can come out with a positive result.

MR. BRIGAGLIANO: Thank you, Jerry. David Downey.

MR. DOWNEY: Thank you very much. Many of you might wonder what a single stock future exchange would be doing here at securities lending, and it's because securities lending is an over-the-counter transaction, whereby you're not really lending, you're legally selling stock and in return you're accepting a forward contract to get that stock back at some point in time.

So you're lending -- you're selling stock and you're buying a forward contract. That forward contract is a future, a single stock future. It has all of the attributes of a single stock future. In fact, at OneChicago, we trade EFPs, exchanging that stock for this future everyday. We price them -- they look just like the securities lending rates.

What's of interest is, securities lending rates have a huge effect on single stock futures. Because it's not transparent, this force acts negatively and positively on these futures. Customers who come in and trade do not have access to this price information, this valuable price information. Accordingly, they are at market risk of people with more intelligence, like the people who control lending rates. So I'm concerned about this because my customers, who are using my product, are doing it in a very blind way.

Secondly, there's a lot of money involved, and I'd like to just run through a couple of round numbers, and we'll use one stock in particular. We're going to pick Sears Holdings, a large organization. As of last night, there was 15,225,000 shares of Sears sold short. It closed last night at $66. That represents $1.480 billion worth of notional value.

In the lending market, 102 percent of that is put up as collateral and reinvested. That reinvestment is split between the lender, the custodian, the prime broker and the hedge fund. They invest in at Fed Funds, which is about 13 basis points or 13-hundredths of a percent, that only comes out to about $1.3 million a year, certainly not impressive, not enough to bring all these people together.

But if we go back to interest rates of 2007 at 5 percent, that would jump up to $51 million a year. Still not bad, but split it between four organizations that size. But there's a difference here. This is in hard-to-borrow stock. And as it goes hard to borrow, suddenly only three people get paid, the custodian, the lender, and the prime broker -- the borrower gets cut out, and in fact he pays a Commission.

As of last night, the Commission on Sears Holding was 28 percent, 28-hundred basis points. The return on 28-hundred basis points on that collateral comes out to about $281 million a year. Now that's something that people want.

The interesting thing is, as we watch these values of the futures fluctuate, these things have fluctuated in the last 34 days between 13 percent for Sears Holding and 42 percent. That indicates a level of inefficiency in this market because of a lack of transparency and a lack of participation. That has to change. This market can be accessible, it should be accessible, and there's too much money around to leave it up to a small group of people.

MR. BRIGAGLIANO: Thank you, David. Irv Klubeck.

MR. KLUBECK: Thank you very much. I'm happy to be here. I'd like to thank the Chairman for inviting me and the Commissioners, and I hope that over the course of not just this hour but the next day-and-a-half that we have an opportunity to explain and explore and to shed some light on the securities lending process and to make sure that everyone involved in the process has a clear understanding of the economics and the rules of economics that actually apply to the securities lending market. Thank you, I look forward to helping.

MR. BRIGAGLIANO: Bill.

MR. PRIDMORE: Thank you. I'm pleased also to participate in today's panel session. For the last 15 years I've worked as an independent financial consultant, and prior to that I had some experience in broker dealer finance. So pretty much all of my career I've had some touch on the securities finance business, including securities lending.

Today I work only for the beneficial owners of securities being lent. I don't receive any compensation from the lending service providers such as vendors or broker dealer firms. My goal is to provide the beneficial owners with an independent assessment of securities lending risks and rewards. Chairman Schapiro is right, in that the common perception of lending was that there was no or little risk in securities lending. Events of the past year have proved otherwise.

In order to fix this problem, first you need to understand how the situation arose. Lending was viewed by many as a custody service and a securities processing service, not an investment service. Most institutional investors delegated lending to their custody bank with little thought. That custodian or lending agent charged a fee based on the percentage of income earned, so more income to the client automatically generated more income to the lending agent.

So there was a natural emphasis on growing lending income so that each participant could get a larger share. Over the past 10 years, technology allowed the entry of third-party lenders that were separate from the beneficial owners or the custodian bank. These third-party lenders often focused on trying to provide better lending performance, which generated more income to the beneficial owners.

With this competition for the very profitable lending agent business, custodian lenders also began to focus more and more on generating higher lending income. Since cash was the predominant form of collateral, how that collateral was invested was a prime factor in determining lending income. Securities lending agents, both custodian and third party, realized they could boost earnings by taking more risk in the investment of cash collateral.

For the most part, it was not done by taking credit default risk -- beneficial owners could and did control that. But rather, the added risk came from taking on liquidity risk. Frequently beneficial owners did not understand the true dimension of that liquidity risk. Thanks.

MR. BRIGAGLIANO: Dr. Reed.

MR. REED: I'd like to thank the Commission for having this roundtable and inviting me to speak at it. I appreciate the opportunity to talk about this.

So I'm one of a very small set of academics that studied this market and study short selling more or less exclusively. So what I'll talk about in my opening statement is just sort of two categories of results that I've found and others have found.

The first category is on short selling and how constraints on short selling affect markets. And the basic idea here is that finance academics would be in probably nearly 100 percent agreement that short selling improves market efficiency. These people are bringing information to markets and they're providing liquidity.

So as a corollary to that, we could think of constraints on short selling decreasing market efficiency. That's a result that's been found -- it's a result that's been found in connection with the securities lending industry, too, as some stocks become difficult to borrow or they become expensive to borrow, these so-called stock specials, market efficiency tends to decrease in those cases. And that's how securities lending sort of connects with market efficiency.

Recently, the Commission's rules on banning short selling and requiring a pre-borrow had the expected effects. They decreased liquidity, and there's a number of papers sort of showing that short selling became expensive and liquidity fell, also market efficiency fell.

One result that's a little bit unexpected out of the recent rule changes was the fact that some short sales actually had more price impact after the rule change than before the rule change. And these were the short sales in the period of the ban for stocks with options.

In other words, since short sellers have to pay extreme fees and go through extreme measures to conduct a short sale through the options market, market participants other than the short seller himself saw that as an informed trade.

The second category of research that I'd like to mention here is research directly on the securities lending market. In the securities lending market there are lots of characteristics, but one of the primary characteristics is that the majority of stocks are easy to borrow and cheap to borrow for short sellers, but everyday there are some stocks that are difficult to borrow. And these so-called stock specials that are hard to borrow stocks tend to arise out of episodic corporate events such as mergers and acquisitions or dividends.

Specialness can decrease market efficiency, and one of the more recent results is the fact that the search costs, the fact that securities lenders are fragmented contributes to price dispersion -- in other words, different short sellers paying different prices to borrow stock -- and also the level of prices. In other words, the lack of transparency in the market for borrowing stock makes it difficult to short sell, which has a direct impact on market efficiency.

MR. BRIGAGLIANO: Thank you, Dr. Reed. And we appreciate the range of thoughtful perspectives we've heard at the open. And perhaps if the Chairman agrees, we could begin with Irv Klubeck providing a brief overview of the securities lending process today from the broker dealer perspective, and then we'll lead in to questions from the Commission.

MR. KLUBECK: Thank you. The securities lending market in the U.S. equities market, specifically, really started in the late 1960s, early 1970s. During that time there was a paper crunch on Wall Street, and in fact back offices of Wall Street brokerage firms needed an extra day just to settle the massive amounts of paper that were being moved by the trades that were happening on the exchanges.

One of the problems with settling trades, or not settling trades, if you will, is that you have risk to the counterparty. Securities lending transaction, in one way, helps mitigate settlement risk. So if a broker, on behalf of a customer, were to sell securities to another broker and for some reason that stock was not available at the time -- and typically this happened especially when the securities markets were in a material form, when everyone actually had stock certificates and they had to go through a transfer process before we could actually make delivery on a security.

So the broker dealer was -- wanted to make delivery of that sale, assuming a customer sold securities, but if they couldn't make delivery on the sale because the securities were not yet available to them -- my favorite example is the Disney stock that had the great pictures of all the Disney characters on the back of the stock, and everybody would take it and place it on their wall for the kids when they would go to college, and hopefully save it some day and then sell their stock.

But if you didn't take the stock off the wall, you made the transaction to actually sell the securities but you didn't have the stock in hand at the time, the broker who was clearing your trade for you couldn't make that delivery on a timely basis.

And so securities lending was really born out of the need to make deliveries, and that need to make delivery required the broker dealer to then go find securities. They had to borrow securities from someone who had them available and willing to lend.

And so the broker dealer would borrow the securities and then use those securities that they had borrowed to complete the delivery of the stock transaction that their customer had made. The cash collateral was received and had to be given to the lender of the securities -- Jerry mentioned 102 percent.

So the broker dealer would borrow the securities and give 102 percent as cash collateral to the lender of the securities. The broker dealer will complete that delivery, and actually reduce their risk. They would reduce the risk because the party who was receiving the actual settlement of the trade now had their securities and paid for the trade that the customer had made, in effect reimbursing the broker. The broker would be able to collect the proceeds of the sale and use that to help finance for the borrowing of the securities.

And why it reduced the risk to the broker dealer was because now the broker dealer had a transaction with a lender, as opposed to a settlement party, and that lender and the broker dealer would mark to the market every day. We would exchange cash to make sure that the lender always had 102 percent or at least 100 percent of the market value of the securities on hand on a nightly basis. And so the securities lending market had daily mark to markets and it still does today, and that is a way of mitigating the risk on the settlement side.

Now the -- as the dematerialization of securities in the U.S. occurred, with the advent of DTC in the 1970s, and most of the securities in the U.S. markets, the equities markets started to clear and settle through a automated fashion at DTC, the securities lending process moved from a physical process also on to DTC and became a dematerialized transaction for the most part.

And to this day, there are a number of automated processes that most medium to large -- and even the smallest of broker dealers -- will utilize to settle transactions. And most of them through the DTC -- Depository Trust Company -- electronic platform. In fact, most broker dealers today, I would say, borrow the vast majority of the securities that they need to make deliveries in an electronic, straight-through process with a lending counterpart. And for the most part it's done in a straight-through way. And in fact, the two parties probably don't have to talk to each other on a daily basis to transact in most securities lending transactions.

This is a great panel because I think we've covered the wide gamut of who is involved in the lending process. So there's a lender of securities, there's a borrower of securities in every case. The borrowing of securities in the

U.S. markets are only allowed to be done by broker dealers. And on the bank side, you have custodial banks or agent lenders who are allowed to lend securities but not borrow securities. So broker dealers actually can both borrow and lend securities.

And the broker dealers -- and that's where my expertise lies -- in the broker side of the equation, broker dealers typically use securities lending transactions to reduce settlement exposure, as I mentioned before, by eliminating fails. We also borrow securities as a alternative means of financing, and we borrow securities all encompass, though, in the U.S. marketplace, only in compliance with Regulation T, which sets out the permitted purposes that a broker dealer in the U.S. is allowed to borrow securities.

I'll wrap it up very quickly. So the broker dealer side of the equation will borrow securities, will give up cash. I mentioned that it is a way of alternative means of financing. Many customers, throughout the course of history, have borrowed securities -- bought securities, rather, on margin. And when they buy securities on margin, what they're really doing is they buy securities and then they borrow some cash from their broker dealer to help them allow them to buy the securities.

In the U.S., margin regulations allow a customer to buy securities and they can pay for half of it and borrow the other half from their broker dealer. The portion of the securities that they don't pay for when they buy the securities -- the piece that they've, in effect, bought on margin -- the broker dealer is allowed to use those securities to help raise cash to replenish its own bank account for the money its lent to the customer. That term is rehypothecation -- I'm sorry, it's a very long word -- but it means basically to borrow securities in this case.

And the broker dealer can take those rehypothecated securities, those securities that were bought on margin, and pledge them to a bank to borrow money to replenish its cash supply, or it can lend securities to another party, and by doing so it replenishes its cash supply.

Thank you.

MR. BRIGAGLIANO: Chairman Schapiro.

CHAIRMAN SCHAPIRO: Thanks, Jamie. Mr. Klubeck, would you mind just a couple more minutes to explain to us what the components of the compensation structures are in the lending and borrowing chain?

MR. KLUBECK: Thank you, yes. I think I'm in almost the right sequence -- not quite, though. So if Jerry and the New Orleans fund -- pension fund, and I hope I got that right, I'm sorry -- if their firm was to contract with an agent to lend securities, and that agent lent the securities to a broker dealer, and the broker dealer was using those securities to either cover a fail or let's say that a conversation came up around a short seller or a hedge fund, so those are the four parties basically in the transaction.

The ultimate beneficial owner, the lending agent, the broker dealer who is borrowing the securities, and then the need for the securities -- and let's say that there's a short seller involved. The vast majority of the profit in the transaction and the interest rate profit, as David described, can be sometimes very small or it can be very large.

The majority of the profit on both ends of the equation would go to the lender of the securities, who would be the beneficial owner, and they would typically have an arrangement with the lending agent in terms of doing that. Current market practices could be anywhere from 70 to 80 percent of the profit in that transaction would go to the lender -- the beneficial owner.

The bank would share in that -- their component of the profit, and that would be the fee, if you will, for them to act as agent in the transaction. The broker dealer, in effect, becomes the middle man in the transaction, borrowing the securities from the agent bank, the custodial lender, and then, in effect, lending them to -- or at least providing so that the short seller could do the short sale transaction.

In David's example you had a wide range. You have fed funds today at 13 or 14 basis points, and then you have the example of Sears -- which I don't have the exact numbers in front of me; I'll use David's numbers and assume they're perfect -- 28 percent spread.

The securities lending market is actually a supply and demand market -- it follows the basic laws of economics. And if Sears, in David's example, if Sears had been in plentiful supply and readily available in the lending marketplace, and there were plenty of shares able to be borrowed, then that security would be easy to borrow and there would be no supply-demand effect on that spread, and then we'd be talking with the 13 basis points equation.

In the case where something may not be easy to borrow, and a security is -- there's a lot of interest in selling a stock short, and there's more shorts, if you will, than the supply would allow, then basic laws of supply and demand would say then, just like any other goods or services, if there's a tremendous demand and not enough supply the price would move towards the proper efficient price.

And in the securities lending market, that price movement is actually the rebate rate, or the interest rate paid by the ultimate borrower of the securities to the ultimate lender of the securities.

So hopefully -- I'll get right to your answer, right to the question, is, that most of the profit goes to the beneficial owner, and in the case of a hard to borrow, most of the payment is made by the actual ultimate short seller.

CHAIRMAN SCHAPIRO: Thank you, that's really helpful. And it leads to a question -- and somebody mentioned this in their submission, and I read these last evening so I can't tell you exactly who mentioned it, but also a question maybe for everybody -- to what extent has the goal of growing lending income driven investment decisions so that more and more investment decisions may be made by funds in order -- in hard-to-borrow securities, because the revenue from that will be higher, rather than maybe fundamental investment strategies?

MR. PRIDMORE: I think that might have been my submission.

CHAIRMAN SCHAPIRO: I actually think it was your submission.

MR. PRIDMORE: You know, it's interesting, in the hard-to-borrow stocks, most of the compensation is coming from the intrinsic value of that lending transaction. For the more readily available securities, the portion of compensation that comes from the intrinsic value is very small, and most of the return is generated in that spread between where the cash collateral is invested and the rebate rate.

And generally it is a fairly small margin. So if you take a little bit of extra risk in investing the cash collateral and, say, gain 10 more basis points of return on the cash collateral -- which doesn't sound like a lot -- it might be -- represent a 40 percent or 50 percent increase in lending income for that transaction.

So the dynamics on the hard-to-borrow stocks, a 10 basis point change in investment return won't make that much difference. On a 2800 basis point return on Sears stock, 10 basis points doesn't mean a lot. But on a more normal transaction which might have a spread of 25 basis points, 10 basis points can mean a lot.

So most transactions in securities lending for the beneficial owner I think are skewed towards those more normal types of returns of 25 basis points. So there is a bigger incentive to take more risk with a cash collateral investment. That's my perspective.

MR. DOWNEY: I agree, but in the general collateral -- today, the beneficial owners -- correct me if I'm wrong -- are basically paying for custody today. Effectively they're paying a few basis points. The fact is, is that I know very few professional traders who are getting any rebate on any name because of the low interest rates. So negative rebates are across the board.

Accordingly, someone who is long in a stock, who is the custody or the prime broker, is lending this out a negative rate, and then getting positive rates from the lender. So there's still a spread out there. And when you talk about 10 basis points or maybe 12 basis points, I think that's what CalPERS said that they earned on their lending. So they made a ton of money, you know, 12 basis points added up to $150 million for them in 2007.

So in many of the general collateral names today, you see negative rebate rates sometimes approaching 50 basis points, 32 basis points, 12 basis points, right. And it fluctuates daily. So there is profits in this trade. Don't be confused that it's just a couple basis points here and there. When you talk about doing this stuff in size, it really adds up to real money that buys an awful lot of pencils.

COMMISSIONER PAREDES: One of the points that Mr. Davis made is the development of checklist on a going-forward basis, and using that as something to key off. I'm curious, now that there's a greater appreciation for what some of the concerns are and what some of the risks are along the whole chain of the transaction, in addition to the prospect of diligence checklists, what other market-based adjustments, if any, have been made or are folks contemplating or do you folks anticipate being made in the future? And I'd be curious in terms of what some of the items are in terms of the checklist that you all are considering.

MR. DAVIS: The central problem that we encountered was in the mark-to-market area. Historically, of course, the bank was always very careful to mark the mark to market -- the value of the securities out on loan, but as we've seen, there's no requirement at all to mark to market the value of the collateral that's sitting there.

And if you invest collateral in paper of various kinds -- and for reasons of market action or that individual issuer the paper is becoming less valuable -- there appears to be no procedure in place to regularly monitor that. And so since that's the only area of loss we've ever experienced, I think that's where we're looking for checklists to come from the bank -- what are you doing about the type of collateral you've accepted or put in place for our securities out on loan, and how are you monitoring the changes in that value, and what would you do -- what can you do as the lending agent to adjust the collateral when in fact the security on loan may not have changed in value at all but the investment you made in collateral has changed.

COMMISSIONER WALTER: In that respect, we've heard that mutual funds may not have experienced the same levels of losses that other lending institutions have. Do you have any comments on that, or is there anything that other types of institutions can learn from how the funds handle this?

MR. DAVIS: Well, we don't invest in mutual funds at all, so hopefully one of the other panelists might have an idea of why the difference exists.

MR. PRIDMORE: I do some work for some mutual fund complexes, and I think that you're right, many of them approached securities lending with a little bit different perspective, and would focus on the reinvestment of cash collateral as one of the key principal areas of risk in the transaction.

I worked very closely with a fund complex that was very skeptical about lending, and concerned about potential about the potential price impact on their portfolio, but also was very concerned about the risk of securities lending, not only broker dealer defaults, but also the investment risk.

And they took an approach that studied the market and studied these risks and put in place a program with a third-party lending agent, and actually entered the lending market in September of 2008, which you could argue was probably the worst time possible to enter the securities lending market.

And from a risk perspective, they operated their program for about a month, and because of the concerns of systemic failure of the financial system, they decided to shut their lending program down, and they were able to withdraw from lending and get all their collateral -- all their securities back and liquidate their cash collateral investments at par.

How do they do that? They invested the cash collateral in 2a-7 money market funds that -- and further, they took an even more conservative approach and invested only in Treasury and agency money market funds. They didn't even want the investment risk underlying a typical money market fund.

COMMISSIONER WALTER: Do you have any insight into why a more conservative approach was taken there? Is it because of the nature of the business, is it because of some of the aspects of investment company regulation, or is it just pure speculation and we can't say?

MR. PRIDMORE: I think it was because of the active management -- active involvement of the investment management people, staff, in the process. They took an investment management approach to the whole securities lending world and decided that the cash collateral investment risk was one of the key areas of risk, and designed the whole program to contain risk.

They also took an approach that was not designed to maximize the income of their service provider, but was designed to maximize the risk-adjusted income that they were going to earn from the program. And part of that was not ballooning their balance sheet with more loans, but instead focus on only the most profitable lending transactions. And in doing so, they keep the size of their book smaller than it might have been in other situations.

So smaller size, less risk; more conservative investment, less risk -- those are the sorts of things that they looked at. I don't know that I could attribute it to any regulation, it was more the investment management approach that they employed.

COMMISSIONER WALTER: Thank you.

MR. DOWNEY: Could I comment on that? There's two different types of people in this world, there are front office people and there are back office people. And front office are traders. They think in a particular way, they have a particular language, you talk in BIP rates.

And back office people, they are very -- they're low key, they're conservative, and they're the ones who harbor all these stocks, and they're the ones that -- they knocked on their door, can I borrow your shares and I'll give you some free money. You see, that's where the pension funds, they gather all their assets and they put them in our back office and it's the back office who are dealing with these sharks, these traders who are very good with BIPs and know how to trade.

And in the mutual fund, mutual funds that I had talked to, these guys are traders. They know exactly what's going on, and I know several who they don't participate in any of that general collateral names, because they only trade the intrinsic value, which is the hard-to-borrow names. Not all of them, but in general I find that the mutual funds are generally more attuned to the fact that securities lending is a financing tool, securities lending is an integral part of trading, and as I mentioned in my comments, that this is a back-office operation. That's what the failure here -- if this was in the traders' hands, this would not have occurred because they would have covered their risk a lot sooner than happened.

MR. BRIGAGLIANO: I have a question for Jerry Davis. You expressed concerns about the master loan agreement that you executed when your fund allowed its shares to be lent. Do you have any views on whether there should be more disclosure in that agreement, specifically of the risks and how collateral can be reinvested?

MR. DAVIS: I absolutely think there should be more disclosure and a more precise commitment from the lending agent, in terms of what they will do under what circumstances. The exhibits to that agreement were marvels of simplicity. The exhibit number three, I will never forget. It purported to list the allowable investments for collateral alone. And it said cash, securities and letters of credit, period, the full content of that page.

There was nothing about the rating of these various instruments, there was nothing at all about the monitoring of the instruments, there was nothing at all that described how the bank was going to care for those instruments. So I think that even though the document itself, for a small fund like ours, was 30 pages, the meat of it was the protection for the lending agent, not for the beneficial owner.

CHAIRMAN SCHAPIRO: If I could just follow up on that and on the conversation about how mutual funds might have done it a little bit better. Do any of you have a sense of, sort of across the industry, when the credit crisis hit the number of securities lending, cash reinvestment programs that experienced real illiquidity or restrictions on reinvestment or the inability for investors to get their -- beneficial owners to redeem?

MR. DAVIS: Wrong panel. You've got to talk to the custodians.

MR. PRIDMORE: I think it was pretty universal. I don't think that there's a major securities lending program that didn't have some less-than-liquid securities in their cash collateral investment portfolios.

And part of the reason was that many of them were purchasing securities that were really designed to fit the securities lending buyer, the securities lending cash collateral investor. And those instruments were frequently designed to appeal to a securities lending investor by having a floating -- a short-term floating rate, but a long maturity.

So they might have a daily fed funds float or a one-month LIBOR floater rate on the instrument, but it would have a three-year maturity. So it could pay a overnight market rate, but when there was a liquidity crisis there were no buyers, because the natural short-term investor, like let's say a 2a-7 money market fund, cold not buy that security.

And other short-term investors were hording their cash and putting it into repurchase agreements or overnight Treasuries, so that left most institutions who had invested in that type of paper with a pretty serious liquidity problem.

MR. DAVIS: You can pretty well identify the banks by the securities class actions that have been filed. I know of a number of them. We are very active litigators. We were not large enough in this particular area to be assigned lead plaintiff, but I know there are least three actions out there involving the big four in the lending business, and probably others I'm not aware of.

MR. BRIGAGLIANO: Do the Chairman or Commissioners have additional questions? Commissioner Casey?

COMMISSIONER CASEY: I just have a follow-up question for Mr. Pridmore with respect to what your view is about the state of independent risk assessment. You mentioned that there were practical steps that investors could take, and do you distinguish those between -- you distinguished between those with good independent assessment practices and those who didn't, in terms of how they fared through the credit crisis.

Do you have a sense of -- maybe any of you could answer this -- a sense of how much improvement you've seen over the course of the crisis?

MR. PRIDMORE: Well, I don't know that the improvement has hit home yet. I think there is so much shock in the system that most institutional funds really, truly were shocked that they had this problem, that they were sold -- they believed they had purchased a program that had limited risk. And I'm not accusing the third-party lenders or the custodian banks of doing anything to hide this risk. It was a risk that really hadn't been experienced in a major way before, and I think that they hadn't really assessed the possibility of it occurring.

But I think that in my discussion this shock is beginning to wear off, and people are saying, let's think about lending now in terms of how do we limit those sorts of risks, and going forward, designing risk controls that take those risks into consideration.

MR. DAVIS: The unprecedented situation we were placed in -- when a manager gets in trouble with us, we always have the discretion to fire them within 30 days. When the securities lending program tanked and it was clear that our cash collateral situation was going to be a very bad one and our revenues were not going to be good for some time, we said, well, let's just quit lending for a while. And the bank said, well, that's fine, but you'll have to write us a check for $500,000 if you want to get out.

So the idea of having to pay to exit a program that we were already losing money on was a pretty instant and nasty shock, and it's left a bad taste in everyone's mouth. So we're still participants of a sort. We're still receiving small monthly checks from the various lending operations the bank is doing, but we got that half million dollar bill hanging over our head for the lesser value of the collateral out on loan for previous lending operations.

COMMISSIONER WALTER: Professor Reed, you've talked a little bit about your research. Can you give us an overview of what the other research in the field is -- and I gather there aren't that many of you -- and whether there's in general a consensus among the folks who have been doing academic research?

MR. REED: Yeah, in some sense there is -- there's one area where there is some controversy and one area where there is more or less consensus. Most of the academic research that's come out, especially recently, on securities lending itself sort of treats it as a pretty illiquid market. And I think there's pretty broad agreement on that.

And since there is an illiquid market there, it can have effects on the underlying stock prices. If you're trying to conduct a short sale, this illiquid market might get in the way of that short sale. So not enough people are able to do the short sale, so you can have situations where prices are too high in the underlying stock market.

Lots of research has shown this. Some of the research has compared prices in the options market to prices in the stock market and shown that occasionally prices in the stock market can be significantly higher than prices for the equivalent thing -- the equivalent combination of options in the options market.

There's a little bit of disagreement about the effect of short sale constraints on the underlying price. There's sort of one group of research -- and there's evidence for both sides, really. One group of research that shows that if short selling is constrained we have temporary price increases in stocks, and there's another group of research that basically shows that as long as everyone knows the prices are constrained the stock prices won't get misaligned and effectively the constraints will just decrease the speed of adjustment and prices won't become efficient.

CHAIRMAN SCHAPIRO: Jamie, if I could ask maybe a final question. What would -- love to hear from each of you on this -- what would be the best improvement, whether it's by regulation or industry practice, that could be made to this market? What's the single thing that's -- I've heard transparency, I've heard disclosure, pricing, but what's the key thing for us to really try to affect change here?

MR. DAVIS: The key thing for the investor, I think, is an improvement in the alignment of interests between the parties involved. I think there's been a real imbalance between who benefits and who suffers among the various players.

From our perspective, we seem to be the big loser in the entire process, and it was our money in the first place that was put out there to buy the stocks that then went out on loan. And so I don't know to what extent any of the other players are suffering any losses other than reduced business, but we have certainly suffered, at this point at least, real cash losses and therefore the interests seem to be out of balance in the way the agreements are structured.

MR. DOWNEY: Mary -- sorry, Chairman Schapiro, transparency is the key here. If we know, like Professor just mentioned, that he recognizes that there are odd pricing and option combos, that's exactly what I told you happens in the futures. That is because there's a pressure that only a certain number of people know about, and only a certain number -- few people control, and it puts pressure on these forward values because of the negative rebate rates.

Transparency is the number one key. They have to remain transparent. You can do it through security futures. It's very easy to do. We distribute it on our website and we can track that fluctuation there. AQS is coming out, and they're going to bring some transparency to this product, as well, if there is enough participants -- and that's the major key -- if there is enough participants.

And the third thing, and this is going to be a bit controversial, but securities lending is really a buy and sell of a stock that doesn't have a section 31 fee associated with it. And you can, in fact, govern people who are trying to loan their stocks out, their general collateral was just to gain money to reinvest, if that's still their game, by simply putting a fee associated with it, just you'd do with any other stock transaction.

And that will slow down the desire to loan these GC names, and then there's also -- there's an embedded forward contract that I'm going to get this back in the future. My product, I have to pay 4.2 cents or forty-two hundredths of a penny per contract.

You should do the same thing, and that will reduce the desire to do these trades in a counter-party risk environment, and you would bring this in to a clearing operation where mark to market discipline is put into effect and you would be able to achieve all of the securities lending goals of lending it out, keeping the markets liquid, and producing profits for the beneficial owner of the stock.

Now Irv mentioned something very important, that broker dealers today are the only ones who can both borrow and lend. I have to disagree. Using the futures market today, an individual with a hundred shares of shield, on margin, who is now paying an interest rate, and this broker dealer is in fact taking that half of a hundred shares, and loaning it out at 28 percent, that small customer could EFP that transaction on a regulated exchange in a clearing house environment, and they can capture that full rate and not cede it to the member -- broker dealer.

So it is available, it's there today, AQS will bring something to the market, there will be others coming to the market with solutions, OneChicago is just one. It will not fit everybody, but it provides solutions that -- and with a little bit of effort on the SEC part -- you don't have to do much, just promote the idea.

Right now you -- today, set my margin at 20 percent performance bond. That puts me out of the swap market, which is another securities lending. I have requested relief to 15 percent, in line with options, portfolio margining. I am now waiting more than a year for approval. There is nothing I see wrong with this. You could, with a very simple act, put me into the swaps game, which would put me competitive with a securities lending transaction over the counter.

One more thing that you have to understand is, this is tied to portfolio margining. Portfolio margining is an interest rate, it's the effective use of capital, and that's part of your job, is to regulate in a way that there's an -- the efficient allocation of capital across our markets. Portfolio margin is hampered today because it doesn't include indexed futures. This is a disagreement with the CFTC.

While not apparent to you now, if you approve that, somehow get over this hurdle, the member firms will change their systems to allow those types of futures to sit inside of the same account as securities. At that time, they will do that because the customers will demand it, they want to be efficient. At that time you will see more of these over the counter trades going in because of that ability to do so.

MR. KLUBECK: The one thing that I think we could do -- David, you said a lot of things that I'd love to talk to you about later, and I don't have time to retort some of the things that I heard in your comments -- but what I will say is that the securities lending marketplace, I think, a lot of talk around transparency and efficiency. I think the market is fairly efficient. I do think that it is and does apply the rules of supply and demand, basic economic laws.

What I do think we could change, though, is -- and this is probably for a later panel -- we talk about the short selling rules, Regulation SHO and the changes that have been made over the last couple of years, and I think they've all been fantastic rules in terms of helping to make sure that securities lending transactions are there to support short selling and -- in the marketplace in general.

I would expand that beyond just the equities markets, and I would include in the fixed income markets, which theoretically may open up a different can, in terms of how that is happening. But I think that the concept of shorting as well as borrowing securities, which because they're tied together today, should extend into the fixed income markets, as well.

MR. PRIDMORE: I think it's really interesting that we're here after a major financial crisis and we're not talking about losses that were suffered by the major broker dealer defaults that occurred. So what does that tell me? That tells me with securities lending the basic fundamentals of risk protection from the broker dealer default risk are -- worked very well.

So not all of securities lending is broken. I think what has been a problem, clearly, has been the investment of cash collateral. And I think that what the Commission can do is step forward and make a recommendation that people do an independent -- make sure they do an independent risk assessment of their securities lending program and focus on the investment of cash collateral as one of, obviously, the key areas of risk.

MR. REED: I'd say if there's one thing we can do it's to try to support securities lending as sort of a background for short selling. I think that the work that I've been involved in, along with the work that others have been involved in, it's sort of unanimous that short selling is probably a force of good in markets generally.

So to the extent that we can make the securities lending transaction easier, transparency is one way to do it, but sort of -- to avoid fees and to avoid limits of any kind on short selling and securities lending, that would make short selling easier and potentially improve market prices.

MR. BRIGAGLIANO: Well, we have time for a couple more minutes. So I want to ask one question to Irving. Irving, so how does a borrower going to a broker dealer know it's getting a good price on the stock it's borrowing? How can it tell whether it should be paying less and it could be paying less somewhere else?

MR. KLUBECK: Using the basic rules of supply and demand, we have relationships with many different lending firms, both in the agent lending custodial side of the equation, as well as broker dealers who also lend their securities. And literally, what we do in the morning is we will call and we will contact the counterparties who we might be able to borrow securities from, and we will ascertain the rates of the rebate rate, or in effect, how much we either have to pay or we might receive by borrowing those securities.

If you follow the chain or the good spy novels follow the money, the cash is coming from the -- let's say again a short seller, given to the broker dealer, the broker dealer passes that cash proceeds on to the agent bank, agent bank down to the end beneficial owner where the cash gets reinvested.

And so what we're really talking about is how much of that cash reinvestment is available back to the broker dealer and to the end customer who might be on the short side. The laws of supply and demand are, again, if a lot of broker dealers are calling looking for the same securities, the party in the other side, the potential lenders, they hear the noise; they understand that there must be a demand for these securities, and they start to raise the spread -- they raise the price, if you will. It's not a -- the price of the securities in the regular trading markets, it's the rebate rate.

And therefore you go from a very small spread -- if the stock becomes very illiquid from a securities lending standpoint, the supply and demand will force that price down and will force suddenly -- we talked about negative rebates, especially in a low interest rate environment, negative rebates are more prevalent.

And so what I'll do as a broker dealer is I will call 30, 40, 50 counterparts, ascertain their rates and whether it's on easy-to-borrow securities or hard-to-borrow securities, and then what I will do is I will try and find the best price or the highest interest rate back to the broker dealer and to my investor.

MR. BRIGAGLIANO: Well, thank you, Irving. I note that in the next couple of panels we'll be taking a deeper dive into collateral reinvestment as well as transparency. So we've now reached the end of the first panel discussion, and I'd like to thank our panelists for their insights and candor. We'll have a short break and we'll start the next panel promptly at 11 o'clock. Thank you very much.

(Applause. Brief recess.)

CHAIRMAN SCHAPIRO: Let's go ahead and get started. I'd like to welcome our panel two participants. Before I turn this over to Buddy Donohue and Henry Hu, I should note for the record -- as I should have at the very beginning -- that Commissioner Aguilar is actually joining us in cyberspace and participating as well.

So Buddy and Henry.

MR. DONOHUE: Welcome back to panel two, which is entitled, Securities Lending and Investor Protection Concerns; Cash Collateral Reinvestment; Default; Lending Agent Compensation and Fee Splits; Proxy Voting.

I'm Buddy Donohue, Director of the SEC's Division of Investment Management. My co-moderator is Professor Henry Hu, Director of the SEC's new division of Risk, Strategy and Financial Innovation.

MR. HU: Welcome.

MR. DONOHUE: As the title suggests, panel two will cover a lot of ground. First, we will explore securities lending cash reinvestment risk, a risk that very much became a reality recently when a number of securities lenders in the U.S. experienced unanticipated illiquidity and losses in connection with their cash collateral reinvestments. We will also explore possible alternatives that might mitigate this risk.

Second, we will briefly discuss the risk of borrower default and the protections that exist with respect to this risk.

Third, we will explore lending agent compensation and fee splits, a topic that received some attention in the media last spring.

And finally, we will look at proxy voting of securities on loan. More specifically, we will look at the logistical impediments that securities lenders may face when they want to vote the proxies of securities on loan, and whether the transfer of the proxy votes to securities borrowers gives rise to the practice known as "empty voting," a subject with respect to which my colleague, Professor Hu, is an authority.

We are fortunate to have a very distinguished panel of experts with us today: Patrick Avitabile, Managing Director and Global Head of equity trading for Citigroup's securities finance businesses; Ed Blount, Founder and Executive Director of the Center for the Study of Financial Market Evolution; Karen Dunn Kelley, Chief Executive Officer of Invesco fixed income, and Executive Vice President of Invesco Aim Distributors, Inc.; Bruce Leto, partner at Stradley Ronon Stevens and Young, and the Chair of the firm's Investment Management/Mutual Funds practice group; Kathy Rulong, Executive Vice President of the Bank of New York Mellon Corporation and Executive Director of BNY Mellon Global Securities Lending; Julia Short, President and CEO of RidgeWorth Funds, and Managing Director for RidgeWorth Capital Management, Inc.; and Christianna Wood, Chairman of the Board of the International Corporate Governance Network.

Each panelist will now give an opening statement not to exceed three minutes. Following the opening statements, the panel will receive questions from Chairman Schapiro and the Commissioners. We would like to have as lively a discussion as possible. Accordingly, please speak up if you disagree with another panelist or have something to add.

Patrick, would you like to start us off with your opening statement?

MR. AVITABILE: Good morning, and thank you Chairman Schapiro and members of the Commission for the opportunity to speak here today. I am pleased to participate on behalf of Citi in this roundtable to examine securities lending and investor protection concerns.

I am the Global Head of equity trading for Citigroup's securities lending program, and I am responsible for trading units in New York, London and Hong Kong. Citi is a global financial services company which provides consumers, corporations, governments and institutions with a broad range of financial products and services. Citi has $11.1 trillion of assets under custody servicing clients in more than one hundred countries. Citi acts as a custodial and non-custodial directed lending agent for a broad range of domestic and foreign clients.

As securities lending has developed into a critical element to market liquidity, it has not lost its fundamental purpose for lenders: incremental income with limited risk. The maximization of revenue, although a daily goal, is secondary to the safety of the principle of collateral and operational efficiency.

Open architecture, customization, flexibility allow a lender the ability to be consistent with its management objectives and risk-reward appetite. Transparency, full disclosure, controls, ability to change its lending profile in order to market conditions are essential elements of a lending program.

In addition to the topics we will cover on the panel, there are additional factors that impact investor protection. A central theme for these additional factors is communication, and I believe that's why we're here today. As new challenges result from market changes in demands, it is essential that the lender, their advisors, lending agent, borrowing counterparties and regulatory bodies maintain open dialogue to make the securities lending financial tool responsive to changing market trends, at the same time as maintaining the fundamental principles on which this market has been established.

For this reason, lender protection must be built on a foundation of continuous lender communication of issues and goals. Open dialogue is essential to the effectiveness of the agent bank to structure a lending program that meets the return objectives of the lender and satisfies the lender's individual risk profile. Periodic reviews of the program as well as regular customized reporting and daily access to loan and investment information ensure transparency and control by the lender.

Finally, maintaining open dialogue will ensure that the securities lending program evolves and remains consistent with the constantly changing and market-sensitive investment philosophy of the lender. Thank you.

MR. DONOHUE: Thank you, Patrick. Ed.

MR. BLOUNT: I'd like to thank the Chairman, the Commission and the staff for inviting me here this morning. I'm the Executive Director of the Center for the Study of Financial Market Evolution, which is a fairly long title to describe a fairly simple mandate. Our mission is to gather and compile and scrub data that will then be presented to academics to conduct research into otherwise opaque sectors of the market.

The Center is based here in Washington and we have a processing facility in Zurich. The original intention was to be able to allow academics to get a robust data set instead of the more typical single data set that they were conduct their research with.

It's been a challenge to assemble this organization and put it together. Our first project has been to try to compile sufficient data to respond to the academic allegations that were voiced some three or four years ago that activist hedge funds were borrowing securities in order to manipulate the proxy votes of corporate targets.

We spent a great deal of time trying to figure out if that could be true by accessing a database that was housed at a consulting group that I owned and ran at the time. We came up with some initial findings that caused some suspicion about whether the academic allegations were true, even though we didn't and couldn't refute them.

We therefore said, well, let's continue to drill down, get more data. That project has continued on, and we are at the point where we expect by the end of the year we will have probably some 90 percent of all the transaction data within the U.S. securities lending market, representing all the activity between 2005 and 2008.

The second project, beyond the borrower proxy abuse project that we're working on, is an analysis of the dynamics of securities lending cash collateral during the recent market crisis. For that, we're relying on data that the risk management association compiles quarterly from its members and presents publicly, but we've been trying to look at it in order to determine what may have happened and what rules might be available from that.

As a personal introduction, my background is that I've been involved in securities lending for well over 30 years, since I was brought from Citibank to Bankers Trust to create a securities lending program to buttress the earnings of the custody service that was at the time deeply underwater in the wake of the DTC immobilization of securities, which destroyed the business model of the custodians that had been in place for a couple of generations.

I stayed involved after I left Bankers in 1980 by founding a Wall Street consulting firm which was essentially systems design, until the early '90s, when we became a database research firm, again tracking securities lending but also working on cash management and a variety of other services.

We were the first to develop a performance measurement system for securities lending and a loan pricing service that operated on a daily basis, which I sold as a business about a year-and-a-half ago, and then took over full-time management of the Center for the Study of Financial Market Evolution.

So thank you again for inviting me today, and I'll do whatever I can to shed some light on these issues.

MR. DONOHUE: Thank you, Ed. Karen.

MS. DUNN KELLEY: Thank you, Chairman Schapiro and members of the Commission for the opportunity to participate in today's panel. My name is Karen Dunn Kelley, and I am the Chief Executive Officer, Invesco fixed income.

Invesco is a leading global asset manager which is also publicly traded on the New York Stock Exchange. Invesco's operations span 20 countries, serving clients in over 100 countries, with approximately $389 billion in assets under management as of June 30th. This includes $149 billion within the AIM mutual fund complex, which is managed by Invesco AIM funds.

Several of the Invesco entities have been involved in securities lending programs throughout the world. The AIM funds operate a very large lending program. Invesco AIM also manages the cash collateral for a variety and various third-party lending agents. I have been involved in the AIM fund's security lending program since its inception in 1999. It was created as an intrinsic value lending program. The funds lend securities through agent lenders and principals with Invesco AIM retaining management of the cash collateral in all instances.

My observations today will be drawn from my experience with the AIM funds program. We believe securities lending continues to play and will continue to play a vital role in the healthy functioning of global security markets in enhancing liquidity, promoting efficiencies, and facilitating trading in equities and fixed income.

In addition, a properly structured security-lending program can provide institutional lenders such as mutual funds with incremental portfolio returns without increasing significant risk.

Recent market upheavals which have been affected throughout all the industry, however, have highlighted certain potential risks associated with the securities lending industry that may not have been fully articulated during a more typical time period.

At Invesco, we believe the appropriate role of securities lending programs is to generate additional fund income without materially increasing the lending fund's risk. Consistent with that view, we believe that a prudently structured and customized securities lending program should be focused on the intrinsic value of the loans as well as risk mitigation.

Implementing a strong securities lending program includes several critical components. First, agents and lenders must work together to clearly identify and articulate the level of risk in which a lender is willing to take. Also, that risk must talk about counterparty risk, collateral selection as well as guidelines as an important aspect of those discussions. Ongoing communication and review of the program is also critical.

Prudent lending also requires continued vigilance with respect to counterparty and borrower risk. A stringent, carefully monitored credit process allows agents and lenders to quickly identify and to mitigate potential trouble loans. This should be coupled with very strong legal protections as well as operational processes.

Another integral part of a securities lending program is a solid set of proxy voting policies and procedures. It is essential for the fund to fulfill their corporate governance responsibilities as a beneficial owner of the lendable securities. Lending funds are obligated to have their voices heard on important proxy issues, but doing so requires careful attention, coordination and operational preparation.

In summary, Invesco believes that the securities lending practice will continue to evolve. All parties must remain focused on accountability, communication and transparency among beneficial owners, cash collateral managers, as well as lending agencies. Thank you very much.

MR. DONOHUE: Thank you, Karen. Bruce. And would you turn off your mics when you're not speaking? It would be appreciated. Thank you.

MR. LETO: Thank you, Chairman Schapiro and members of the Commission for allowing me the opportunity to express my views today at this roundtable. Mutual funds are important participants in the securities lending markets, and comprise a significant percentage of lenders. My remarks today will be focused from the point of view of representing mutual funds and boards in the securities lending process.

Although I represent several fund families that engage in securities lending, this statement reflects only my own personal views.

The Investment Company Act of 1940 does not directly address securities lending. It does, however, include broad provisions that require good and safe custody of portfolio securities, that limit the leverage that funds can incur, and that protect funds against conflicts of interests with their affiliates.

The staff of the SEC has provided guidance on the application of these provisions to the securities lending process primarily in a series of no-action letters, beginning in 1972. Securities lending by funds did pre-date those letters, however.

In general, in my view, the current regulatory guidance on securities lending is somewhat outdated, and was drafted at a time when the securities lending process looked somewhat different from what it looks like today. Consequently when new wrinkles in the process are identified, legal guidance must be drawn from no-action letters and other guidance that was drafted before such wrinkles occurred.

For example, the use of unregistered securities lending cash collateral pools is a relatively new phenomenon that did not exist at the time that the no-action letters were drafted, and that only has been addressed to a limited degree through SEC exemptive orders and the rule making processes.

In their oversight of securities lending arrangements, fund boards would benefit from updated regulatory guidance that takes account of current market conditions. Ideally, the updated guidance would be made through a notice and comment process, resulting in an interpretive release or rule making that has received the benefit of comments from fund boards and other industry participants.

The interplay of proxy voting in the securities lending process is another area where new or additional guidance would be useful. According to SEC staff interpretations, in the event management has knowledge that a material event will occur affecting a security on loan, the directors must call the loan in time to vote or otherwise obtain rights to vote.

In practice, however, management often does not have knowledge of material events, because issuers typically do not give notice of the matters to be voted upon until after the record date. Furthermore, even if the fund were aware of a material matter to be voted on, it may not be in the best interest of fund shareholders to recall the security in order to vote. Thus the fund and its board are placed directly in the crosshairs of two different responsibilities.

Proxy voting, further, of portfolio securities, is generally considered to be part of the investment management process rather than a board role. Thus the current standards regarding proxy voting in the securities lending area would clearly benefit from some updated guidance.

Existing guidance contemplates oversight of lending agents and their fees. For example, the staff has stated that the fees to be charged by a lending agent should be negotiated between the fund and the lending agent, reduced to a contract, and approved by the fund directors. In some very old guidance, the staff also has suggested that fund directors, in carrying out their fiduciary duty to act in the best interests of the fund's shareholders, should determine that the fee paid to a securities lending agent is reasonable, and also implied that the director should make a comparative analysis of the fees charged by various placing brokers.

Affiliated lending agents require even greater scrutiny. The SEC staff has provided somewhat more recent guidance on how affiliated lending agent arrangements can comply with the Investment Company Act of 1940, and the board's responsibility in that regard.

The SEC staff also has taken the position that an affiliated lending agent cannot receive compensation based on a share of the lending revenues absent an exemptive order. In the past few years, the SEC has not issued those orders, presumably out of concern that the bargaining process with an affiliate may in some circumstances present an insurmountable conflict.

However, such affiliated arrangements which permit revenue sharing may be beneficial for some fund groups. Further clarity surrounding the board's responsibility with respect to fees in both affiliated and unaffiliated securities lending arrangements would be useful. In addition, it should be possible for the SEC to adopt an exemptive rule or provide some other guidance or interpretive release that effectively would address its concerns with respect to affiliated securities lending agency arrangements.

It is unclear from the guidance how much flexibility a lending fund has to invest cash collateral. While the SEC staff has at various times mentioned that collateral could be invested in various specified ways, the only definitive statement is that the type of investment for cash collateral is a decision for directors of the fund. The industry assumes, however, that the SEC requires that cash collateral be invested in highly conservative liquid investments.

Although liquidity is a clear requirement for the investment of collateral that may need to be returned upon short notice, there may be circumstances where an investment company should not be limited to such conservative investments. Rather, where consistent with the fund's investment program, greater flexibility may be appropriate. Of course, in every case the investment of cash collateral should be consistent with the fund's stated investment policies and prospectus disclosures, including risk disclosures. Further guidance in this area also would be beneficial.

Thank you.

MR. DONOHUE: Thank you, Bruce. Kathy.

MS. RULONG: Good morning. Before I begin, I would like to also thank Chairman Schapiro, the members of the Commission, and the staff for inviting me to participate this morning.

My name is Kathy Rulong, and I am the Executive Director for Global Securities Lending at BNY Mellon. Prior to my experience in securities lending, I spent approximately 17 years in the capital markets and portfolio and liquidity management departments at Mellon Bank. My credentials also include a certification in public accounting.

My employer, BNY Mellon, is a global provider of financial services, helping institutions, corporations and high-net-worth individuals manage and service their financial assets. BNY Mellon operates in 34 countries and serves more than 100 markets.

Among the primary businesses at BNY Mellon is asset servicing, which offers clients worldwide a broad spectrum of specialized asset servicing capabilities. With $20.7 trillion of assets under custody and administration, our company provides both custodial and non-custodial agent securities lending to securities owners. These owners include, but are not limited to, domestic and international investment funds, public pension plans, ERISA plans and registered '40 Act funds.

The market events of the past 24 months have had an unprecedented impact on the securities lending industry. Sustained and severe market illiquidity and rapid credit deterioration, particularly in the financial sector, challenged the collective wisdom of industry participants, wisdom which had developed and was broadly accepted for well over a decade.

The essence of this wisdom was that the capital markets could be expected to provide near-term liquidity for short- to medium-term, high-quality, interest-rate sensitive investments in most conceivable circumstances.

This wisdom carried the industry through several major downturns in the market. But the prolonged and extraordinary market disruption of the past two years demonstrated that even this conservative approach could be severely strained by such unparalleled events.

The failure of the market has subjected the securities lending industry to an unprecedented but warranted level of scrutiny by beneficial owners, their agent lenders, their investment managers and their respective regulators. The course of these events is driving significant, and in my mind, positive changes for the industry.

To an overwhelming extent, beneficial owners understand the importance of securities lending to efficiently functioning markets and also to the benefit of their own bottom line. These beneficial owners want to continue to lend their securities. Many, however, have reevaluated or are in the process of reevaluating the risk profile of their securities lending program and are redefining the level of acceptable risk for their company or institution.

Industry consultants are also actively engaged in helping their clients with these assessments and the ultimate decision making surrounding acceptable risk. This process has led to increasing transparency and reporting, related both to the loan side of the business and also the lending reinvestment portfolios.

It has also led to a reemphasis of the importance of risk-adjusted returns for securities lending programs. It is leading to increased interest in the intrinsic value approach to securities lending, which presumes a reduced level of risk and return in the collateral reinvestment portfolio, and therefore focuses attention on the lending value of securities on loan.

As another example, it is encouraging that beneficial owners and their agents are reexamining both their cash and non-cash collateral requirements in light of recent experiences and the types of assets that they are lending.

In summary, securities lending can add significant value to a beneficial owner's portfolio, and can be customized to reflect the objectives and risk tolerance of the owner. Its contribution to smoothly functioning capital markets has been broadly recognized.

Thank you.

MR. DONOHUE: Thank you, Kathy. Julia.

MS. SHORT: Thank you. First and foremost I would like to also thank the Chairman and the Commissioners and the staff for inviting me today and for putting together this roundtable on this important topic.

My name is Julia Short, I'm with RidgeWorth Investments, which is an investment advisor registered with the SEC since 1985. We are a money management holding company. We have eight style-specific institutional investment management boutiques, and approximately $60 billion in assets under management.

I serve as President and the CEO to the RidgeWorth Funds. In that capacity, I'm responsible for the oversight of management of the operations and the administration of the RidgeWorth Funds, which would include the securities lending program. And I serve on the Funds' board of trustees and I serve the Funds' shareholders in that capacity.

The RidgeWorth Funds are a family of 50 mutual funds with approximately $32 billion in assets under management across equity, fixed income, asset allocation and money market funds. And we have participated through a large majority of our equity and fixed income funds in a very successful securities lending -- I'll say programs -- since 2001. So we do believe that done correctly, securities lending can be a very good value to shareholders and provide incremental value to their fund portfolios.

My comments today will be related to '40 Act mutual funds, and they are my own; they don't necessarily represent those of my company nor its affiliates nor the RidgeWorth Funds. They are based on my experiences with the Funds as well as observations in the industry and conversations and dialogue I've had with other industry experts.

When I thought about the topics -- and we have quite an agenda ahead of us today with many different, interesting topics to talk about today -- I think, clearly, from my perspective, the largest risk to the beneficial shareholders has clearly been identified as the collateral reinvestment risks that come with securities lending, and how important it is to manage that. So when I thought about how the SEC could add value through guidance and recommendations around securities lending programs, my comments would be geared towards collateral reinvestment.

There's three areas in particular that I think we should take a look at. The first is the investment guidelines. Whereas it is required for securities lending to be a fundamental policy of any mutual fund that engages in securities lending, it's not been my experience to see it listed as a primary, a secondary or even tertiary investment goal of a mutual fund.

Therefore I do believe, unless disclosed otherwise, the typical investor has the expectation that this is an incremental income. And I think it should be handled as such. Therefore I do think collateral reinvestment vehicles should be geared towards preservation of capital rather than incremental yield.

Secondly, I think disclosure is very important. There's a lot of discussion around disclosure today. There's going to be a panel talking about transparency. I think it's very important to have clear disclosure, and I would caution as we go through this that more is not always better. And I think it's very important as we go through that at the end of the day we are leaving our shareholders with the ability to go through the information and walk away with, is this the right investment for me knowing my risk profile and what my investment goals are.

The third item that I would talk about -- we don't hear a lot about it -- and that's really with the collateral reinvestment itself, if you look at the limitations put on a mutual fund, up to a 33.3 percent are able to lend in a securities lending program. If you take that out -- that's based on the total assets of the fund, which includes the collateral reinvestment. So theoretically, in a fully utilized securities lending program, the equivalent of 50 percent of the net assets of a mutual fund could be invested in a collateral reinvestment vehicle, but yet we don't have any discussion around diversification or issuer concentration on what could amount to such a large investment in a fund. And I think there's risk there that we could use the Commission's guidance.

With that, I'm excited about today, and thank you again for the opportunity to participate.

MR. DONOHUE: Julia, thank you. Christy.

MS. WOOD: Chairman Schapiro, Commissioners, members of the Commission staff and public who are here today, my name is Christy Wood, and I'm Chairman of the Board of the ICGN. The International Corporate Governance Network is very pleased to be here today.

The ICGN is a global organization dedicated to the cause of improving corporate governance standards throughout the world. Its members represent investment organizations with approximately $9.5 trillion in assets. Over a third of our almost 500 members come from the United States and represent the leading pension plans and private asset managers in the country.

My own background is that of an institutional and mutual fund portfolio manager for over three decades, most recently also as the Head of Global Equity at the California Public Employee Retirement System, where I was responsible for $150 billion of global equity, hedge fund and corporate governance program assets.

To my knowledge, the ICGN has written and adopted the only securities lending code for investors. The 20 institutions who contributed to the code listed on page two of our written submission represents some of the largest investors in the world.

This code was written out of concern that lending activity had become so important that it was impeding the share voting process and interfering with corporate governance engagements generally. For the sake of time, I will not repeat some of the points made by my co-panelists. I would like to make a few different points.

I must begin by emphasizing that the ICGN is very much in favor of securities lending as a practice, as well as short selling. We believe that both practices further price discovery, market efficiency and liquidity, but we think the process needs to be improved.

Securities lending is now practiced -- as it is now practiced -- has wrought havoc on the share voting process for public companies. Investors who want to recall securities are often unable to in time. There is also double counting of shares at annual meetings, and there's been a notable lack of communication between portfolio managers and lending departments, so that shares supposed to be voted are discovered to be out on loan.

There are a few things that can be done. Securities lending has suffered from a lack of transparency, and in the marketplace especially to trustees and beneficiaries, who believe that mutual fund investors and public pension plan clients have a right to know how their shares have been lent out for profit, and whether or not they've been lent out for profit or whether they've been used for stewardship purposes.

We urge the SEC to require that a light be shown on the whole process, so that portfolio managers and, in time, beneficiaries know what's going on. The stewardship initiatives and commitments should be kept, and an investor's lending and voting practices should be public and not contradict one another.

Second, the Commission can improve the decision-making process of investors and raise the vote on important issues, while reducing the incidences of unnecessary recall by requiring companies to post the complete agenda well prior to the record date. That way shareholders can make an informed decision whether to recall if necessary.

Further, to avoid interfering with lending done for the purposes of dividend strips and arbitrages, companies should separate record dates from dividend payments and shareholder meetings, specifically issuers should not set record dates more than 30 dates in advance of the shareholder meeting or record date, nor less than 15 days after the shareholder meeting or record date.

These suggestions will facilitate responsible voting, improve the lending process and improve transparency for everyone's benefit. Thank you for the opportunity to comment.

MR. DONOHUE: Thank you, Christy. Panelists, we deeply appreciate the very thoughtful statements that you have made. Perhaps if the Chairman agrees, we can begin with one of the panelists providing a brief overview of how the cash collateral reinvestment process works. Following this overview, we'll turn the floor over to the Chairman and the other Commissioners for questions. So we start off with a toss-up.

MS. RULONG: I can take it, and then when I miss something you can fill in for me, Karen. Most or many securities loans, particularly in the United States -- and I think the earlier panel touched on this -- are collateralized with cash, whether it's dollar cash or frequently offshore it may euro cash.

When the lender -- the lending agent -- receives that cash, the cash is then invested in an investment, either a separate account or some type of a commingled vehicle that the beneficial owner has agreed to those investment guidelines. The yield that is received from that investment vehicle -- again, it can be a separate account, it could be a commingled fund -- that yield is the gross revenue that is received. From that has to be paid the rebates, which I think we talked earlier about rebate. And rebate is the fee that is charged -- if there is an interest rate -- a fee to be charged on the cash collateral that the borrower has given. That is subtracted from the earnings from the reinvestment pool, and that net amount is then what is distributed between the beneficial owner and the lending agent.

I don't know if there is any other comments there. Pat?

MR. AVITABILE: Thank you, Kathy. Yeah, I'd like to just add that from the starting point of when a lender decides to lend his securities, he has to make a number of decisions, especially if he's dealing with a directed agent. The decisions to lend is, one, he's the principal in the transaction, and therefore will make those decisions, and one of them is what to do with the cash, what to do with the cash collateral.

And those are the investment guidelines that need to be created and customized for that particular lender. He sets the investment -- the types of investments, the duration, the credit quality, the concentration, places restrictions on any securities or investments that he does not want to include. So it's a very, very detailed set of guidelines that the client provides the lending agent.

Then there's also models, different models on how he can operate. He can choose to invest the cash himself, or he can choose to have the lending agent follow those guidelines, again acting as a directed lending agent. Or he can choose to take that cash and have it deposited in a fund of his choice, a collective fund of his choice.

So there's a number of different models, hybrids that he can use in order to manage that cash, but most importantly is the fact that those are the client's guidelines, they are flexible, he should always have the opportunity to amend, to adjust, to change those guidelines as market conditions warrant. It's a total open architecture type of environment. It could be a separately managed account.

And those are the guidelines that would be instituted on a daily basis. Flexibility and reporting would be the next thing, total transparency and disclosure on a daily basis. The lender should know exactly what investments have been purchased to ensure that they are within his guidelines. And his guidelines are typically the guidelines that are mandated by the fund, so they'll fall within those guidelines.

And there's two checks and balances. One, the client is looking at them on a daily basis, and then secondly, within the securities lending agent's domain, typically they have a compliance officer or someone who is actually reviewing those assets on a daily basis to make sure that they are in compliance, not to mention the fact that there are many systemic controls in the variety of securities lending systems that enable those transactions to be monitored and controlled adequately.

MS. KELLEY: I would just want to add one more thing to that, and that is, we get into then the conversation, now you've got this -- as Kathy talked about -- you've got the loan out, and that creates a level, and then there's a spread created. And I think that also the other thing that we want to think about as we think about cash collateral reinvest is that is the other side of this spread. The lend is one side and the cash collateral reinvest is the other side. And the lender also has to make the decision, do they want the starting point of that equation to be what security goes out on loan, or do they want the starting point of that equation to be what can the cash collateral reinvestment give back in terms of a yield.

And it's the starting point of that that gets into a lot of discussions about intrinsic value lending versus other things. And I think that one of the other things that is very fair to say -- and I know we spend a lot of time talking about the upheaval and market considerations of the last year, and there is not anybody who participates in the financial markets that was not affected to some degree.

But I believe one of the panelists in the last panel indicated that all lenders had problems, or excuse me, all lenders had problems with liquidity and/or cash reinvestment pools, and I think that that is maybe a little bit broad of a statement, that that is not the case, and that many lenders -- in fact, one of the panelists in the last panel suggested that they had somebody who started lending in the fall of '08, managed the risks very appropriately -- and I don't even know who it is -- according to the story, and actually got out of the program 100 percent whole.

So I think that we really do have to recognize that there has been a crisis, there has been affected in all aspects of the marketplace, not just securities lending, but it does not say everybody in securities lending has been affected.

MR. AVITABILE: I would agree with that last comment, absolutely.

MR. DONOHUE: Well, thank you, Kathy, Karen and Patrick. Chairman Schapiro.

CHAIRMAN SCHAPIRO: Thanks, Buddy. I just want to make sure we're very clear on this point about -- it sounds, you know, like very good practice that the lender has tremendous discretion in the design of the lending program, that they can be quite specific and quite customized, that they get a lot of reporting. Is that true across the board, or is that just true with -- in your experience with your firms, because I took away from the last panel that there's sometimes quite broad investment guidelines for collateral that might not quite meet this high standard of customization and lender involvement in the decision making.

MR. AVITABILE: My comments were based on my knowledge of what my firm does. I can't speak to other firms, but that's how we operate.

MR. LETO: I can address from my experience, again, representing various fund groups and the information that's provided to fund groups and fund boards. I think there's a distinction to be made between the situation -- well, I guess let me back up one second and say that the guidance is that if a fund is going to engage in securities lending, that the cash collateral investment needs to be done by someone who has a section 15-approved investment advisory agreement, or through guidelines that are established by the board or by the adviser that has that section 15 contract, and then provided to the securities lending agent.

And I think there is a distinction between the scenario where a fund group provides specific guidelines on specific types of instruments that -- and I think you called it the direct investing approach or the directed agent approach -- and I think that's where the fund or the adviser to the fund says to the lending agent, "We want the collateral invested in either a separate account or a pooled account for our funds only that can invest in these five or six or eight or ten investments."

But then there's another type, which is quite common, and in fact has grown in popularity, I would say over the last -- in my experience -- five, eight years, which is rather than the specific items, which by the way usually come from the prospectus of the fund, the lending agent makes it easy by providing a menu of options of four or five different types of funds, either registered 2a-7 money market funds or, ever since 1996, 3(c)(7) unregistered pools which operate like funds. And those pools have various offering documents with various descriptions of what they can and can't invest in. And they have various levels of risk and maturity and duration, et cetera.

And in my experience, typically the Funds -- and this may get to your question from the earlier panel about why things weren't quite so bad -- but in my experience, the Funds typically are investing in either the most conservative pool or the second most conservative pool out of a suite of four or five different pools. Typically those unregistered pools are 2a-7 compliant, or at least state that they are 2a-7 compliant.

And I think where the distinction comes is, certainly where an adviser has given the specific list of securities to the lending agent to invest the collateral in, there's tremendous transparency, where at least from my experience, I haven't seen the transparency and I cannot speak to whether someone at the adviser has gotten the information. But where a fund's cash collateral is being invested in an unregistered pool, I am not aware of the same type of transparency in terms of what the pool's invested in being provided certainly to fund boards. Whether it's being provided to the adviser, it's really a function of what the offering circular for the pool states will be the normal release of portfolio information.

CHAIRMAN SCHAPIRO: So some of the difference may be mutual funds just do this differently than pension funds or other potential lenders.

MS. WOOD: I was going to make that observation. I think there are different practices in the mutual fund industry, where there's more -- potentially more transparency all up the line.

And I think my other point that I was going to make was, while there is plenty of reporting, I'm sure, available, the question is to whom. And I think that's a problem with reference to whether it's a back office or a front office individual, and where exactly the accountability lies for the risk being taken.

So I would say in the pension plan world, where I'm a little bit more familiar, I would say in the best staffed and largest pension plans, again, you know, the transparency doesn't go very far -- deep into the organization. And so those that are monitoring risk -- for example, I think most of the risk management systems that are available in the pension plans today don't take into account the risks necessarily being taken in securities lending portfolio.

I think that's a fundamental structural flaw. So I think there are different practices in different parts of the investment world.

COMMISSIONER WALTER: Can I follow up? We've talked some just now and in the earlier panel about why funds did better, mutual funds did better. Can we talk a little bit about your analysis of what caused the losses with respect to cash reinvestment, and in particular I'm interested in -- I think we all are interested in -- several items, whether it's intrinsic value versus volume, security finance kind of an approach; whether it was declining reinvestment rates; whether there were reinvestments that subsequently became illiquid and were downgraded even though they were liquid and of high quality when purchased, or any other causes that you see for the problems that occurred.

MS. SHORT: I think, going back to actually both questions, there are definitely differences in securities lenders, based on the sophistication and their capabilities of looking at the program holistically and looking at the risk that's intrinsic to the program.

I think as we look back over the course of the last few years, another issue that the SEC is dealing with right now is directly correlated to what we saw in the collateral reinvestment, and that is coming out with the comments we all just submitted around money market reform. And, you know, even for funds that have their collateral reinvestment invested in 2a-7 funds, they certainly weren't without risk during this period of time.

And I think those two items correlate very much together as we look to improve metrics around 2a-7 so we don't have those -- a repeat of those types of issues. We were seeing the same thing over in the collateral reinvestment pools.

From a mutual fund perspective, I do think -- as has been indicated -- perhaps more conservative approaches were taken to the collateral reinvestment. At the same time, they did fall in the form of 2a-7 funds, as well as 3(c)(7) private placement funds, and in some cases joint or separately managed accounts that were all run as dollar NAV-type funds and type accounts.

The level of transparency available in those would differ depending on the structure that was available then for the adviser and the board to look at and review, and also based on the disclosures that the underlying asset manager of that asset was willing to provide, because they have different requirements. And as we all know, people are willing to provide their holdings and their information on different frequencies when not required to do so.

So when we look back through the investments that were made, and we go back four or five years, we saw a lot more of these enhanced cash liquidity vehicles that were coming into popularity, that did maintain a dollar NAV, but then that they were able to provide an incremental yield greater than a 2a-7 fund by taking perhaps some incremental duration risks and going a little bit further and longer out the curve.

So within those vehicles, although they were investing in many of the same types of securities that 2a-7 funds were investing in -- for example the structured investment vehicles we've all heard about and gone through over the last couple of years and have made numerous press releases -- you're seeing similar type of vehicles in these enhanced cash, but they were able to go out for a longer period of time, so a lot of the issues --

COMMISSIONER WALTER: Can I ask you one follow-up question about that?

MS. SHORT: Sure.

COMMISSIONER WALTER: Was there sufficient transparency into the valuation of those vehicles so that people actually knew they would support a dollar NAV?

MS. SHORT: I can only speak from my experience, and I could say from my experience, yes. I think it was an interesting time, too, though, because you could get into a whole discussion on valuation during that time period, and how meaningful some of the valuations were when you're in an illiquid market. You know, it's kind of one right off -- right on top of the other -- but there might be other experiences.

COMMISSIONER WALTER: Isn't there also an inherent tension between using the dollar-per-share price model and elongating the maturity of the underlying investments that really doesn't work as well?

MS. SHORT: Absolutely, and I think that's what occurred over the last couple of years. And you saw most of these products no longer exist today because of that very tension that existed between those two synergies. I would say during the time that people were investing in those they thought it was a suitable investment. There had not been these types of issues and there was no precedent to think that there would be. And I think the intentions of people in general were very positive, and they were looking for incremental yield.

However, there was an inherent risk. I think the industry has learned a lot from that. Where I do think SEC has an important role is preventing a recurrence of that, because our industry tends to have a short memory, and there is the ability to repeat ourselves in a surprisingly short period of time.

MR. BLOUNT: Could I add another perspective to that as well? The data that's available to describe that period which is provided by the RMA shows a fairly -- an extremely unusual time, where the securities lending markets reflected the turbulence that was taking place in the broader market system. But if you look at the data for securities lending in particular, especially the cash pools, there was a dramatic run up of about 90 percent in the total value of the pools in the second quarter of '08, which is after Bear was absorbed by Morgan.

That 91 percent jump actually was followed by a three-quarter drop of 60 percent in the value of the pools, which took place because of falling market values, deleveraging of the hedge funds and a variety of changes which put pressure on the cash pools. The cash pools which had jumped were now collapsing.

So the investments that were in those pools were being stressed by the need to sell them off in order to repay the cash collateral to the borrowers who were lining up in order to get their cash back, because they were deleveraging.

So many of the instruments that were put in those pools originally, and which had been considered to be reasonable assets, suddenly were not only under tremendous stress but they were themselves being subjected to pressures in their own valuation markets, because some of those instruments traded beyond securities lending pools, as well.

So there was kind of a feedback loop that was taking place that put the cash pools under pressure at the same time the assets were under pressure. So part of it, though, was simply a reflection of the overall turbulence in the market at the time.

One of the other things that happened, when we talk about intrinsic value, is the cash managers for the securities lending programs in the fourth quarter of '08 actually went negative intrinsic value across the board, meaning they were paying borrowers to leave balances in the pools to avoid having to sell off those assets. Fortunately they had instruments that could still provide the yield. The yields were still relatively high enough to be able to allow them to pay those rebates.

CHAIRMAN SCHAPIRO: Could I follow up on that? So was it European experience where I understand they accept securities, equities in other securities as collateral much more than they accept cash. Was their experience different as a result of that through the financial crisis?

MR. BLOUNT: There's not as much data available on the European market, but the common understanding is that the pain wasn't as great.

CHAIRMAN SCHAPIRO: So can you expand -- or can any of you expand on that a little bit -- and talk about the relative benefits of accepting securities versus cash, in this context, or why it developed differently even in Europe than in the United States?

MS. RULONG: I'll just comment on non-cash a little bit, because there has been, certainly in the European markets, a move back to some extent to non-cash. They had traditionally, offshore, had been more dominated by non-cash, and really had started to accept cash more recently than in the U.S.

And we've seen a increased desire on the part of clients in the U.S. to do non-cash lending, as well as the borrowers have shown an increased desire to also give us non-cash rather than cash. And I think the key there that everyone has to be very cognizant of, if you don't have a borrower default, then every day the non-cash collateral should re-price, and if there's a problem in any of that collateral, that will be replaced or it will be increased -- the amount of collateral will be increased if the value of the securities you have have gone down.

But in the event that you do have a borrower default, that non-cash collateral coming back to valuation, it's absolutely critical, one, that that collateral is very diversified and that there's proper valuations within that collateral. And the industry uses third parties to hold the collateral for us, tri-party agents.

And so it's -- certainly those of some of the things on non-cash that we're looking at to make sure that there is a sufficient level of diversity on the securities that we're taking, that we also have better valuations of those securities that we're taking, and also looking at correlations.

So if you're lending equities and you want to take equities, there is probably a very strong correlation between the two, and it makes a lot of sense to do that and reduces your risk. If you're lending Treasuries, and you're thinking of taking equities, that is a totally different analysis that you have to do, because in the event you have an issue, you're going to most likely have your Treasuries rise in value and those equities falling.

So I think the events of the last year, year-and-a-half, have certainly required all of us -- and I think we all are doing our -- we've stepped back and we've looked at our experiences, both the beneficial owners, the agents and independent investment managers, as well.

MR. AVITABILE: And I'll just -- I'd like to just add to that. As Kathy was saying, about the non-cash collateral that comes out of the U.K., OECD government, that tends to be the most popular form of non-cash collateral that's being posted today.

And equities, many cases some of the non-U.S.

beneficial owners will take equities as collateral. As she said, there's price correlation, there's also a high level of diversification, so you can limit the concentration in any one issue. And it has an exchange traded price at the end of the day.

The other thing is, is that one of the oldest models, I guess, in the U.K., is the delivery by value model, the DBV, which is a model similar to the tri-party, where the security is lent versus cash, sterling, but that sterling is converted into a basket of equities. And again, it's a menu -- it's menu driven, much like the tri-party agents here in the United States have. You can choose the FTSE-100, 250, you can choose the different ones. You can have different -- apply different concentration risks. And it's been a very successful model that's worked.

So certainly as the industry continues to explore equities as collateral, it would also be good to look at how the U.K. has done it and the successes that they've had with that. But as Kathy says, it makes a lot of sense if you're doing equities versus equities because of the price correlation, and you would to that by market as well, so U.S. versus U.S., France versus France, and that type of situation.

MR. BLOUNT: I have to be -- I feel compelled to take kind of an opposite view on that, or maybe inject another caution. It sounds intuitively appealing that there would be, as you said, a probable correlation. And I would assume there probably is a correlation, but if you look through the trade to the hedge funds that are borrowing the equities and putting up equities as collateral, many of them are involved in pairs trading, where there's an expectation that they're actually going to move in different directions.

So it may be that the collateral that's put up is the long side that they expect to rise, the short side may move in a different direction, so that you're not actually going to be getting the kind of correlations that you would hope.

So before endorsing an overall blanket recommendation for equities as collateral, I would think that it would be worthwhile to impose some requirements that the correlations actually be proven, and tested as well, in an illiquid market where they could go quite the opposite direction. But it does sound intuitively appealing.

MS. RULONG: And I'll just agree with what you said, and I think that's why -- the analysis is being done, I think, by beneficial owners as well as agents, around -- and we've had now hopefully the perfect storm that we won't see again for a long, long time, but we have that data to use.

But we've found that, you know, if you get enough granularity, you get enough margin, that coming up with the right parameters, that you can look at different types of collateral for various types of loans.

COMMISSIONER PAREDES: One of the things we heard last panel and this panel as well, at least the last panel by implication, is the question of risk management on the lender side -- spotting and identifying what the risks are, and there's an enhanced appreciation in light of recent events. And of course trying to figure out what to do about it -- some of that discussion was also suggested in context of pension plans versus mutual funds.

An offshoot of that, of course, is the question about to what extent do the lenders and different lenders have the leverage to actually impact what the terms of the loan look like, in terms of pricing, but also in terms of the ways in which the collateral can be reinvested. I guess in some sense the ultimate leverage is, is you can decide not to lend. And to the extent there is value created, everybody is losing a piece of that.

But I'm curious to hear a little bit more specifically, based on some of your experiences and discussions with other folks, how that discussion takes place, and particularly now, if you're somebody who is on the lender side, and you have these concerns, how the dynamic might be changing or might be expected to change in the future.

MS. DUNN KELLEY: I'll just start that off. From the lender side, I think first and foremost, you have to make -- and this was alluded to in the last panel as well -- is your lending program going to be philosophically from an investment activity, or is it going to be -- and they talked about the back office, or front office-back office -- but is it an investment activity, and should it be looked at that way versus not.

I think very much, and from other things that we've heard on the panel, many of the mutual funds view it as an investment activity. You then said, well, how do you look at the risks and mitigate the risks? Well, in the discussion between yourself and your lending agent -- I mean, you have the right to interview, put out RFPs and decide who your lending agent is going to be, so then you pick a lending agent that you can create a customized program that fits your reinvestment needs, fits your collateral needs, fits your program, and from there you then have identified the risks.

And the next step to that is to create the mechanisms for what will be the communication, the transparency and the accountability in terms of creating the reporting that does make sense, so that you can answer those risks.

So again, along the path, you've got many opportunities to set this up. I will tell you that the other side of the coin is, I cannot speak to what happens to others -- I can just speak to my experience, but that is the experience. And if you look at it from an investment activity, you really go through all the same bells and whistles that you'd go through in any investment activity, to say is this appropriate for my product, how do I do it and how do I either mitigate or -- as Bruce said -- maybe certain funds can take greater risk in collateral reinvestor products.

So I'm not suggesting -- I can tell you how we do it. We mitigate the risk. But there could be a different risk profile. But if you take it from that aspect, you can take it through the entire curve and create the appropriate reporting so that you can mitigate those risks.

I will tell you, and Kathy said we had a perfect storm last year -- I'm not suggesting to you that a perfect storm will not create problems and upheaval, but I am saying that you can certainly get your hands around what your issues are in a timely and appropriate fashion.

MR. DONOHUE: I'm mindful of the time here. We have a half hour left to cover the last three topics, so if we could, I'd like to move on to default risk. And I'd ask one of the panelists to please explain what is meant by default risk.

MR. AVITABILE: I'll take this one. Default risk has, in my mind, two different categories. One, there is the default, as far a bankruptcy. Okay, you're lending securities, you're taking collateral, whether it be cash or non-cash collateral. And like in the case of Lehman, one morning you wake up to do mark to markets and they default, okay, they're no longer there.

The second one is more of a daily default, and this is all outlined in a client's agreement. It's called the "events of default." An "events of default" could be as simple as a broker doesn't mark to market that day -- their operations, their systems are down, they can't mark; okay, a broker fails to return the security; he's defaulted on a recall.

So there's a number of things that would be listed in your agreement that would be the events of default, and then primarily you have as the ultimate default would be the bankruptcy.

You have a number of layers of protection that are built in the securities lending program when you're dealing with a directed agent. Certainly first you choose your counterparties. There's typically a list of counterparties that's approved by the lending agent, as far as its credit worthiness, but within that list, clients can either choose to eliminate, only lend to a few or many of those broker dealers, and they can choose to set their own credit limits against each one of those counterparties. So they have full discretion on who they're lending to.

Secondly, it's the collateral. It's the collateral that's coming in, which would be that you're looking to that in a default situation, and then the mark to market -- every day that collateral and that loan is mark to market daily.

And lastly, in many cases, particularly in the United States, most lending agents provide an indemnity against borrower default. And simply stated, that means that in the event of the default, in the event of Lehman, when we've taken the collateral to go out and buy the securities, and if the security prices were higher than the collateral that we had, assuming there weren't any losses in the collateral, then that difference would be covered by the lending agent.

So that's an indemnity that many of the clients have against the default. So there's these different layers of protection that exist in a default situation.

CHAIRMAN SCHAPIRO: Could I just ask if others have comments on whether those are sufficient protections against default, or are there other things we should be thinking about?

MR. BLOUNT: I think there's a couple of loopholes in the contracts. Thinking back to a study that we conducted about five or six years ago, from an investor protection standpoint, one of the sensitivities is the grace period that the agent has in order -- within which to declare an event of default, and the nature of the conditions that would trigger that grace period.

I think that's the weakest part of it. But there's not necessarily one way or the other to go on it, because if the agent is forced to declare a default by some formula, it might not be the best time -- it might be better to let the borrower slide a little bit longer, because then you trigger all kinds of multilateral netting requirements which could force them to liquidate their entire portfolio.

But if the investor is going to look at one part of that, it would be, in my opinion, the grace period.

MR. AVITABILE: I would agree with him, and that's typically discussed at the time of negotiating the agreement, and many times it's part of the agreement.

MR. LETO: I would also point out that the indemnification is not uniform. I mean, it's certainly the predominant model, but it's a negotiating point. In the spread -- or the split -- you get a better split if there's not an indemnification clause.

MR. DONOHUE: Well, I guess with that we can move on to topic three.

MR. AGUILAR: Buddy, do you mind if I ask a question?

MR. DONOHUE: Oh, no, no. I'm happy to hear your voice!

MR. AGUILAR: In between coughing, I've had it on mute. Took me a second to unmute it. There's been a lot of discussion, which I've appreciated, about the processes and the safeguards that exist, but it's unclear to me whether since many people speaking seem to be '40 Act knowledgeable or involved in institutions that are heavily '40 Act, it wasn't clear to me how much that is in fact a widespread practice through the industry, that it would apply whether or not you're '40 Act.

And I guess I'd like some thoughts as to whether or not some of the practices and processes that have been discussed seem to be endemic to non-'40 Act institutions as well. And if I could also perhaps get a little bit of feel of the industry and how much of that perhaps is '40 Act, how much is outside the '40 Act. I mean, I've seen numbers of industries at the end of 2008 it was like $2.5 trillion and as high as $5 trillion a couple years before that, but it's unclear to me how much of that would be under the '40 Act, how much of that would be outside of the '40 Act, and whether or not the safeguards and controls and oversight that we've been hearing would seem to be -- unstated would seem to be '40 Act practices, how much of that is throughout the industry. If I could get some feel for that, that would be helpful to me.

MS. WOOD: This is Christy Wood. I'd like to just respond not to the question of the split on the industry assets, I wouldn't be an expert to opine on that, but I do feel some expertise to opine on the pension fund world.

And I would say that many pension plans are thinly staffed and don't have the ability to necessarily pay for talent that is at the top of the market. While there have been some of this changing, I guess I would say that you have a lower-level expertise and I think most pension plans are very thinly staffed and the level of expertise there, in terms of entering into these types of contracts. And then in addition to that, the transparency up to the fiduciaries, the trustees and maybe even some of the portfolio mangers, is not an exact clear path.

So I would say that, in my observation, the pension plan world suffered more than its fair share of losses last year, and I think some of the cash collateral that they were invested in, I think they were surprised that it was riskier than they thought. And in some instances, I think, you know, they were reaching for yield and unknowingly aware of the risks. So I would say that the experience throughout the industry is not consistent.

MR. BLOUNT: I can suggest where the data is available to answer that question -- this is Ed Blount. The firm that I sold two years ago tracks the participation of mutual funds, '40 Act funds, pension funds, insurance companies and the like in the securities lending markets. You have a panelist on the next panel who has probably access to that data.

But just generally, as I recall, mutual funds, '40 Act funds tend to have relatively low participation relative to their total portfolios, but because their portfolios are so large, they tend also to be fairly large players in the securities lending markets. The pension funds, both public and private, are far more active in securities lending, probably 85 percent, 90 percent of pension funds are involved in securities lending programs, and their utilization rates, the value that they put on loan is much higher.

But because their assets are smaller than mutual funds, they tend to be about the same. So it's relatively lower participation and bigger funds, and mutual funds more participation on the pension funds.

MS. RULONG: Just one quick comment. I think part of the question -- and this is Kathy Rulong -- part of the question was that, are the same mitigants available to the non-'40 Act funds that are available to '40 Act funds in securities lending programs.

And I think -- I think I can actually probably speak for the industry. I know it certainly is true with us, that any of the mitigants, whether it's the daily mark to markets, whether it's the reporting to clients, the availability of reporting to clients, that is all equal across the entire program, doesn't matter what type of client you are.

MR. AVITABILE: I agree with that.

MR. DONOHUE: Well, switching topics for the panel, what are the different types of lending agent compensation?

MR. BLOUNT: Well, a quick response would be that generally the agent takes a share of the earnings, if it's a cashed-based program, a share of the earnings from the cash pool after rebating the bulk of it to the borrower.

But that's only a quick answer. The return to the lending agent is a function of the relationship that -- as a bank, in particular -- that the bank has with the institution that's providing the loan, which really dates back to the origins of the securities lending business itself.

Securities lending was modeled on the ADR business, where banks as ADR issuers would produce an ADR in advance of the delivery of the ordinary shares overseas. They wouldn't charge a fee for that, they would just provide that service in order to get the issuance fee.

Over time, that evolved, because therefore they gave the business away for the overall relationship. It was not on a collateralized basis, but there was no cash. In the

'80s and then into the '90s, cash became much more prevalent, so it became almost like an escrow account -- you'd rebate the yield on the escrow and split it.

But really the value of -- for most banks, the value of securities lending is in supporting other services and becoming part of the overall relationship, even though it's a split-based business.

MS. SHORT: I would just layer on to that. I think, too, I like to oversimplify things, by my earlier comments on disclosures, and if you really look at a securities lending program, I think there's -- and you look at the parties, I think when we talk about compensation, we're mainly talking really about, to a large degree, the split between the agent and the lender.

So if you think about the components of compensation, and we can easily divide them into two primary -- one we'll call the reinvestment spread, which is that cash collateral reinvestment, the other the intrinsic spread, which is usually based on the rebate rate and some measurement, usually the fed funds rate or some form that it's measured against.

And we look at those, well, if we put the two together, we're going to get the gross spread or the gross income generated by the program. And typically firms will work with their lending agent to come up with a suitable split of those assets. The thought of the split of the total gross spread is thought to incent the lending agent as well as to, frankly, attempt to align both motivations for participating in the program. And those can range, depending on how they're negotiated.

MS. WOOD: I would just like to add a couple of comments on the topic of compensation. A statement was made in the last panel that I think 70 percent to 80 percent of the profit went to the beneficial owner. And I don't think I would agree with that characterization. In fact, I think it really obscures the prime broker's role in the entire lending circle and relationship, and I think the prime brokers are making significantly larger profits than the beneficial owner, first of all.

And secondly, I think we wouldn't necessarily concur on the 70-80 split, even between the beneficial owner and the lender -- sorry, and the agent. I think this is an area where more transparency is needed, and I would strongly encourage the Commission to require more transparency so clients, I think, have a better idea of where the profits are being made, because I think it varies widely from institution to institution, and their sophistication levels are widely variable as well.

COMMISSIONER AGUILAR: If I could ask another question, because there's been discussion of what happens with the splits on profits. What's the situation when there happens to be a loss on the cash collateral investment? What happens with the losses, do lending agents share in that as well, or they only share in the upside?

MS. RULONG: It's Kathy again. Because the -- you have to look to the contract that is signed with the individual client. So where the client takes responsibility for the reinvestment risks in the portfolio, if there are sales or defaults on securities within that portfolio, those are at the risk of the beneficial owner in most cases.

MR. AVITABILE: And I'll add that it's typically made very clear in the agreements that are signed with the beneficial owner.

MR. BLOUNT: And I think I'd add that it's not a decision the bank can actually make, because the Federal Reserve has rules. And if the banks were to indemnify against losses, they'd have to reserve capital, which in most cases would make their programs unprofitable. But it's a Federal Reserve capital requirement.

MR. AVITABILE: And to add, we need to keep in mind that the lending agent is a directed lending agent, and the principal in the agreement is the ultimate lender.

MR. DONOHUE: Bruce, a question for you. Are there any checks on what a mutual fund can pay a lending agent?

MR. LETO: There is some guidance. Again, it comes out of the old, no-action letters. There is a statement in sort of the original sort of grandfather of the no-action letters that says that the fees have to be negotiated between the fund and the lending agent, reduced to contract and approved by the fund's board.

There are some other statements in a couple of the other letters that talk about the directors having the fiduciary duty that requires them to determine if the fees are reasonable and based solely on services rendered.

And then there's a fair amount of guidance in the affiliated securities lending agency arrangement. There was one particular no-action letter that's actually more recent -- I think it's from '94 to Norwest Bank -- which talks about the board having fiduciary obligation to ensure that the compensation is not excessive. And that statement -- it's a little unclear whether that statement is broad enough to encompass affiliated as well as unaffiliated lending arrangements, but the one that was actually in front of the staff at that point was an affiliated arrangement.

And then there are, in that same letter, there's guidance related to reviewing quarterly the specific affiliated lending arrangement and the fees that are being paid. And then there, again, from that same letter is a comment that to the extent that an affiliated agent is used, the affiliated cannot receive revenue-based compensation.

So that's kind of the guidelines that come out of the SEC guidance. I would say that -- and this probably goes back maybe eight years ago, nine years ago, around 2000, 2001, so this is even before the discussions again began with respect to securities lending in '04 and '05 -- but the inspection staff would typically review securities lending arrangements and there was a fair amount of information that would be required, at least stated in the comment letters, that would be required to be given to boards. And most of that information, actually, did relate to the fees.

And so it's kind of interesting -- you know, we're spending a lot of time talking about what the collateral is invested in, but to the extent that there were issues that were raised on inspection with respect to the securities lending process, at least from my experience, it related to the supervision of the fees.

COMMISSIONER WALTER: Does it strike any of you that there is a lack of alignment between the lenders and the lenders' agents, and is there anything that should be done either in a regulatory sense or in a business sense to bring that back into line, like a sharing on the downside? The more I listen, the more it strikes me that there are too many parties going in too many different directions might be one of the issues that we've had.

CHAIRMAN SCHAPIRO: I'd love to hear the answer to that, and maybe with an additional point, which is, if you are a pension fund of a smallish governmental entity, so don't have very sophisticated staff or enough staff, how do you know if you're getting a good deal on the fee split and the compensation arrangements? How do you know -- what can you benchmark your relationship with a lending agent against?

MS. WOOD: Well, I'd like to say that you don't know. I think that you rely heavily on vendors who may not be entirely aligned with your interests. And I think it's very difficult to know exactly what's going on.

And that's why I argue for transparency, and I think along the lines of Commissioner Walter's question, I think perhaps one of the things the Commission could consider is some alignment of interest, where there is not just sharing on the upside in profits, but to the extent that there are losses, that not just the beneficial owner participates in that. And I think that would certainly create a different relationship.

MR. AVITABILE: And just to add to that, I think that the RFP process is a great way to be able to take in various bids from multiple lending agents. And that could be -- you could have as many as 20 or 30 participants in that RFP process.

Now, as you mentioned, Chairman Schapiro, it's possible that there's no one in the pension area that has the time to even do this or to look at this. So in that case, they may need to hire a consultant to take them through and walk them through the RFP process, which is a way of basically getting the best -- finding out what the span of ranges are for fees and for all services. That's comparing cash reinvestment as well as fees, what they do on proxy voting.

And the consultants typically will help -- will be able to at least guide them on the right questions to ask, especially for funds that are small, like you said, governmental agencies, that are just not familiar with it; they need some place to go, they need to go to a 101 session and understand what to ask. Sometimes they just don't know what questions to ask, and they need to be able to do that, and one way is through a very, very thorough RFP process.

MR. BLOUNT: There is a sort of a knee-jerk amongst smaller funds to look only at the split, whereas, historically a very attractive split, say 80 percent of the returns, could look like a good deal even though a 60 percent split for a fund from an agent who has the ability to distribute more loans could be much better. So the 60 percent of a more productive program could be better than 80 percent of a less productive program.

Then the next part is, you have to do a risk-adjusted analysis. If it's a concentrated program that goes only to one counterparty, then they're subject to the liquidity exposure that comes from that. So it's not an easy task.

MR. HU: I'm afraid we have to move on to the last topic, topic four, and I've been authorized to only go a few minutes beyond the 12:30. We've seen today with a typical stock lending transaction, so far as the company whose shares are being loaned is concerned, the borrower owns the shares, including the voting rights associated with those shares.

And how does this relate to proxy voting, the fourth topic, in terms of this panel? Well, in a number of ways, and at the most elementary way, with a typical stock loan agreement, the borrower holds those votes without having any economic ownership, while the lender has the economic ownership but doesn't have the votes.

So this is one example of what can be referred to as a decoupling of the economic interest of voting rights. And absent Federal Reserve or other constraints, at least potentially this might result in a pretty extreme version of empty voting.

So I wanted to start at this most elementary level, and briefly work our way up. I want to direct two related questions to the entire panel, a toss up. Who controls the voting rights as to the shares on loan? Is it always the borrower? And second, what difficulties might there be in terms of the lender somehow lending those shares, yet managing to keep the voting rights; you know, what are the difficulties with those kinds of arrangements? I throw these two related questions out to the panel.

MS. WOOD: Well, I would like to say that you've put forth, I think, a very interesting proposition, that is that perhaps there are some structural modifications to the industry where the beneficial owner, who has the economic interest primarily, has the ability to continue to exercise their rights, even after the security has been borrowed.

I think many industry participants have said that this is perhaps too difficult, not able to be accomplished. But I think that this is a central issue, which is obviously of concern to investors. For example, the change -- the Commission has significant rules on how majority owners can behave if they own 60 percent or 70 percent of a company, for example, and if they're not independent and they may be on a board, for example.

Yet they can lend their shares to other parties who can vote on their behalf and nobody -- that's entirely opaque. And there are, I think -- there are a lot of potential abuses, I think, to voting, because of the lack of transparency and lack of mechanics to be able to see what's going on. This is an issue, certainly, of primary concern to investors.

MR. LETO: To address your first question, which is who controls the voting, it's my experience -- again based on my practice -- that the borrowers do control the voting, and that while there are -- while it's a little bit easier now, because there are some mechanisms that have developed through third parties to give the information in terms of the types of items that are going to be on the ballots to the lenders, but it's still quite imperfect.

When this issue became really in the vanguard I guess early 2007, my experience is that most of the clients were kind of sitting there scratching their heads, saying, how are we going to do this, because you do have this issue of the record date. And unless it's some major issue like the Hewlett-Packard merger, or whatever, where you know there's going to be a vote that's coming up, and so it's just a question of when the management there strikes the record date, it's very, very difficult to figure out when these items are going to come up.

It's my understanding that the companies like Glass Lewis and RiskMetrics did develop a product over the next year or two -- so let's say in the beginning of '08 -- that searches all sorts of things, including the broker search cards that are required of issuers. But even that's discretionary, because you're not required under SEC rules to say what the items are that are going to be voted upon, you're only required to give notice to the broker -- to solicit a number of beneficial owners that the broker represents in order to get the proxy statements, et cetera.

So what was explained to me was that it's still maybe 40 percent of those items are identified. So answering that part of your question, I think it's still quite difficult to figure that out.

COMMISSIONER WALTER: Christianna, ICGN has said that when securities are recalled for voting or recalled, the borrower will try to find out the reason for the recall and may be resistant to returning the securities if it's for voting reasons with some sense that there may be threats not to borrow again if the lender does that. Can you flesh that out? Is that an accurate statement of what you said?

MS. WOOD: Yes. We have found that a number of the members of the ICGN, some of them large pension plans -- and I think this was part of the source of our concern and why we came out with a code of best practice, that in fact there are economic consequences to recalling votes, and some of the parties associated with the recall process did make attempts, from time to time, to discourage beneficial owners from recalling the securities.

And then I think there was also concern that if there was too much recall activity, there would be later consequences for those investors, in terms of the economics if they would be able to negotiate for their lending program. And I think that we did put that in our written response, and we have found that from the survey that we did throughout this decade -- I think we began in 2003 and did research through 2005 and then updated our research in '07.

COMMISSIONER WALTER: If you concentrate, I'd like to get your reaction, too, on the duty that many of the lenders were talking about owed to their shareholders, their pension plan participants, to vote in the best interests of those people. And if you have a program that runs into these kinds of problems and you can't vote, how is it that as a legal matter those duties are being fulfilled? Does it lead you to a point where your lending program has to be modified in a fashion that potentially even might make it unworkable?

MS. WOOD: Well, I'd be happy to respond to that. First of all, let me say that most pension -- public pension plans have a stewardship program, and they consider corporate governance and corporate stewardship to be among the most significant duties that they have to execute on behalf of public pensioners. After all, they're dealing with the public capital, and there is a higher duty of care that I think trustees of these plans feel that they need to execute.

Just speaking on behalf of some of them, I think -- so my own experiences from the largest pension plan in the country, where we identified well in advance which votes we wanted to vote on, and then we lent out the rest of the securities. But we had to have a very sophisticated program by which we do that.

And even then, sometimes, we find among our members who contributed to the Code that they would frequently arrive at a meeting only to find out that they had a fraction of the shares that they thought they were able to vote. And so I think there's a significant amount of confusion and even internally to organizations of pension plans about the recall process and the consequences for recall potentially for the economics of the program.

The other thing I guess I would say is, the biggest disconnect is with the trustees of the plan, I would tell you, not just in the lending practice, but the recall practice and really how much is actually being voted. I can just say, frequently in discussing this with other large institutions, I think they always looked at what the gross number of shares they had was. No one ever netted out what was being lent.

And I think there is significant confusion that transparency could fix here, and I think that if you go to the beneficiaries which are the public pensioners themselves, they, I think have a right to know how much of the shares are being used for profit and are going into the return streams, frequently of the returns in the pension plans.

And I think this is another point which I would take issue with. Sometimes the profits of the lending program would be embedded into fixed income returns, or returns due to other securities programs. And I think that there's some confusion there as well, and I don't think that is necessarily right and proper.

But I do think people need to know how much of the securities are being voted for stewardship purposes and how much of the securities are being lent out, and I think right now there is no transparency there in most public plans.

MR. AVITABILE: I'd like to just add to that. A couple of things that's been mentioned, the first being, it's our view that clients, regardless of whether they're pension funds, mutual funds, should have the option to vote the proxy, okay -- granted that when they lend the security, if it's held over the record date by the borrower, they give up that right based upon the way the mechanism works today.

However, if they choose to want to vote that proxy, they should be able to have that right, and there should be a process in place that allows them to do that. And this may just be very simple, but the process is relatively easy by taking in feeds from data sources of announcements, of proxy vote announcements, taking that in, matching them against your system, matching them against the client's inventory that wants to vote the proxy, and that would tell you if it's out on loan or not.

For example, if you get a proxy vote into -- coming in 10 days prior, 10 business days prior to the vote itself, if the security is not out on loan, you can configure your system to be able to immediately restrict it from loan. If it is out on loan, your next port of call would be to reallocate it with someone who doesn't want to vote the proxy, and then thirdly you would recall it.

As far as recalls, this hasn't been our experience where a broker would say, "Well, I don't want to borrow from that lender," because quite frankly, they don't know who it is. It's on an omnibus basis. And that was the whole purpose of the ALD. The ALD is the disclosure of the lender's name, who they are, is done with the credit areas of those firms. On a trader-to-trader basis, there is absolutely no disclosure of who that lender is.

We call up for a recall, it's a recall regardless of if it's a sale, regardless if a client just feels like I want my security back, I don't want it out on loan for whatever reason, or he's going to vote the proxy. If the recall doesn't settle on time, providing that we've had -- again, the issue that we see right now is the announcement, when the issuer makes that announcement. If he makes it in ample time, you can have a recall period and then you could do an automatic buy in. You can buy in the security and have another three days and have the additional three days to settle that. So you can get that security back, because the agent lender is working on behalf of the principal counterparty, which is the lender.

Now there are times when you can't get it back because the issuer announces it today for tomorrow. So you'll do your best, you'll call up the broker and ask, and then sometimes he can get it back, because he'll borrow from someplace else. But if it's a tight security, a special security, maybe a bit illiquid, those may fall outside.

Also lenders should have the option to vote all the proxies or just the material proxies or create a subset, a list of securities that they wish to vote the proxy on. And typically in the services that -- the outside vendor services that you would have, it would list the different categories, and you can show that menu to the underlying client, and that under client can say, okay, I will vote categories one, two, three, four, five, when that category is attached to the proxy -- okay, I won't vote -- I don't care about the admin, I don't care about the changing in the color of the building or whatever that is, I don't want to vote those.

So it can be very customized, there can be a process. It's not perfect today. It can be better, because there's some that fall outside of it, because of the announcement dates. I think that's maybe something that, you know, as an industry we need to kind of figure out how it works. I don't think that when the security is out on loan it's the borrower who votes the proxy, because the borrower, the prime broker has probably settled somebody's short sale. So it's Mrs. Jones in Kansas City that owns the security now, and that's going to be voting the proxy.

And so I think based on the mechanisms that we have in place, we can make it work to a certain extent, but there's more to do.

MS. KELLEY: May I add a few things to that, as well.

MR. HU: Briefly, please.

MS. KELLEY: Just on a more practical basis, I would want to say that -- and again, we've had a lot of discussion between pension funds and '40 Act funds, and I don't want anybody to think I'm opining up here that '40 Act funds are more sophisticated than pension funds because I know a lot of very sophisticated pension funds.

But from a very practical basis, our proxy voting policies are married to our securities lending policies, and what we do is we do utilize these outside sources to get the most up-to-date, most integral information on proxies. They then go to our proxy committees, where investment professionals as well as administration and legal and compliance professionals sit, and we do in fact take that very seriously and look at the proxies and decide whether or not we are going to vote them.

And additionally, knowing that the question was going to come up today as we were vetting through the process, I actually went to the operations department and said, did you -- when you've recalled loans to vote them, have you ever had repercussion from the borrower or from the lending agent saying, no, you won't be able to lend again, so on and so forth, and they said in 100 percent of the cases they have never had that experience, and that actually we have gotten the loans back and we have voted them to the manner in which we had opted to vote them.

So I just wanted to, on a practical basis, give you our experience there.

CHAIRMAN SCHAPIRO: This might be a silly question, but couldn't you contract with the borrower to vote the shares in accordance with your instruction without calling them back, and that could be done on a next-day basis, instead of having to worry about record date and whether you have sufficient notice?

MR. LETO: That actually was something that was done in at least one case, because there's a no-action letter that specifically says that meets the standards from the letters from, I don't know, '78 or something like that. But it's my understanding that it's just not done that way currently, but it certainly is permissible and it, in fact, it was at least at one point a recognized practice to actual contract for that.

COMMISSIONER WALTER: Does that work when it's Mrs. Jones in Topeka who owns the shares now? I mean, you've got two -- you could potentially really have two people, and probably not infrequently, who want to vote the same shares.

MR. LETO: It might not.

MR. BLOUNT: That's exactly the problem: it's been delivered out, there's a new owner.

MS. RULONG: I think it's important to make sure that for the -- just on the topic of double voting, that the custody records that we keep are very exact on what shares are available to the beneficial owner to vote, and what shares have left the bank under a loan. So those records are within the custody systems of the major custodians.

The other real quick thing is, just RFPs, we talked a little bit before about RFPs, frequently if not almost all the time have questions about proxy voting and what are the abilities, and Patrick went through those. But what are our abilities to notify of when a proxy is coming up, and then to get the shares back. So it is becoming very active topic for beneficial owners.

COMMISSIONER WALTER: I can ask lots more questions, but I thought you might want to ask some, Henry.

MR. HU: Well, I guess one of the -- very, very briefly, I mean, the question relates to how empty voting relates to all this proxy stuff, right. Traditionally, for hundreds of years, when you think of shares, you think of the possession of a package of economic voting and other rights, as well as disclosure and other obligations.

And today the foundational assumption can no longer be relied on, that you can now possible to decouple the traditional link between voting as well as other rights on shares and economic interests, quickly, cheaply, on a large scale.

And so for now it's possible for an investor to hold significant voting power while having limited, no or even perhaps negative underlying economic ownership. And so, one of the questions relates to how securities lending relates to kind of empty voting, right, so that we already -- you all already referred to the record date capture strategy, that absent Regulation T or other constraints, you just borrow the shares just before the record date and then return it afterwards, or possibly in terms of securities lending in terms of it servicing the hedging needs, ultimately, of the derivatives dealers, offering equity swaps or put options to outside investors who want to reduce their economic exposure while retaining full voting rights.

So in the very, very few minutes we have remaining, I'm kind of curious in terms of what some of the things might be done to address these kinds of issues, assuming that it makes sense to address these issues. Ed.

MR. BLOUNT: If I can -- I guess underlying the importance of the issue that you raise, for the integrity of the corporate governance system itself, but then step back and point out how difficult the challenge is to identify.

And whether this is widespread or not, if there are even a few cases where the vote is being manipulated somehow in the securities lending markets, that would be sufficient to demand a call for action of some kind.

The problem that we face, no matter how much data that we have, is that it's not sufficient to merely track an increase in activity across the record date, because there are some extremely good alternative explanations for why that activity may exist, probably the most significant of which is that it could be that broker dealers are trying to borrow shares back from loans that they previously made but they don't wish to break in order to get their margin long holders the right to vote. Or it could be banks that are borrowing back shares in order to get their own customers the right to vote.

So a spike, especially when it's tracked from one provider, one lending agent, could not -- could in fact not be suggestive of manipulation, but rather rectification -- a remediation of the process.

No matter how much data is available, there could be cases that slip through the cracks. Having now worked with this problem since you raised it some years ago, I think my conclusion is that we will probably find -- and I'm kind of getting in advance of the findings -- that this is not a widespread problem, but it still could be a problem.

And what we may end up saying is that there are certain issues that appear to have given indications of suspicious action. And it could be just at the margin -- you know, 51 percent could be enough to swing a vote, so we're not talking about a big spike in the securities lending market.

But if we can identify perhaps with those who are tracking materiality and activity, those votes, where there has been something suspicious, it could be possible to give to the examiners or to someone else on a retrospective basis a short list of names, so that they could go in and investigate and see whether or not these shares were in fact borrowed for the proper purpose.

I don't think you can get ahead of it. You can't say you can or cannot do this, but you can check it after the fact, and that might be a chilling enough step to take that it would prevent people from manipulating.

MR. HU: Well, we have now reached the end of the second panel discussion on securities lending. I wish to thank all our panelists for their insights and candor. We will now have a slightly less than 60 minute lunch break before the start of our third panel. The third panel will start at approximately 1:30 p.m. or just a little bit after that.

Thank you all.

(Lunch recess.)

MR. BRIGAGLIANO: -- Aaron Gerdeman is a Senior Vice President at Sungard. He manages product development for Sungard's Astec Analytics. Chris Jaynes is the co-Chief Executive Officer of eSecLending. Mike McAuley is a Senior Managing Director and the Chief Product Officer for State Street's Securities Finance Division. Jeff Petro is Vice President and Head of Taxable Money Market Trading at Federated Investors. Shawn Sullivan is the Global Head of Prime Services at Credit Suisse.

Greg, would you like to start us off with your opening statement?

MR. DePETRIS: Thank you, Jamie. Thank you, Chairman Schapiro, Commissioners and SEC staff for providing us the opportunity to appear here today. We've been encouraged by both the Commission's and the industry's thoughtful consideration of structural evolution in the securities lending market, and we're honored to be here now for a more detailed discussion with such a distinguished group of co-panelists.

Quadriserv is a privately held company whose owners include representatives from each segment of the securities industry, supply, value and delivery chains, including borrowers, lenders, intermediaries, market makers, global exchanges and technology companies.

Our goals reflect the simple objectives of nearly all marketplace innovation. To quote former Chairman Levitt, the underlying essence of a market is to be a place where buyers and sellers come together. Every other feature of the market, whether crafted by tradition or technology, exists only to serve that purpose.

To that end, we have developed and now operate a central market for securities lending. The market is comprised of an anonymous, publicly accessible electronic price discovery mechanism, the introduction of central counterparty guarantee -- the introduction of a central counterparty to guarantee credit and payment risk, an a straight-through processing platform that connects the DTC settlement and the primary operators of industry-ride reconciliation services.

We believe that this centralized structure will, as it has in so many areas of the capital markets, complement existing OTC practices, provide dramatic improvements to the investing public, and allow new efficiencies to grow the market overall.

This panel is charged with contemplating specific concepts for which definitions are important. When we talk about electronic platforms, we're talking about an infrastructure and price discovery mechanism that resembles what I just described.

When we talk about central counterparties, we're talking about strong, reliable and highly-rated central counterparties with histories of unblemished risk management and broad industry participation. And when we talk about transparency, we mean price transparency such that all borrowers and lenders, including end users, can publish the price at which they are willing to transact, see the price at which they've transacted and make that information public to all market participants.

Operating transparency is such that all borrowers and lenders transact in a standardized instrument, subject to common and universally applicable operating standards. And risk transparency is such that all market participants are subject to commonly understood, robust and universally applicable risk management standards.

Transparency, electronic platforms, central counterparties and accountability share productive histories in nearly ever corner of our capital markets, precedence that looking forward should be instructive and a cause for optimism.

Over the last 15 years, structural and technological enhancements to the markets for cash equities, equity derivatives, foreign exchange, fixed income, futures have led to improved liquidity, increased volume, reduced costs for public investors, and a reduced cost of capital for publicly traded companies.

Each of these market segments was unique, and each traveled a distinctive path to relative efficiency. Importantly, along the way, however, participants were careful not to mistake idiosyncratic product features as limiting characteristics of the evolutionary process. Discerning these distinctions will be important, as similar develops take place in the securities lending market.

The natural market system was imbued with a fundamental American ideal, that fostering competition through innovation would help preserve the world's preeminent capital market structure. We have succeeded in fulfilling that ideal in large part because as innovators we don't stop at the question, is it good enough, but rather ask the more difficult question, can it be better.

We're here today not because the securities lending isn't good, but because we think it can be better. Thank you, and I look forward to your questions.

MR. BRIGAGLIANO: Christine.

MS. DePETRIS: Thank you, Chairman Schapiro and members of the Commission for the opportunity to be here today. I am pleased and honored to represent Brown Brothers Harriman on this important topic. Brown Brothers Harriman is a private partnership established in 1818, and serves clients globally through three businesses: investor services and markets, investment management, and banking and advisory.

Our firm was founded and has operated on the principle of protecting the long-term best interests of our clients. I commend and thank the Commission for examining the topic of transparency and the securities lending industry in the context of its place in the capital markets and with a view toward long-term stewardship.

The securities lending market is a developed market that operates in a well-established base of legal principles and standardized operating procedures. ERISA, the Investment Company Act of 1940, Rule 15c3, Regulation T, Regulation SHO, Rule 204T, agency lending disclosure, along with the capital framework recommended by the Basel committee are a few examples of regulations that ensure appropriate transparency and integrity to loan participants and to regulators.

Central counterparties serve an important function in the clearance of standard and discrete transactions, however the CCP structure raises issues, when its duties extend beyond clearance, and when support of the transactions it is clearing involves ongoing administrative complexity.

Unlike the clearance exchange traded securities of commodity contracts, a securities loan is not a discrete transaction, yet rather a continuing commercial relationship.

The ability to effectively manage a loan as a set of ongoing obligations between a borrower and a lender is critical to ensuring the interests of beneficial owners are protected and that the overall integrity of the loan market is preserved.

We believe that one of the lessons of the last 18 months in the structured asset market is that treating the loans as fungible commodities comes at the expense of appropriate loan administration.

Lending relationships can be effectively managed by a bilateral relationship between lender and borrower, entailing sufficient end-to-end transparency to allow for individual attention to origination, collateralization and liquidation on default.

The mediation of a CCP could change an identifiable bilateral obligation into a new species of derivative dependent upon a limited number of market makers for performance and underguarded by guarantee funds already committed to other purposes.

The only aspect of lending that is asserted to be more transparent under the CCP proposals is loan pricing. We should not confuse price publicity with transactional transparency when assessing CCP models. Any losses experienced by lenders of securities over the last 20 years have been the results of loss in the investment of cash collateral.

If there is a need for enhanced transparency, it is transparency between agent lenders and beneficial owners, to one the source of compensation for securities loans, and particularly whether this compensation entails cash investment and its attendant risks, and two, further education, communication and disclosure regarding the risks and nuances of lending to ensure it does not impede nor detract from the investment policy or objective of the fund.

I urge that we proceed with caution before considering an alternative -- before considering altering an industry that has operated efficiently and evolved collaboratively over a 20-year period in the face of broker dealer bankruptcies, currency crisis, and perhaps the ultimate test, the events of 2008. Thank you.

MR. BRIGAGLIANO: Thank you, Christine. Aaron.

MR. GERDEMAN: Thank you. Thank you, Chairman Schapiro, Commissioners, Commission staff, and my fellow panelists. It's good to be here with you all discussing these important topics in securities lending. If I may, I'd like to focus my topics -- my topics on transparency in securities lending.

In my work over the past nine years, providing benchmarking and price discovery services to the industry, I've seen the market grow ever more transparent, and that has been a good thing.

Today we have a competitive marketplace in which borrowers and lenders vie for business, aggressively negotiating loan rates for hard-to-borrow stocks. Large and small service providers, both the established and the upstarts alike, compete on price and quality of service. Institutions who wish to lend their securities for additional income can select from numerous routes to market.

And these different types of lending programs can be quantitatively aligned to the investors' goals and risk appetites. Regular benchmarking allows these institutions to compare the performance of their lending programs to their own expectations, as well as to their peers' results in the wider market. These advances in the industry's competitiveness, the market's efficiency and accountability for performance have been made possible in part through transparency.

Far from completely opaque, the securities lending market now boasts large data sets of daily borrowing and lending activity, covering millions of loans and the vast majority of the U.S. market. This market data provides essential transparency to borrowers and lenders as they negotiate loan rates, to investment managers as they evaluate their securities lending programs, and to analysts conducting market research.

Anyone in the securities lending space who wants to be in the know taps into this market data. One positive outcome from the market's recent turmoil is that we see more and more institutions requesting analysis of their lending programs and discussing their securities lending strategies in detail at their board meetings.

That increased attention by many institutional investors may serve them and ultimately the entire securities lending industry well by further promoting accountability, transparency and efficiency in the market.

Thank you.

MR. BRIGAGLIANO: Thank you, Aaron. Chris.

MR. JAYNES: Thank you. I'd like to thank the Chairman, members of the Commission and staff for inviting us all to participate here today. Briefly, some background on eSecLending. We are a Global Securities Lending agent, managing securities lending programs for large institutional investors, pension funds, mutual fund companies, other asset management companies. And we provided in a different -- or an alternative route to market or approach to the traditional custody lending programs that were really the dominant route to market when we formed about 10 years ago.

Our aim is to provide investors with greater control over their programs, greater transparency into the way their programs were managed, and introduce competition via an auction process to try to better both determine allocations to borrowers and tools to market, but also to provide better pricing transparency to the ultimate loans or agreements that are being negotiated.

I'll give some brief background on the history of our firm, which I think is going to be important to provide better context to some of our thoughts on how we think the industry can move forward.

We were formed originally in 2000, but we grew out of an asset management firm, where the origin of our company started in the late '90s, where we were an asset management firm looking at creating lending structures for some of our own internally managed mutual fund and commingled trust products.

And when we looked at the industry, we saw it as a investment process, a trading process, but not an operational or a custody process as had been widely, I think, recognized at that time. However, when looking at it as an investment process, we noticed lots of things that we were used to seeing and become accustom to in the investment management world were really not prevalent or widely accepted in securities lending.

Things like performance measurement, things like benchmarking, things like monitoring performance and switching providers based on performance of the underlying agent, use of multiple providers, use of specialists who can add value in certain asset classes -- all these things have been used for many years in the investment management world really didn't exist in lending. And so we looked to create a different process that we thought could provide beneficial owners with greater control over the program, greater transparency into how things ultimately were operated.

Now if we look at how we think the investment -- the industry could move forward to benefit investors, I think there are really two key misperceptions or views in the market that are slowly changing, but I think need to change more dramatically.

The first is that, again, lending is not a custody function, it's not an operational function, it's an investment function. It needs to be treated as such. There were some panelists earlier who mentioned some great success in managing through some of the crises last fall. In both of those stories, they were done so by managing programs as an investment process, by changing and reacting to the market as things changed, not passively sitting by and letting the market change without doing anything.

Secondly is this notion that the market or the product isn't something you need to pay attention to, again prevalent misconception over the years. It was sold as agents, as something you didn't need to pay attention to. It was purchased and ultimately used by beneficial owners as a market you didn't need to pay attention to, and I think clearly with the money that's being made, with the risks that are being taken, that mindset needs to change and beneficial owners need to take accountability and need to look at how to structure programs; need to look at how they can manage things in concert with their agent to more effectively manage and mitigate those risks.

MR. BRIGAGLIANO: Thank you, Chris. Mike.

MR. McAULEY: Chairman Schapiro, members of the Commission and staff, thank you for inviting me to participate today. One housekeeping matter, in addition to my State Street duties, I'm also the current Chair of the Risk Management Association Committee on Securities Lending. My comments here today, unless I indicate otherwise, will be in my State Street capacity.

Just have some brief comments on the topics of our panel. Transparency, with regard to the operation of securities lending programs, is critical in allowing participants to make appropriate judgments. We fully support transparency by securities lending agents, and believe that the industry standards in this regard are currently very high.

With regard to electronic platforms and exchanges, the majority of our U.S. equity loans are electronically executed through a centralized industry utility that also provides automated contract compare and billing services. We execute loans of specials, or harder-to-borrow stocks or U.S. equities through bilateral negotiations, because we believe that is the best method to obtain the optimal value and terms for our lending clients.

All of our clients' loans of U.S. equities are electronically cleared and settled, delivery versus payment, within the DTCC and the DTC's stock loan tracking system provides automated income tracking and payment. Accordingly, we believe that the current electronic trading system served the industry well in the execution, clearing and settlement space.

Securities lending is an ongoing transaction that does not end at settlement. Almost all of the process of a securities lending transaction takes place post trade. This includes substitute payments, corporate actions, mark to markets, contract compare, billing, billing collection, rerates, collateral substitutions, reallocations, recalls, returns, and buy-ins.

All of the risk inherent in the securities lending transaction arises in this post-trade environment. Accordingly, it is our view that the securities lending market would benefit from focusing on further automation in the post-trade space rather than attempting to change the current execution environment that already is heavily automated, is focused on delivering value to beneficial owners, and presents little or no risk.

With respect to a central counterparty, we would support changes that would allow agent lenders and their clients to utilize the OCC's existing central counterparty for securities lending or any other mechanism that allow innovation of bilaterally negotiated loans to a central credit intermediary as another alternative for distribution of our client's securities, provided this mechanism did not result in increased costs, operating risk or liability for post-trade processing and provided the benefits of lower credit risk for beneficial owners and reduced capital charges.

With respect to other benefits, we believe a number of changes to the bankruptcy laws, accounting rules and stay procedures would improve securities lending for beneficial owners by making it easier for agent lenders to engage in multiparty netting across products and to execute closeout procedures without concern of having stays imposed.

In addition, we also believe that allowing U.S. dealers to pledge baskets of highly liquid U.S. equities as collateral would provide benefits to all parties in the lending transaction, and would allow beneficial owners to diversity their collateral options and provide them additional options for managing risk. Thank you.

MR. BRIGAGLIANO: Thank you, Mike. Jeff.

MR. PETRO: Thank you. Thanks to the Commission for inviting Federated to the table. We've heard excellent representation from mutual funds today, so I thought I would actually change things a bit and just be simplistic.

I work for an extremely conservative mutual fund company which manages over $400 billion in assets; $330 billion of that is money market funds, so we do simple. I'm part of a team of portfolio managers, credit analysts and traders where there's a natural friction that already exists between the process of the money management of the money market funds. So that credit process is already there for us.

My number one job is to provide liquidity at par every day to every shareholder. And my shareholders and my customers happen to be the sec lending portfolio managers, the board, my shareholders. Ultimately they are all my customers. My job is to have the policies, procedures and the risk parameters to be set in place so then we can be successful and I can really -- I can sort of drive the outcome and the environment of securities lending at our firm.

But this in no way our core business. Our core business is running equities, running fixed income, running money market funds. Securities lending is alpha generation for us, and every portfolio manager knows that and the board knows that. So I have to set up the risk parameters for what I think is the least amount of risk with the most reward.

What I probably don't do as well is I don't lend securities. I don't foresee myself having an operation in my firm that I'm going to lend securities, so I do trust that the operation that my third party lenders are going through meets the same rigorous standards from the standpoint of policies, procedures, risk management that I do in my own 2a-7 funds.

I am an expert on cash management, though, so I take full responsibility for that. I feel the transparency is from top down. Transparency is what the board knows, what the shareholders know, what the portfolio managers know. Everybody needs to know exactly where the risks and rewards are, and that's my job to bring that to them.

I feel different, maybe, than other people, but I feel like I'm in the right product -- but I feel I'm in the right product for the right reasons. We know why we're in it and we know what our expectations are.

MR. BRIGAGLIANO: Thank you, Jeff. Shawn.

MR. SULLIVAN: Thank you, Chairman Schapiro. I appreciate the opportunity of being here today. My name is Shawn Sullivan, and I'm a Managing Director at Credit Suisse, and I run the firm's financing books, which include securities lending.

When asked about transparency, I think about risk and price. Three years ago the Commission took action to require full counterpart and data disclosure which would allow investors, agents and broker dealers to make informed trading decisions around counterparty risk. In response, the industry developed the agency lending disclosure initiative. This calls for the electronic transfer of all stock loan data so true counterparty risk can be assessed.

Price transparency. It's important to note that the easy-to-borrow securities make up over 90 percent of the securities lending market. These securities are readily available. The rates on the easy to borrows are pre-negotiated between the agents, the vesters and the broker dealers. These rates are quoted off well-established benchmarks and spreads that have been agreed upon.

Additionally, there are venders that will share price information. Many investors are using these pools of data to mark to market their securities lending program to ensure they're getting fair value.

It has been suggested that requiring broker dealers to pre-borrow securities before executing a short sale would curtail fails to deliver. Credit Suisse does not believe that a pre-borrow requirement is necessary, especially on easy-to-borrow securities for which there is ample supply.

Additionally, the regulatory requirements enacted pursuant to Regulation SHO and Rule 204 have achieved the goals of facilitating timely settlement. The actions of the Commission have dramatically reduced fail to delivers in today's market.

Electronic platforms. Electronic platforms are absolutely essential to the growth of our market, while also maintaining a controlled environment. There are many vendors that provide automated tools, which is allowing the market to scale and become volume insensitive.

These solutions, combined with significant IT investment by both agents and broker dealers, limit manual intervention, and more importantly, investor risk. Stock loan has truly evolved over the last 10 years. A vast majority of all stock loan transactions are today executed on these electronic platforms.

Central counterparts. Central counterparts have many forms and will perform many different functions. Every market is different, and the design of a CCP is only useful if it truly addresses the unique characteristics inherent in the securities lending market.

I don't know of a proposal today that will actually meet these requirements, however I have no objection to exploring the possibility. More importantly, the use of a CCP should be voluntary and based on the value that it brings. Thank you.

MR. BRIGAGLIANO: Thank you, Shawn, and thank you to all the panelists for a very thoughtful and provocative opening statements. Do the Chairman or any of the Commissioners have a question currently?

CHAIRMAN SCHAPIRO: Jamie, let me start with one. I was struck when I read -- I think it's Greg's submission -- that talks about the objectives and benefits of a CCP, and they really do mirror very much what we're all working on in the over-the-counter derivatives space, in terms of providing transparency, preventing fraud and abuse, efficiency, minimizing systemic risk, providing risk management tools.

And I sort of heard mixed support, and I definitely heard some non-support for the idea of CCP, so I'd love to get just a little more of your thoughts on central counterparties in this space from any of you.

MS. DONOVAN: I'm happy to start. From our perspective, just by way of background, our program predominately represents asset managers, '40 Act funds in the U.S. and collective managers globally. And historically we have always operated in an intrinsic value program.

And I think what we heard from other panelists was that key to the success of '40 Act managers, particularly in the States, has been the ability to customize and manage the risks. And our experience has been, is that '40 Act managers particularly, and beneficial owners generally, tend to like to manage their risk themselves, rather than outsource it.

Our clients want to see through an intermediary, and I said, they trust their own risk management rather than delegating that. They want to be active participants in a securities lending transaction, they don't want to be consumers. And in some ways, the concept of a CCP model would inhibit our clients' ability to customize and manage those very risks with which they have the greatest concern.

CHAIRMAN SCHAPIRO: So if you put aside your particular firm's customers and maybe put aside '40 Act managers -- because I think one of the things we learned from this morning is that the '40 Act companies have done things a little bit differently -- would you have the same view with respect to other lenders, pension funds, state and local governance?

MS. DONOVAN: I guess it depends on how we're going to define performance and risks. If we look at what the four main risks are on a securities lending transaction, we look at counterparty, we look at collateral and reinvestment, we look at operating risk and we look at legal attacks and regulatory risk.

I think we have to ask ourselves, does the CCP model solve for any of those risks, and more importantly, over the last 20 years, has any -- has the securities lending industry presented any type of systemic risk as a result of the activity and as a result of borrower defaults in some of the extenuating market circumstances that we've experienced.

And I think if you dig further and look into those issues, the answer to that question is no. So from our perspective -- and I'm speaking broadly across the market -- we, from an operating perspective, we may be solving for a problem that perhaps doesn't exist. From a pricing perspective, I would say that we -- as some of my other panelists agree -- we would certainly support some type of mechanism that would ensure greater price publicity.

But I think looking -- taking it further to a CCP model, which is going to mutualize risk in some way, it's probably not in the best interest of beneficial owners.

MR. McAULEY: This is Mike McAuley. I would agree with those comments. I think if we look at what brought us to this discussion, it's certainly the events of the last couple of years. And where did the problems arise in the securities lending, well, the main problems arose when the cash collateral reinvestment side. The lending side performed well.

And if you look at a business model where we currently have two intermediaries between the ultimate beneficial owner and the user of the security, a CCP simply adds a third intermediary which increases the cost of that transaction.

So the question is really, is the increased cost of that transaction worth the additional credit intermediation, the third credit intermediation, because currently there exists two right now with the indemnification of the agent lender. So what is the value that we're getting out of putting a third intermediary into the business model when I think the industry showed that it could handle the events of the last couple years on the securities lending side, on the transactional side.

MR. SULLIVAN: I would also add that I would think a CCP would most likely reduce liquidity in the marketplace. Currently, beneficial owners have full disclosure on the counterparts they're dealing with, and that was by a mandate. And if you're dealing with a CCP, you're not necessarily going to know who is on the other side of that transaction; you don't know what their habits are.

And the securities lending market takes the know-your-customer concept to the next level and beyond. There's significant conversations that are had about recalls, about proxy voting, the different tax regiments. There's so many nuances within the securities lending market that a CCP would really have to be an extraordinary mechanism in order to be useful.

MR. PETRO: And from the standpoint of being the beneficial owner, it's important that we do know who that ultimate counterparty is, because it's part of our risk-weighted monthly committee to know -- obviously not the hedge fund, but who our counterparty is after the lender. And without that information, we're not sure where our biggest risk lies, and then also with the indemnification from the third-party lender.

MR. DePETRIS: This will be probably a long-winded response, but I'll try to take them in order. To Chris' point, I think it is important to think about kind of risk-weighted or kind of relative risk performance.

The question is, kind of, where is the return and where is the risk? And I think that that's an important consideration in any discussion about a central counterparty. At the end of the day, the central counterparty's job is to guarantee default and to guarantee payment in specific cases.

And so, clearly, as we think about counterparty risk, you need to be clear about where the counterparty risk relationships are. And it's important to -- from the beneficial owner standpoint to know that those agent-lender obligations or agent-lender disclosure reporting doesn't change. At this point, unless there's a change to the ERISA law itself, the only eligible counterparty to a securities loan would be the broker dealer.

So unless that changes and it becomes an actual clearing corporation, everything needs to stay the same. So the risk element, if we want to look at that, is really going to be from the broker dealer intermediary to the clearing corporation. In the case that we're talking about -- and it's difficult to kind of generalize here, because there's only one reference point -- in the case of the Options Clearing Corporation, as an example, which is a AAA-rated clearing corporation, the largest derivatives clearing organization in the world, that risk under Basel II is a zero risk rate.

So the actual counterparty risk, if you want to talk about kind of systemic impact of that distributed risk, is a positive impact on that. So from the standpoint of reward, then -- and if you want to take the counterparty risk and the default risk -- and you can kind of debate the value of that -- and then kind of lay that back into other risks, cash reinvestment risk, the rewards then are the revenues earned from taking those risks.

So from the standpoint of the role of the central counterparty -- and again, I think to Shawn's point he made before is completely valid -- it's important to separate the distinction between the credit function an the price discovery function. They are not one and the same. And from the standpoint of providing price discovery -- and again to Shawn's point that 90 percent of those assets may have little need for the price discovery function -- 10 percent of them do.

The point is, for the 10 percent of those assets that do have the value, it's important to optimize that value. So in all cases where there was an overwhelming demand and a lack of supply, the auction market mechanism is probably the best price discovery mechanism.

The role of the central counterparty, then, is to grow the universe of potential bidders in that auction and remove the potential bottleneck or the potential credit constraint of the universe of demand. And so from the standpoint of reward, then, as you calculate that risk -- the risk component, the reward is, what is the best value for the asset and the most likely or the most -- the optimal way to get that value is to increase the universe of bidders to pay the best price. So I think that it's an important consideration talking about risk reward.

MR. BRIGAGLIANO: Another question from Commissioners?

COMMISSIONER PAREDES: I'm actually curious to maybe try to get a little more back-and-forth on this particular point, and whether or not there any responses to what was just said, and then perhaps likewise back.

MS. DONOVAN: Thank you for that invitation. I guess what I would offer is, when we're talking about CCPs -- we do need to separate the discussion from price publicity and price transparency from the operating aspects of the transaction, because traditionally defined, the CCP will become the sole counterparty to the beneficial owner, and the CCP will also be the one responsible for providing all post-trade maintenance and in reporting.

And I think what's important to note is -- continuing on a point Shawn had made -- that liquidity is fragile in this market. We have a market where the objectives and the motives from the demand and the supply side are not aligned, meaning that beneficial owners -- this isn't -- this is optional, they are not required to participate in lending, there is nothing about their investment policy nor their fiduciary responsibility that compels them to lend to ensure their investment objectives are met.

Conversely, you have hedge funds who need to short securities, they need to borrow in many ways to fulfill their fiduciary responsibility and the objectives of their investment plans. My point for saying that is that unless this is constructed in such a way that the beneficial owner feels that they can customize, they can see through, they can control the activity, I think you would have a significant pullback in liquidity from the beneficial owner perspective.

COMMISSIONER WALTER: Could you, in effect, have your cake and eat it too by having a CCP be available and letting businesses that did not have a great desire to customize gravitate towards it, while leaving the customization process -- I mean, the same thing may be happening in the over the counter derivatives market. I gather the suggestion that you're making is that there's such a need to customize there is not enough business left over that is of -- that is not of that sort, but I'd appreciate it if you would comment on that.

MS. DONOVAN: Well, I think if we think about the operating aspects of the securities lending transaction, in many ways they are quite standardized. And my broader question would be is, what problem are we trying to solve for through the CCP operating model, operationally, because if we look at how the securities lending industry dealt with the Lehman default recently, and historically if we look back at Drexel, if we look back at Barings Brothers, if we look back at the Asian currency crisis, note there was no systemic risk that was ever incurred as a result of an -- for securities lending transaction operationally.

So that's the question that I pose, is what operational problem are we solving for with the CCP? And particularly in light of clients, given post-Lehman Brothers, who are looking for greater transparency and greater control.

MR. McAULEY: This is Mike McAuley, and I'd just like to add to that. I think we have to separate again the discussion about a central counterparty from the discussion about an exchange or an electronic trading platform. I think that's where the discussion of price discovery comes in.

There is an existing CCP for securities lending at the OCC, and I think that there could be what you described if it -- some of the rules were changed to allow it to be easily used by agent lenders or beneficial owners in a way that you could have bilateral negotiation, you could novate that loan to the central counterparty and maintain the bilateral credit relationship, but with an additional intermediation of the CCP.

But those are the things that I think need to be discussed, and I think that, you know, something potentially could be done in a way that would gravitate some people to a CCP model.

CHAIRMAN SCHAPIRO: What would you say are the most important aspects of the securities lending process, the whole process, that need to be automated or need further automation?

MR. McAULEY: I think if you look historically -- put 2008 aside and cash collateral reinvestment -- many of the agents here would feel the same way, but one of the biggest risks is corporate actions, and is there a way to automate the corporate action process in a way that reduces loss? I think that's probably one of the highest risks that certainly agent lenders face in the processing of securities lending.

The recall process, there's been instituted just recently automated recalls, and to make that -- to put more focus on that and allow that to be * more automated in a way that everybody would use that procedure, I think would add further automation. I think we could -- there's places that could use additional automation that we can focus on, I think, focusing on the trade, if you want, the trade environment and settlement environment which works well now, and as Christine mentioned, really presents no risk, I think would benefit by focusing on that post-trade environment.

MR. SULLIVAN: Most of the mark-to-markets -- and that's where your most exposure is for your counterpart -- are executed automatically and probably have cleared by 7:30 in the morning, and we're talking about hundreds of thousands of mark to markets per probably broker dealer.

So it's highly automated. I think that's the most important -- as far risk is concerned -- is that beneficial owners like a choice. They want to deal with highly credit-worthy counterparts that they know can withstand a market disruption. And when you have -- an OCC is a CCP, and it has never gained any traction, and it hasn't gained any traction because it doesn't address those concerns of having a choice.

If there's a default if you're not marked, there's going to be a loss, there won't be any reduction in the loss, that loss will just be spread out amongst the participants. And if you have more bidders in the process, you're most likely going to have a deterioration in the credit quality of the counterparts, and that's something that a beneficial owner does not want to be exposed to.

MR. DePETRIS: I'd just say that, number one, there's a significant difference in the nature of the margin being collected. So as opposed to the over-the-counter margin, the 2 percent standard margin over the counter, the CCP-based margin regime is risk based, it's got -- it's a tiered margin regime with a lot of considerations -- volatility, the balance sheet of the actual broker-dealer member.

But all of that aside -- and the fact that as a CCP in the default scenario there has never been an issue, obviously, there. But more importantly, I think, and Shawn's point about the reconciliation is a good one, the multilateral reconciliation process does happen automatically, it does happen efficiently.

And importantly, I don't think we're talking here at all about an either/or scenario, we're talking about two complementary market structures, one hopefully kind of either offsetting benefiting or being kind of integrated with the other over time. And in that -- in the CCP world, that reconciliation is happening once. It's happening in the morning once for all participant members of that CCP. So the reconciliation point, the point of failure, all of that is reduced dramatically.

MR. JAYNES: I think one other quick point. You'd mentioned a potential hybrid solution where certain clients all go toward the CCP, other clients all go away from the CCP to bilateral. I think there's a different kind of hybrid solution where assuming the CCP can actually add value in certain markets or certain sectors, we and our clients would certainly look to trade certain of our securities through that mechanism if we could be comfortable with credit, if we could be comfortable that we were getting a better price from a risk return, and we would continue to trade bilaterally with other markets and other sectors and otherwise.

So I don't think it's an all or none; I don't think we have to wake up one day and say, every single one of our loans suddenly now has to go through a CCP. Where CCPs can add value, where they can show better risk return to clients, we as agents ought to be looking at utilizing those. And that isn't proven today.

Certainly advancements are being made, and we'll look at that, but we don't view it as an all or none, we view it as a potential -- another tool that we can use to improve returns and ultimately improve results for our client base.

CHAIRMAN SCHAPIRO: Jamie, I have one last question on my end. Several of you said, let's separate the use of a CCP from price transparency. And so any comments you have on the sufficiency of price transparency would be very helpful to us. We heard a lot about that this morning, and it was maybe one of the top three issues that was raised.

MR. GERDEMAN: Thank you for the question, Chairman. I might start off answering by also answering some of the questions that were brought up a bit earlier. So I do apologize. I'll just bear off course for just a second.

Starting with price transparency -- someone brought up an example of Sears Holding, and I'll just use that as an example of the kind of transparency on prices that does exist today in the market.

In the data that we track within the lending pit, a cooperative of transaction data -- it's an end-of-day compilation of millions of transactions that occur in the securities lending market. And across that, the average rebate rates, at the end of day yesterday, were just under -20 percent. So that's about a 20 percent -- roughly -- fee that borrowers on an intrinsic level are paying to -- for the right to borrow that security.

And then I would also mention that there is some transparency outside of prices. We talked briefly about -- I think there was a question regarding the market share of '40 Act funds, and so on, in the size of the market. And mutual funds do account for about 10 percent of loan volume, but they do count for a larger portion of lendable assets, about 25 percent. And previous panels touched on why that might be, restrictions on lendable amount and so on.

Finally, compensation splits among agents -- 60 percent of mutual funds see splits ranging between 75 percent and 80 percent, they keep that much revenue, and that's just talking about mutual funds. And this kind of data we provide through our research reporting.

To more directly answer your question -- thanks for being patient -- the kind of transparency I alluded to for your trading desks in securities lending is that end of day, next morning, security-by-security detail about the various rebate rates in the marketplace, as well as loan volumes, distribution of counterparties on an anonymous basis, showing essentially trends in market color in the securities lending space.

MR. McAULEY: I'd also just like to comment on that, as well. We've heard a lot about transparency throughout the discussions, and I think to frame a discussion, we have to define what we mean by transparency, because there's different kinds of transparency. And even within that -- so I think we have to, in that definition, it has to be, what is it that we want to be transparent, and to whom do we want it to be transparent to.

If we talk about price discovery, I think -- or price transparency, there's levels even within that. So are we talking about the price that the beneficial owner charges the broker dealer to borrow the security? Or are we talking about the price that the broker dealer charges the end user of the security to borrow the security or to use that security in a short sale? Or are we talking about the combined price?

And even within that, there's further -- you go further, deeper -- are we talking about the price that an index fund might get to lend a security versus a fund that is actively traded. I think other people on other panels have mentioned that the price isn't just a function of supply and demand. A lot of price is determined by the individual characteristics of the lender and the borrower.

So -- and those can include things like how they're structured, how they're managed, what their risk appetite is. So a particular lender who is willing to take a certain kind of collateral, securities collateral, say equities as collateral if we're talking about a non-U.S. transaction, might get paid a different rate to borrow the same security that someone who wants Treasuries as collateral will get paid, because Treasuries, typically in the market, are costly to finance, and therefore cost the dealer more to borrow the security if they demand -- if the underlying beneficial owner demands type of collateral.

So price will fluctuate as individual beneficial owners adjust their risk appetites or set limits on their programs as it relates to collateral or other things, and there's a lot of other factors like that. So I think, as we talk about price transparency, we have to recognize that price isn't just a function of supply and demand.

MR. SULLIVAN: I would also add that when it comes to the hard-to-borrow market, there is no shortage of competition amongst broker dealers trying to get as much of an allocation as they possibly can. And the agent leaders, in their fiduciary role, extract value. There is constant conversations and negotiations that go back and forth every day trying to get best price.

My firm contributes to -- contributes its stock loan data and prices to two vendors, and the beneficial owners have that data if they subscribe to it, and they can see if their agent lender is getting a fair price.

And as far as the other side of a prime broker or broker dealer's price transparency is concerned, we provide downloads of information on all the hard-to-borrow securities that we have to offer, as well as the rates. So before we get a telephone call, our customers know pretty much where the market is. They can either -- they can get a push list that we will give them outlining all the securities, or they can log on to our system and automatically get that data.

MS. DONOVAN: I would offer -- just as we spoke about the CCP model and separating the pricing or transactional components to the operating components, I would offer the reverse as we speak about performance measurement, meaning -- a question or a comment was asked in the last panel, how do I benchmark my performance. Perhaps the question should be, how are you defining performance, and is performance a function of the appropriate balance between all the risks, how is your agent managing all the risks that are in lending, as we -- the four risks that we spoke about previously, in addition to ensuring that they're getting an appropriate return based on the parameters that you've set forth in the program.

So in many ways as -- we seem to have broken this discussion of performance just down to the pricing of the loan transaction, when in many ways what we would encourage is that for beneficial owners to step back and create a policy around lending that's consistent with their overall investment objectives.

And what's important to that, too, is that beneficial owners have to have access to all the risk and return information about securities lending. So agent leaders need to ensure greater transparency and communication and education around here are the risks, here are the return dynamics. And then perhaps beneficial owners can construct a program that's consistent with their investment objectives, and then set performance criteria around that.

MR. DePETRIS: I just want to add to that. I think that the definition of price transparency sounds complicated, and it is in a lot of ways. And so one way to think about the central counterparty and to think about the price discovery mechanism is to say that for some subset of the market there's no confusion, there is simply a standard credit, the best available credit anywhere.

There is a price discovery process -- everyone participates. There's public bidders, there's public offers, there are intermediaries, and every element of the supply and value chain. And from a benchmarking standpoint it's very easy to understand that definition, and maybe we can take some of the mystery out of it.

MR. GERDEMAN: One more point on the topics you brought up, Chris, on benchmarking. It is important to go beyond just the price. That's an important element, obviously, because it's one of the levers that a lending program can pull to increase revenue, but of course the events of the past year or so showed that it's not necessarily the only tool, and it highlighted the reverse side of that spread, which is the investment premium sought in the cash collateral.

So in any benchmarking analysis, the beneficial owner, the institutional investor participating in a securities lending income, needs to consider the multitude of factors that were mentioned, not just the rebate rate or the price on the loan or even your portfolio in aggregate, but the yield and the investment range in your cash collateral program, your counterparty borrower distribution.

Of course you don't want to be too concentrated among one broker dealer as a borrower, and liquidity constraints such as loan turnover rates and so on. So all of these different factors do need to be considered in addition to price, but price is definitely important.

MR. BRIGAGLIANO: Aaron, we heard Shawn talk about some of the data that his firm pushes out -- pricing data, and you've commented that there is significant data available. Do you have a sense that other firms, most other firms, all other firms do the kinds of things that Shawn was talking about in terms of giving data to vendors so that when you acquire data from a vendor you can see the whole market? Do you have the whole universe?

MR. GERDEMAN: Many of the -- especially the largest institutions, intermediaries in this market participate in one or two or however many data exchanges. It's mutually beneficial -- the whole is greater than the sum of the parts, and that rule of thumb is true here, as well.

But like Shawn alluded to, if you look at the market rates that we aggregate, there's no one rate for a securities loan. We do publish weighted average rates, we publish ranges, you know, high-low across the market, different distribution metrics. And we have to publish that distribution because there is no one rate. It depends on the -- let's say the expected length of the loan, right -- is this loan coming -- the security coming from a stable portfolio, maybe like an index fund, or is it an actively managed fund that makes more frequent sales forcing recalls?

All of these factors are considered by the professional traders on the stock loan desk who take all of that information. Part of it is the information that I try to provide through price discovery processes, but the other part of the information is how -- they know their customers best and they're trying to execute for the most revenue possible.

MR. BRIGAGLIANO: Christine, is there any way that price publicity could be enhanced? I think you mentioned that there could be some additions there.

MS. DONOVAN: Sure, it can always be enhanced. And I don't have any particular recommendations, but I would say we would be supportive of further progress and type of electronic exchanges that promote a price publicity.

But to Aaron's point, we do think there are many mechanisms now that allow not only traders representing beneficial owners, but beneficial owners when reporting to their boards to access information that can support appropriate benchmarking.

MR. BRIGAGLIANO: Any of the Commissioners, or the --

CHAIRMAN SCHAPIRO: I have a little bit of an off-the-wall question, and it comes from a gnawing concern I have, that we've talked about while there really isn't systemic risk here, and there's great risk management here because parties know their counterparty and they are not concentrating positions and they are understanding the creditworthiness and all the different levels of risk, and of course we've just been through a period where we thought all those things were true in lots of other aspects of our financial markets.

So is there anything you can tell me that's different here -- I know we haven't had the crisis, but we've had the collateral reinvestment issues, for sure; we haven't had a major crisis of securities lending -- what can you say to us that suggests we shouldn't be worried profoundly about this anyway just because it hasn't blown up yet? And I'm sorry if that's a little bit of an unfair question, but I'd love to hear your thoughts on that.

MR. SULLIVAN: I would say that as a broker dealer, I'm borrowing securities and I am posting as collateral a superior asset, cash. In addition, I'm posting a margin of anywhere from 2 percent to 5 percent. And in a crisis, I think it's well accepted that equity markets would most likely fall in a scenario where there's a default, and as a result the defaulting counterpart is holding the inferior asset, the stock, that's falling, and has the cash which happens to be the best asset you could possibly have, and they could buy back those assets at a discount, and would have access cash on hand after the default.

MR. JAYNES: I think clearly that some of the checks and balances that have been put in place in the market, particularly in the case of Lehman, worked very well.

And I don't think any of us can sit here and say nothing can ever go wrong again. Clearly none of us can make that statement, though I think the industry has built in lots of different checks and balances to try to make sure our default or counterparty default doesn't happen.

I think back to the earlier point, though, about viewing this as an investment function, there still does need to be a mindset shift, I think, in this industry. If we're all now increasingly recognizing it and viewing it as an investment function and a trading function, I think there are still big pockets of the market that have learned it as a custody function, learned it as an operational function, and don't view it in the way they should in treating it as investment function.

And where there's risks, there's risks, I think, in not viewing it properly and therefore not taking the steps to put in risk controls, not taking the steps to actually understand -- you know, if you talk about transparency, transparency around how my program is structured, what is my agent doing, how is my agent generating those returns, what risk am I taking to get those returns, those are all logical and good questions that any investor should take, and those that treat it as an investment function, ask those types of questions -- I think historically there's been others who have just said, I don't pay attention, send me the check at the end of the month, and so they're unaware of some of the risks, they're unaware of even how the returns are being generated.

And we, as an industry, need to do a better job on both the agent side as well as the -- I think the investor side to try to recognize this product for what it is and treat it accordingly. There's clearly developments going on in that, there's clearly been improvement in that, from better benchmarking data, from better education, from wider recognition of this as an investment product. But we still have a ways to go, and I think we all collectively need to help continue to push that -- the market forward and get that misperception kind of changed once and for all.

MS. DONOVAN: In response to your question, Chairman, if you look at this industry, and your concern is -- your question is a good one, how can we ensure that something won't blow up in the future. I would suggest that we look at what are the four main risks in the product.

We've got counterparty risk, we've got collateral and reinvestment risk, we've got operating risk and we've got legal, tax and regulatory risk. So if we look at those four main risks, the questions are, is there a solid foundation with regard to the legal operating platform of the transaction, and are the operating procedures such that it can facilitate an event of default in the case that one happens.

I think we've seen that that has happened with Lehman. To Shawn's point, yes, it's a collateralized transaction in a margin, however you need that collateral to buy in that replacement security, so the liquidity and the stability of the collateral is important.

It would be our position that if you look back in the history of this industry, the last time the industry had a -- there were losses incurred, it was in 1994, it was as a result of structured assets, inverse floaters specifically, that were purchased in securities lending collateral pools, and that's how clients incurred losses.

So I think the attention needs to be on collateral and reinvestment. We've talked a lot in other panels about perhaps equities as collateral in other forms. I would urge us to look at that proposal very, very carefully. Again, it's collateral, and in the case that it's cash collateral it's the reinvestment of that cash collateral. And if any weakness has been exposed in the last 20 years, it's really been in that risk.

MR. McAULEY: I'd also like to add, I think one of the things that gives me comfort is the credit risk management. When you look at a central counterparty, and that's kind of what we're comparing it to here, certainly the risk gets mutualized among the clearing members or the participants.

Well, to some extent that occurs in securities lending already -- not necessarily a full mutualization -- but through the credit process, and through the client's ability to tailor their program, their securities loans are spread over many borrowers. They're not concentrated in specific borrowers and credit limits are set.

In addition, you add that to the credit process that the agent lenders go through, because they're providing an indemnification, so they have to protect themselves as well, and they place limits. So that level and that spreading of risk occurs already, and I think to the extent that there's a loss, it's going to be focused in a particular area, but it's not with respect to the entire portfolio of the client, because that risk has been spread and it's been capped by credit limits.

MR. BRIGAGLIANO: Well, that brings our third panel to a conclusion, and we appreciate the comments and efforts of all the panelists. And let's reconvene at 2:55 for our fourth and final panel of the day, the Future of Securities Lending.

(Brief recess.)

MR. BRIGAGLIANO: Welcome back to our last panel of the day, entitled The Future of Securities Lending and Potential Regulatory Solutions; Market Evolution; the SEC's

Role Filling Regulatory Gaps. I'm Jamie Brigagliano, and with me is my co-moderator, Buddy Donohue, the Director of the Division of Investment Management.

MR. DONOHUE: In our wrap-up panel today, we will explore the following topics: How are securities lending practices likely to evolve; What factors will most influence the growth or contraction in securities lending; Does the securities lending market represent a regulatory gap; Should the SEC have an enhanced role in the oversight of securities lending; Would investors benefit from greater SEC oversight; And, are there particular regulatory reforms the SEC can pursue that would better protect investors with respect to securities lending?

MR. BRIGAGLIANO: Once again, we are very fortunate to have a very distinguished panel of experts with us. Sticking with the format that we have been using, I'm going to ask the panelists to introduce themselves and to provide a very brief opening statement. When the panelists are finished, we'll proceed directly to the substantive topics, with the Commissioners asking questions, panelists responding, and we look forward to a lively discussion. Accordingly, panelists should not hesitate to comment on remarks or observations from other panelists, so by all means speak up.

Before we begin, I'd like to welcome and introduce our panel. Leslie Nelson is a Managing Director in Global Securities Lending at Goldman Sachs. Rick Ketchum is the Chairman and CEO of FINRA. John Nagel is the Deputy General Counsel and Head of Global Compliance for Citadel Investment Group, L.L.C. And Mark Faulkner is the Founder and Head of Innovation at Data Explorers.

Les, do you want to start us off?

MR. NELSON: Certainly. Chairman Schapiro, Commissioners, I'd like to thank you and the Commission staff for the invitation to participate in the roundtable. I'm honored to have been invited to be part of this panel on the future evolution of the securities lending market and to discuss the regulatory landscape as it relates to the market and the business of securities lending.

I've been involved in securities lending at Goldman Sachs since 1990, and have had the opportunity to be active in this business during a period of unprecedented growth and development. I have also been privileged to have worked as part of industry groups that have helped this market develop, often with an open, constructive dialogue with members of the Commission staff as well as with SROs such as FINRA.

We in the industry appreciate this dialogue and the opportunity we have today and tomorrow to do a deep dive with you on securities lending and related matters. Long gone are the days when securities lending operated in the background, and we are happy to be at the table to help answer questions and provide information.

Some of the growth in the securities lending market that I just mentioned has been reversed over the course of the last year as a result of market conditions and the impact that these conditions had on hedge funds, the largest source of demand for securities borrowing.

Market value declines, coupled with changes in trading strategies employed by some hedge funds, caused the value of securities on loan to decline, a trend which is beginning to reverse itself.

It is interesting and somewhat paradoxical to note that we have never seen as much urgency in our securities borrowing activity as we do today, since we now operate in the equities market in the United States in what is essentially a zero-fail tolerance environment as a result of Reg SHO and more specifically Rule 204. Rule 204 has been undeniably effective in bringing U.S. equity fails to levels that are truly de minimis.

As the panel proceeds, we can certainly discuss in more detail how demand, supply and regulatory action can move the market to contract or expand in the future. With this as background, we are in a position to discuss how the securities lending market might evolve. The evolution of the securities lending market in the U.S. in the near term is likely to be most influenced by a combination of recent market events and regulatory changes that may occur in the future.

With regard to market factors, two that affected securities lending over the course of the recent financial crisis are likely to be the most impactful. The first of these was the serious impairment of some of the cash collateral pools in which securities lending cash collateral was invested.

The second issue related to the degradation in the financial condition of several broker dealers, most notably Bear Stearns and then the failure of Lehman Brothers, which raised counterparty concerns. As our panel proceeds, I hope that we can discuss how these two factors have already influenced the securities lending market and what may happen in the future.

The regulatory framework for securities lending in the United States is the second major theme of this panel. This market has been highly -- is highly regulated and has been for many years. There are a whole host of regulations that have provisions directly aimed at securities lending. These included Regulation T of the Federal Reserve system, Exchange Act Rule 15c3-3, Exchange Act Rule 15c3-1, Reg SHO, and ERISA.

The SEC and SROs have broad regulatory authority over the broker dealers that participate in securities lending. The Federal Reserve and other banking regulators, such as state banking departments, have regulatory authority over banking institutions that act as agent lenders. These agents, some of which are custodians and others which are non-custodial agents, provide the bulk of the liquidity in the market, lending on behalf of their beneficial owner clients.

With respect to regulatory developments, I hope that we will have an opportunity to discuss an area where the SEC could pursue regulatory reform that would impact securities lending practices. This relates to prime brokerage, where action is pending to replace the 1994 prime brokerage no-action letter with one that has been modified to take into consideration client compliance with Reg SHO in a prime brokerage setting.

Specifically, the new no-action letter would require that prime brokers report to executing brokers client behavior as it relates to incorrect order marking, that is, long versus short and vice versa, and non-compliance with locate requirements in order to assist the executing broker in determining whether it is reasonable to rely on the client with respect to order marking or locate compliance.

While this change would put more of a burden on broker dealers, as opposed to things like pre-borrows or so-called hard locates, we feel that this would be the most effective way to stop abusive naked short selling, to the extent that it is taking place.

Thank you again for the opportunity to participate this afternoon.

MR. BRIGAGLIANO: Thank you, Les. Rick.

MR. KETCHUM: Thank you very much. And let me thank you, Jamie, Buddy, from the staff and as well, Chairman Schapiro and Commissioner Walter and Paredes for taking the time today and allowing me to be with you.

I will start with hopefully an acknowledgment of reality, that we at FINRA, just as you at the SEC, believe we need to know and understand a great deal more about the securities lending market. We don't come pretending to be an expert or to have a clear understanding of every regulatory action that may be appropriate with respect to this, and indeed found the last panel highly valuable from an information standpoint.

But I do have a few reflections that hopefully you'll find interesting and perhaps somewhat different than what you've heard again and again today.

I guess to start with would be the experience that FINRA has had through both itself and through our legacy organizations in recent years in the area of securities lending. And we have found problems with firms, particularly those firms that have used finders to help match borrowers and lenders. These finders were not associated with the broker dealer and were not required to be registered, unlike traders or registered representatives in other pieces of the business.

Our legacy organization, NYSE Regulation, found that employees of members firms were skimming profits from their broker dealer employers by paying the finders a fee for services that were never performed. As a result, FINRA took enforcement action against numerous firms and individuals that, with the tremendous help of the SEC, eventually led to numerous criminal convictions.

I mention this not from the standpoint that this is not an area that I think there's been substantial reaction to by the firms since these actions, but it does demonstrate an overall concern from a control standpoint, and it led to our Information Memo 532 to alert firms to those potential regulatory problems.

I think the point just made earlier is a significant point, again, to look at; sort of approaching it from a regulatory standpoint, I'll look at it perhaps in a slightly different way. Indeed, we have seen, just as noted, a significant reduction in open-borrow balances over the last two years and reductions with respect to securities available for loan. Agree that that has created a great deal of pressure on firms, particularly in the environment of the temporary rules and the shift in Reg SHO.

And I would remark on one reaction to that that causes us particular concerns, which has been some of the steps that has resulted in some retailization of the securities lending marketplace. Until recently, firms did not borrow from custodial customers, especially retail customers, because of the requirements of the SEC's customer protection rules tended to make this type of borrowing more inefficient.

But in the new environment, with the recent pullback in stock lending, firms are increasingly attempting to borrow from retail customers, who are seen as essentially the last large untapped source of additional securities. And since the customer protection rules never really contemplated this retailization, most of the rules around borrowing fully-paid securities from customers do not focus on any of the customer protection issues you would expect to be in place.

I think that raises a number of issues with respect to retail customers, including the loss of SIPC protection, the loss of voting rights, unfavorable tax treatment for payment in lieu of dividends, and just the general concerns with respect to potential conflicts in the part of brokers adopting those programs.

None of that is not to say that firms have not generally been responsive in trying to provide disclosures in those areas, but we do see that as sparking the need, and we are looking hard at the possibility of additional rulemaking in that area to ensure that firms understand their disclosure obligations.

I guess the second area, and certainly not novel from what you've heard today, that strikes us as one well deserving additional attention from a regulatory standpoint, is -- and I know that this is not new from what has been said today -- that this area continues to not be currently regulated like a marketplace, but today continues to be treated -- and as noted before, thought of with respect to many of the participants, --- although perhaps not with respect to many others -- as an operational function.

That results in -- that, in part, relates to the fact that each transaction is negotiated bilaterally, but done so without full transparency or participation of other market participants. Yet it seems to me that securities lending operates in a very similar way to OTC securities markets, with the price albeit not necessarily the only relevant piece of information, but the price still remaining the rebate for a stock.

And in the situation particularly where the stock is hard to borrow, the availability and the lack of availability of this information, I would suggest, does cause real risk for -- at a minimum -- bad decisions being made by investors.

It does seem to me, therefore, that there would be a great deal of value in stepping back in a variety of other areas to try to rethink on the model and ask whether the types of questions that the Commission and we at FINRA traditionally worry about with respect to organized marketplaces, don't have some substantially greater relevance to how this market works today.

I think that's particularly true in a world today, given the -- well, it may loosen up again -- an environment where firms can no longer rely solely on finders to bring them buyers for borrowed stock, and an environment where there are retail participants which has largely existed through unpublished rates, and a lack of transparent dealings between counterparties, it does not create an efficient, transparent model for persons to evaluate value in the securities lending marketplace.

It's always been my belief that when market participants have knowledge of supply, demand and related pricing in an open market, the cost of financing will be set by the demand-and-supply equilibrium, and the market will operate more efficiently.

In light of that, I think we'd suggest that regulators, at least, and particularly from the SEC standpoint, should look closely at the value of taking steps to increase security market lending transparency. Certainly with respect to the over-the-counter market generally, one way to have done that has been to cautiously approach things from the standpoint of trade reporting or information reporting, one way or another.

But also, I think important to note, that as market participants have become more aware of some of the market efficiencies, electronic markets have begun matching borrowers and lenders, and that provides both transparency and opportunity for the market to operate efficiently and a reduced risk from the standpoint of counterparties, all of which strikes us as a value certainly to consider in how this market moves forward.

In addition to improving transparency, I think we need to collectively look back and ask how we oversight this market. In marketplaces generally you use market surveillance to oversight markets, you don't use strictly examination tools and the like. And the question, if there were more valuable information, how effectively to identify situations where a customer may not have received a good price or where may not have received the type of disclosure, again strikes me as something that is worth thinking about.

And then finally, as I indicated before, with our concerns with respect to the retailization market, we believe that to better protect investors we should institute protections for non-institutional retail customers who participate in the market, somewhat similar to a suitability requirement. And we will be proposing a rule that would provide structure around fully-paid lending.

So again, I thank you very much for the chance to be here today, and I look very much forward to hearing the insights of the other panelists.

MR. BRIGAGLIANO: Thank you, Rick. John.

MR. NAGEL: On behalf of Citadel Investment Group, I'd like to thank the Commission and the staff for the opportunity to be here today. At Citadel, we have over 19 years of experience as an active securities lending market participant.

And to support our private fund and market making businesses, we've built infrastructure that allow us to deal directly with the primary sources of securities loans, supply and demand, rather than rely entirely on intermediaries. Based on this experience, we believe that a well-functioning securities-lending market benefits all investors.

Owners of securities can generate additional income or obtain financing by lending securities. Securities lending also contributes to tight bid-offer spreads and market liquidity by enabling the orderly settlement of short sales.

At the Commission's May Short Sale Roundtable, I explained Citadel's view that short selling benefits all investors and our economy by promoting liquidity and price discovery, and serving as a risk management tool for investors.

While the securities lending market has made great strides in recent years, we believe there is still substantial work to be done before the securities lending market can reach its full potential. Despite its growing size, the securities lending market remains relatively opaque because there is little centralized collection or dissemination of loan pricing data.

Many securities loans are still bilaterally negotiated between market intermediaries on the phone or by email and each party to a securities loan generally faces the credit risk of the other party for the duration of the loan. Until recently, no centralized venue existed where borrowers and lenders could readily find each other and transact directly.

In many respects, these challenges are analogous to the challenges facing the over-the-counter derivatives markets. We applaud the Commission's efforts to increase transparency -- the transparency and efficiency of the OTC derivatives markets and encourage the central clearing of standardized derivatives contracts.

Similar considerations apply in the securities lending markets where central counterparties could reduce bilateral credit risk and foster rigorous and consistent risk management practices. The development of electronic trading platforms for securities lending is also important and may lead to similar increases in transparency and reductions in transaction costs.

Experience shows that centralized markets are more competitive and greater competition makes markets more efficient. The securities lending market is in an important part of our capital markets. The Commission should encourage the modernization of the securities lending market and enable more direct interaction between borrowers and lenders. This would reduce the cost of borrowing, increase returns to securities lenders, increase market transparency, and reduce the overall risks of securities lending. Thank you.

MR. BRIGAGLIANO: Thank you, John. Mark.

MR. FAULKNER: Thanks very much. On behalf of Data Explorers, I'd like to thank the Chairman, the SEC and the staff for inviting us to address you today. I think this roundtable and tomorrow's is going to be hopefully a very useful source of opinion and comment on these very important markets.

I'm Mark Faulkner. I'm the Founder and the Head of

Innovation at Data Explorers. Data Explorers is a privately held company that for many years has been gathering OTC data on the securities lending markets and making that available to a global client base ranging from issuers, investors, agents, principals and hedge funds. The volume of the data we gather has peaked in the past, but is now around about $11 trillion worth of information gathered daily available for loan, representing 120,000 securities. Today the balance is around about $2 trillion out on loan, about 45,000 securities there. This information represents the holdings and lending activity of about 22,000 funds on a global basis.

The securities lending business, as you've heard earlier on today, and I'm sure you'll hear again tomorrow, plays a pivotal part in the liquidity and efficiency of the capital markets. Without it, prices would be wider and positions less liquid, to the detriment of investors.

Securities lending balances today are in excess of $2 trillion. The industry generates, we estimate, about $15 billion per annum for the 25,000 or so funds actively lending inventory through the marketplace -- quite an important number, quite a significant number, and not including the premium charged -- very reasonable premium we heard yesterday, or earlier on from Shawn, charged by prime brokers to the hedge funds. I'm sure John would agree.

The securities lending balances today are about 50 percent below their peak, which was reached in May of 2008. We believe that looking at the conditions in the market, it might take three to five years for those balances to be reached again.

We would encourage this regulator and regulators around the world caution with regard to over-regulating the activity, which has really dramatically self-adjusted in light of the scale of leverage and activity in the financial markets globally.

Recent history does suggest that regulation made in haste is regretted at leisure, as you're outgoing Chairman would have acknowledged during his "greatest regret" interview, Madam Chair.

With justification, the U.S. government has been and may still be the largest securities lender in the world, and how they withdraw from this market and how they do that could be quite an interesting challenge for the markets to address, both in repo and securities lending terms.

Securities lending can be an excellent proxy for short selling activity, and it's very important, however, as you've distinguished between these two different roundtables, securities lending is not short selling and short selling is not securities lending. There might be no need or some need to regulate more or less both or neither or one of these activities.

Investors globally do benefit from making well-informed decisions, and short-side intelligence is an important information tool for them. Madam Chairman, you asked earlier, I believe, a question along the lines of, since specials may be trading so expensively, to what extent might asset managers choose to buy specials to benefit from the increased income that they might derive by lending them. I think the answer to that question is, it's highly unlikely that they would do so. If you do believe the academic research, the short-selling community is quite well informed, and as they develop a short sale position, they tend to benefit from that economically. So, yes, you might benefit by lending, but I think it's unlikely that investors buy specials to benefit from lending them.

However, I think it's very important that they do understand what's going on in the short side of the market, as well as they do, perhaps, in the long side of the market. Anthony Bolton, President of Fidelity International, writing in July in the FT, said that regulators should recognize the skill with which some hedge funds read the approaching disaster last year and try to learn something from them. The best hedge funds, and I'm lucky to be joined on the panel with two of them, represent a body of well-informed investors who have done extensive work on the risks of both individual companies and the financial systems as a whole. We can learn from this community.

So what lessons have we learned? Well, I think we can say looking forward that the institutions of the world will be focusing more on risk and risk-adjusted returns from their securities lending programs, not just how much money they might be making.

Regulators should actively encourage investors and participants to share risk and return information and to quantify and understand the risk positions better. Reporting really does need to improve in the area in securities lending, and we welcome some of the initiatives there.

Recent realized and unrealized losses have predominantly come from cash reinvestment, not securities lending. Securities lending is a term sometimes unintentionally used as a collective noun. Securities lending is one transaction, cash reinvestment is another. It is important not to combine these two distinctly different activities under one banner.

For example, in Europe and Canada, and elsewhere in the world, much of securities lending market does not involve cash collateral or a reinvestment at all, and these lenders have typically avoided large losses in the recent times.

Counterpart risk, as the Lehman Brothers default demonstrated, has typically been well managed by the securities lending. I won't sort of go over the last panel, but legal agreements, positive margins, tri-party services, collateral diversification, independent mark to markets have insulated the classic securities lending side of the equation. It's important to consider counterpart risk in its proper context. It is possible that it's possibly been overemphasized by some at the moment.

An open-mindedness from regulators around the world towards collateral flexibility might help, and it certainly might help the U.S. avoid past expensive mistakes. By encouraging a regime in which cash has been the predominant form of collateral, the U.S. regulators have inadvertently encouraged many practitioners to build cash balances, which in turn have driven earnings in the good times and losses in the bad times.

This encouragement has distorted behavior to the potential detriment of all investors engaged in this activity, many of them -- as we heard this morning -- who were unfortunately not able to understand the risks being taken in their name.

Lending cross-subsidization between investors is another issue that the regulators might want to look at -- inter and intra-fund family lending. Cross-subsidization has crept in to many business models and become almost unavoidable. Volume lending, to the extent that it still exists, has led in some circumstances to an inefficient allocation of business balances, cash risk and return.

The securities lending industry, in common with many areas of financial markets, has historically exhibited far too much dependency upon the rating agencies. Madam Chairman, we welcome your interest in the rating agencies and expect new business models to develop over time. We really think that the people selling the risk shouldn't pick up the tab, the people owning and buying the risk should be picking up the tab. We welcome your initiative in that area.

One further thing to say about the work that's been done by the Federal Reserve, the juxtapositioning of many bundled services within one might call super banks is concerning us. Custody, clearance, tri-party, collateral management, securities lending, prime brokerage, repo, cash management and execution have created many -- very few organizations that may be viewed as too big to fail, but because they have so much information and so much access to what's going on in the market, they're not going to fail, they know too much to fail. We think that potentially there are significant conflict of interest issues here.

In the future, potentially there should be a greater role for independent utilities and exchanges or some non-transactional participants in areas such as clearance, custody, reporting, exchange, et cetera, et cetera.

With the above in mind, the diversification of counterparts and independent collateral processes and providers rather than a concentration of services limited to a small number of super banks might be the preferable outcome.

In summary, securities lending is an integral part of the capital markets, and not just about the support of short selling. There is a significant amount of transparency available to investors, practitioners and regulators already regarding securities lending and short selling. However, if there was one area that requires focus from all participants, including the regulators, it is cash collateral. That's where the risks have arisen and manifested themselves to the significant detriment of investors.

You asked earlier, Madam Chairman, where would you focus, what would be the major area of concern? That's the one to focus on. Thank you very much.

MR. BRIGAGLIANO: Thank you, Mark. Questions from the Commission?

CHAIRMAN SCHAPIRO: Thanks, Jamie. Thank you all very much. This issue of cash versus non-cash collateral really, I think, is very interesting to us. And since the non-cash collateral hasn't brought with it the same kinds of problems that we've had with cash reinvestment, do any of you see a trend in the U.S. towards the European model of non-cash collateral?

MR. FAULKNER: I think to the extent that -- it depends who you're asking. If you're asking the borrowers, they'd very much like that to be the case, because they typically happen to be long inventory that they'd like to, for want of a better of word, recycle as collateral.

To the extent that some of the owners of assets, because of their regulatory environment, are unable to take non-cash collateral, and perhaps be able to take equities -- there's a limitation at the moment -- but I think it would be welcomed by the market. There are independent tri-party providers that can support this activity on a global basis, they do so already, and I think it would be a very beneficial trend if it were to be adopted.

The data in America -- our data in Europe is somewhat misleading, because people can point to an increase in cash collateralization in the grandest terms in Europe over recent years. We would argue that that data is slightly misleading in that it probably points to the success of the exporting of the U.S. global custodian cash reinvestment model, and that the indigenous European business has been somewhat swamped by the bubble, if you like, of the exporting of the U.S. cash model.

So the answer to the question is, I think it would be a very positive development if it were to be able -- if the market here were to be able to take more securities as collateral.

COMMISSIONER WALTER: And what do you see as the countervailing disadvantages or risks to moving in that direction?

MR. FAULKNER: Ignorance, as always; taking one big position; lending bonds and taking one equity, those types of things. But quite a lot of the issues have been worked out. It's not all good news in Europe. There were people that lost money in Europe, and what they tended to lose money on was a trade that I think Kathy Rulong was talking about earlier on, which was the sort of collateral upgrade transaction, which was basically lending Lehman Brothers bonds and taking equities as collateral, which really didn't work.

MR. NELSON: If I could just chime in on the question of the move or non-move of the U.S. market to non-cash collateral. We haven't seen an appreciable move in that direction, however we're still sort of in the aftermath, and actually the effects of the impairment of the cash collateral pools has not ended yet.

And in fact, what was alluded to this morning, in the first panel, is that there has been as a result of the -- some of the paper in these cash collateral pools, there was a real desire on the part of the cash managers not to have to liquidate investments in those pools.

So various arrangements were put into place to allow the cash managers to maintain stable cash balances. And if this market is going to move to a more non-cash collateralized balance, it's going to come when those cash collateral pools have all worked out their issues, they're fully liquid, they've been wound down. And we do believe that there would be increased interest by beneficial owners in receiving non-cash collateral.

Being able to provide equities as collateral would be something that the broker dealer community would be in favor of generally. Treasuries, at some points in time, are extremely expensive for us to borrow, so it pushes us in the direction of providing cash. To the extent that we have a broad range of non-cash collateral options, which would still be marked to the market everyday, and subject to the same risk control, we think it would be a benefit both to the broker dealers and the beneficial owners.

CHAIRMAN SCHAPIRO: Les, short of moving from cash to non-cash collateral, are you seeing other -- are you seeing changes in the composition of cash collateral pools now?

MR. NELSON: Well, we don't necessarily have a lot of visibility into the specific investments. What we are seeing -- because the phenomenon that we experienced 6 to 12 months ago was that the rebate rates being paid on easy-to-borrow securities were extremely high, and that was reflective of the fact that the agents wanted to maintain the balances and were competing for the balances with broker dealers so they would not have to liquidate securities in their pool.

The best data point that we have that these collateral pools are working themselves out is there's been a dramatic decrease in that rebate rate that's being paid on easy-to-borrow securities.

MR. FAULKNER: Can I just make a comment about the portion of the collective noun securities lending revenue that's generated from cash and from non-cash. At times, as I believe one of the panelists observed earlier on, in the recent past most securities lending on a global basis was being done for nothing, because as Les suggested, so high were the rebates being paid to hold on to the cash that we ended up with a situation where lending wasn't profitable at all, if you looked at the lending -- the intrinsic value -- for many people, for many organizations, because of the, sort of -- for want of a better word -- cross-subsidization between above- and below-the-line profits, above being the reinvestment profitability and below being the intrinsic value.

I think it's also important to say that there are many different kinds of securities lending programs. Just as asset managers have different styles and follow different markets and different capabilities, you can do business with organizations that focus almost entirely if not entirely on the lending fee, the intrinsic value of lending assets, have smaller balances, smaller utilizations, but may do very well at getting the right price for the securities which they're lending.

There are other styles of lending where it's more about volume, it's about generating cash returns in addition to securities-lending returns. Sometimes those different strategies aren't well articulated and are bought by people that don't necessarily understand where the money is being made, how it's being made and how the different strategy impacts their risk profile. Just another argument that backs up many of the people's arguments today that this should be an asset management activity not a back-office activity.

To go one step further, why do mutual fund managers typically -- have they done better than pension fund managers -- because they're asset managers, it's what they do. It's more of a -- it's closer to the front office than the back office. It's what they do.

COMMISSIONER PAREDES: One of the points, if I heard correctly, earlier, Mark, you had mentioned was the extent of self-adjustment taking place -- I think it was the phrase that I'd heard. If you could just maybe share -- and maybe the rest of the panelists, as well -- what some of the self-adjustments are that you've seen, and those that you anticipate that perhaps haven't come to pass yet but that folks are considering or that discussions are underway with respect to, all which gets at the question of, even if there's not a regulatory change ultimately in any respect, what's the industry going to look like in the future given the lessons learned from the past?

MR. FAULKNER: Well, if I could kick this one off. I think maybe John might be able to talk a little more from a hedge fund demand side of the business. What I'm really suggesting is that in a world which deleveraged, in a world which several funds didn't make it, in a world where capital and balance sheet were being more properly or highly priced, positions shrank. Securities lending is often a hedge for a long position, which weren't being put on, so they therefore didn't put the short on. Businesses shrank. There were fewer new issues. There was a time when there were virtually no restructurings other than sort of fire sales of companies in desperate trouble, and people weren't taking positions.

And so we've seen the world become, for want of a better, a smaller place, which I think is right-sized, for want of a better word. I'm certainly adapting to being on this side of the Atlantic by using that term.

The other thing to say is, the investment performance of the capital markets, and equities in particular, has shown this world to be a less-short place. The average hedge fund is net long, not short, and that's good news, because they might be making a little bit of money now.

So basically, in line with the market conditions, the securities lending business has adjusted. And also the short-term regulations have encouraged people to really think twice about getting short in the past, and that's what's been happening. John, I don't know if you've got --

MR. NAGEL: I certainly agree. I mean, I would say we've seen an intense focus throughout the industry on liquidity risk and credit risk, which I think until the last couple of years people paid a lot less attention to. And in terms of -- we certainly don't have the issue of the cash reinvestment program, but we certainly read the reports of what happened.

I can tell you, we've always focused a great deal on modeling liquidity risk and modeling the credit risk of counterparties, and I think from one end of the industry to the other, that's become an area of focus. And we think those lessons have been valuable, although very painful.

As I mentioned in my opening remarks, we do think that a central counterparty, which now exists in -- the

Options Clearing Corporation offers a central clearing counterparty solution. We think that offers a -- it's one option. I'm certainly not arguing that that should be the only available way to transact securities loan -- everything shouldn't be centrally cleared -- but we're happy to see -- with a central clearing counterparty you have consistent risk management practices, consistent credit practices.

And one of the benefits of that is that we saw in the crisis last year, whether it was because of rumors or because of concerns real or sometimes not real, credit lines would get pulled -- either everybody pulls credit lines from everybody or everybody pulls credit lines from one particular market participant, and with a central counterparty, it's a more consistent framework at a predictable process, so we don't have this kind of volatility, I would call it, in terms of lines being pulled and creating disruptions.

MR. KETCHUM: the only thing I'd really add to that -- that was a great point -- is that having the regrettable feature of age and having gone through this since Latin American bank crises in the '70s through the crash in LTCM and a variety of other things, the world tends to focus on becoming more liquid and less leveraged after crises pretty well.

Now, none of us have lived through this type of crises, and I do believe that much will be learned, certainly with respect to the business of securities lending, where participants didn't focus nearly to the degree they should have on risk, though I would probably save my concern -- my conclusion that the world is a less-short, less-leveraged place to the next time we go through a 10-year bull market and check it then.

And in between I would just recognize the important points that those who know far more than I do here, which is that in between there will be a great pressure to find stock, and that means both that -- as I indicated before -- there will be an effort to turn over every frontier where the securities is available -- with respect to people who may be less rather than more sophisticated, have learned less rather than more lessons with regard to it -- and the other piece is, it is a great thing to recognize and an important thing to recognize that the separate transactions of reinvestment create meaningful risk that have cost people a lot.

And, personally, from a FINRA standpoint or my own personal one, I think firms are exceptionally capable of managing the risk with respect to equity collateral, and probably should be considered, but I don't think we should consider ourselves if the risk that were described there really do exist. And when you move from a cash reinvestment risk to a management of concentration positions and equities, firms that have not been doing this on this side of the pond, as opposed to Europe, need to rethink their supervisory provisions and how they basically look at the business if they're going to do it successfully.

CHAIRMAN SCHAPIRO: Rick, would you think that given the -- which is a little frightening -- retailization of securities lending and the increasing role of unregistered finders who may or may not be honest brokers in this process, given those two events, would you think that a central counterparty kind of structure that the last panel talked about -- I don't know if you had the ability to hear that -- would be an investor protection as opposed to a systemic risk protection feature?

MR. KETCHUM: Well, I start generally with a strong belief in the value of central counterparties. I think points made in the last panel with respect to the more diffuse nature of this and perhaps less systemic risk strike me as generally right, although I note they basically were saying don't worry, as long as the market goes down, we're fine, but markets can also spike up and people can be exposed the other way and go broke.

But I do think, yes -- the short answer would be it does seem to me that both from a transparency and a systemic risk standpoint that there is a significant benefit to such systems, or at least creating an environment where there aren't barriers to those systems and where there are appropriate incentives and persons who participate in them are appropriately rewarded from recognizing that they operate in that environment. And I think all those things are usually, and I would think here, great public policy tools.

MR. FAULKNER: Could I just say, this idea that some guy sitting in his boxers in his bedroom can find stock better than a regulated broker dealer should be something that you should stop letting regulated firms do. The idea that finders are necessary for the efficient operating of a market is completely misguided, and I think that they should be -- that one of the things that you might want to consider is prohibiting regulated firms from using the services of unregulated finders. I just don't see what value they add, and I see no need for them to be part of the market structure.

On a second point --

MR. KETCHUM: If I can -- I really endorse that, at a minimum, if there are finders -- I don't tend to question whether a business model may or may not have value, but if there are finders, I see no reason why they don't need to be registered broker dealers.

MR. FAULKNER: And if anyone is watching on the Web, my name is John Smith from Ohio. (Laughter.) And the other thing, on the retailization of the marketplace, I think that just proves to the fact that broker dealers with margin lending boxes and that capability and that potential source of supply have looked at that as being a better, more stable, higher -- a better economic source of inventory, perhaps, in recent times than in the past.

And they've been resistant to putting balances with lending agents, that perhaps they didn't feel they needed to, they actually wanted to borrow easy stock and difficult stock from the retail boxes that they have in place. To the extent that there might be need to be some more scrutiny of that activity, I'm not in a position to comment, but I think that's the explanation, is that if you've got the inventory available within your margin lending business and you don't necessarily want to put that balance out on the street, if you like, that's where people have been looking to do that -- do more business of that kind.

MR. NELSON: Mark, let me -- there's a difference, though, between utilizing customer margin securities in a rehypothecation structure than there is to borrowing fully-paid-for securities. I think we do some of that borrowing of fully-paid-for securities, and I don't think our attorneys have been -- have actually been -- our attorneys have been more concerned about that, have applied the same customer protection rules and other elements of the market to that activity. Maybe they were looking into the future.

But I think there's a well-established regulatory framework that says that when you're borrowing from a non-broker dealer you have to do the things that 15c3-3 requires you to do. You have to collateralize them at least at 100 percent, you have to self mark -- you don't wait for them to issue the mark. If you owe them collateral, you give them collateral. You have to give them a statement of what it is that they're lending to you. You have to discuss with them what the fee is going to be. You have to give them the appropriate reporting.

So it actually is quite -- I think the regulations are quite explicit in terms of what it is we need to do, including things like not being able to deliver securities lending collateral directly to their brokerage account. You have to deliver that collateral away. So in fact the standards that I think exist within the current regulations are quite strict with respect to what it is we need to do when we borrow from one of our retail or private wealth management clients.

MR. DONOHUE: Les, this is probably a question for you, but John you may know. I don't know the answer on this. This is why I'm going to ask the question. I was always -- my experience has always been on the side that's lending, not the side that's borrowing. In light of what happened with some of the lenders and their utilization of the cash collateral, are the borrowers starting to put limits on what the lenders can do with the cash collateral when they get it? Is it something you're starting to worry about?

MR. NELSON: I guess we worry about it in the background. However, the securities lending contracts are quite clear with respect to who bears liability for that investment. And it really is -- and it was pointed out this morning by the agents -- that it is, in fact, the beneficial owner that's lending securities that has the authority to direct the cash collateral manager with respect to the collateral reinvestment criteria and the acceptable instruments and so forth that bears the risk.

So we believe that's a well-established legal principle, but we are, I think, just more -- we've always been attentive to our counterparty risk. And in the wake of -- as a result of agency lending disclosure, where we have complete transparency within our credit groups as to who the principals are on the other side, I think our primary concern is credit exposure. The cash collateral reinvestment risk is really theirs to bear.

I think that when we are dealing with the large agent lenders, that concern is not as great as it might be if we're dealing with someone that's small in the market. A good counterpoint to that is when we borrow from our clients, our so-called retail clients, we rarely give them cash collateral. We give them, usually, U.S. Treasury securities, because they don't have the ability to manage a collateral reinvestment program and earn a return on that. So we remove that as a component of the transaction so that it is not an issue for us.

MR. DONOHUE: One of the reasons why I raised the question was that there is at least one example where an insurance company took the collateral and invested it in highly-illiquid securities, and then really lacked the ability to unwind the positions. I was just wondering how folks were dealing with that, or whether that was a one-off.

MR. NAGEL: I think -- I certainly agree in general, as a consumer of borrowers as we are, our focus is on credit risk. And in terms of dealing directly with the agent banks, our relationship and interactions are with the agent bank. And so it's really not our place to tell the ultimate lender what they can or can't do with any cash collateral we put up.

I would say, though, it is a very important part of this market to understand who your counterparty is, in terms of appreciating what the recall risk is, are you going to be able to get the stock -- if you borrow a stock, are you going to be able to keep that borrow on. And so those are the kinds of things we focus on. But in terms of collateral we put up, by contract, it's theirs to do with as they see fit, and we would see that in terms of the role of the agent bank or whoever is dealing with the ultimate lender of securities.

MR. FAULKNER: Given what's happened in recent time, they might benefit from some advice from the investment banking community. Could I just come back to a question -- I was reminded of something that was asked this morning, which I think is important, about borrowing shares and voting shares. And a question came up along the lines of, would it be possible for the lender to tell the borrower what to do with the shares if there was a vote coming up.

I think the question was meant to be sort of just lobbed up there for somebody to say something along the following lines, which was, you can't really do that, because the borrower doesn't have the shares; they've borrowed them for a purpose, to settle a transaction in the market, to do with a settlement, a hedge, an on-lend to somebody else. So they can't be told what to do with the shares because they don't have them anymore. And that was just, I think, an important point.

MR. NELSON: And I would just add that Reg T is quite clear in the United States that it is not a permitted purpose for us to borrow securities in order to permit non-owners to vote those shares.

And some of the activity that has been cited in academic studies about increase in borrowing activity, as a proxy record date is being approached, is really explainable by the fact that we -- when we rehypothecate customer securities, when it gets close to the date of a vote, we try to reduce to possession and control as many of those positions as possible so our clients can vote. So there would be -- we would be replacing rehypothecation of customer securities with explicit borrowers.

A contributing factor generating volume at that point in time are the beneficial owner clients of the agent lenders that have directed their agent to get securities back so they can vote them. We get a recall, we have to go out and find some other source to borrow it. So there would be an uptick in the level of borrowing activity.

That has been explained in some academic papers as a vote manipulation scheme or Exhibit A, but in fact has nothing to do with that and just has to do with trying to give the owners the rights to vote, because it is clear in Reg T that we only can borrow securities if we have a delivery. And a broker dealer, the way it controls votes is it allocates votes based on ownership and the ownership of shares on its records and how many shares it has in its possession. And it does not have the ability -- we do not give voting rights to non-owners as a result of having excess securities in the box.

MR. FAULKNER: And just to add that nobody likes surprises in the financial world. Borrowers don't like being recalled when they may have been indicated to them that the stock was stable and not callable for voting purposes.

So there are economic consequences of regularly calling securities back. Callable stock is less attractive and earns less money in the lending market. I was very surprised to hear that people were put under specific pressure and almost threatened when they recalled stock to vote. But it's not at all surprising to me that there is a different price which to be paid for what is effectively more callable securities.

Very often when a recall happens at late notice, it can get very expensive for the borrower or the person that's shorted that security, and they're under tremendous economic pressure. But it's not forgivable for them to sort of force that back through to the lender.

On the note of the ICGN's call for clearer understanding and more explicit pre-advice of voting information, and what might be a sensitive issue to facilitate less surprising recalls, I think that's a fantastic idea. And also the idea of perhaps moving voting -- removing voting and dividend payments from one another is an extremely positive suggestion which we would endorse, too.

CHAIRMAN SCHAPIRO: Do any of you have a sense of how well the recall mechanics work, and the extent to which there are recalls for votes? We got lots of different information this morning, but I didn't come away with a clear sense of this is a frequent thing that stock is recalled for voting purposes.

MR. NELSON: Well, I would say, Chairman Schapiro, that it's sometimes difficult for us to get the transparency, for want of a better word, as to why securities are being recalled. We understand, though, as a borrower, that -- as opposed to any other right with respect to a security -- one of the things that in a securities lending transaction contractually the borrower is making the lender whole with respect to any distributions on the securities on loan.

The right that we cannot manufacture is the right to vote. So we take very seriously a recall that we get when it's approaching record date for a vote or we're being told by the lender or the lending agent that the reason they're recalling the security is because they want to vote that security. And we try to then source supply from alternative supply sources in the market where they are intending not to vote. So we can't make the lender whole for the vote, so we really want to get it back if a lender wants it.

And I know of no -- and it was alluded to this morning -- retribution that borrowers exact towards or direct towards lenders that are recalling for the right to vote. We want them to participate in the market, and if they want to vote, we want to get the securities back to them for them to vote.

CHAIRMAN SCHAPIRO: And then do you -- does the lender bear the cost of your locating shares to get the vote back to them, or do you bear the cost?

MR. NELSON: No, we bear the cost of that.

MR. FAULKNER: It's also worth stressing there was a call, which is understandable, for more transparency between securities lending activity and stewardship activities within organizations. And I think, again, an excellent idea, but not one that a regulator needs to be getting involved in. This is about an IT decision. This is about data that's available daily to organizations that lend some portion of it, the appropriate portion of it, probably not who is borrowing it at what rate, but that certain amounts of securities are on loan and not in the depo, available for voting.

I think some of the stress that's been historically developing between corporate governance departments and securities lending departments has been the very significant loss of face when an organization has perhaps pledged to management their support on an important corporate issue, and then not being able to deliver that. And that's clearly made people feel very uncomfortable and angry and disappointed.

And the transparency that's been called for there is something that doesn't need any regulation, it just needs a little bit more wiring and better communication within organizations that lend.

MR. DONOHUE: Unfortunately, that's all the time that we have today. I'd like to thank all of our panelists and the Commissioners for the entire day. We certainly have a lot to consider going forward, and I'd now like to turn the for over to Chairman Schapiro for closing remarks.

CHAIRMAN SCHAPIRO: Thank you, Buddy, Jamie and Henry, who was with us this morning, for your great work in moderating our panel discussions today. As I begin these very brief closing remarks, I first want to extend my sincere thanks and those of my colleagues to our distinguished panelists, those up on the stage right now, but throughout the day.

We do appreciate your willingness to take time from your busy schedules to join us for what has been a substantive and I think highly-informed discussion of very important issues. We appreciate that so many of you traveled to Washington -- some, like Mark, from very considerable distances in order to be with us today.

And I also want to thank my colleagues on the Commission and also Commissioner Aguilar, who is joining us from cyberspace, for participating today.

The Commission is charged with protecting investors from potential abuses and manipulation while ensuring that the regulations governing the securities markets promote efficiency, liquidity and capital formation. And this charge really serves as the foundation of our assessment of securities lending.

We're committed to closely reviewing the benefits and pitfalls of securities lending, and I do think that today's very candid discussion of often very differing viewpoints will be really instrumental in informing our consideration of the securities lending market and our assessment of whether changes can be made to enhance investor protection.

We really are so fortunate to have been able to gather such a distinguished and varied group of professionals who have provided insights and recommendations in the areas of securities lending, and we do look forward to tomorrow's panels as well.

Before we conclude, I do want to thank the staff, members of the SEC, who really made this possible. There are countless professionals who worked behind the scenes on this roundtable to do everything from posting website materials to preparing signs and setting up the stage, and even greeting the panelists and guests as you arrived this morning. And we do appreciate all of their efforts.

I would like to specifically acknowledge the core team of people who have devoted very substantial time, energy and effort to creating this informative roundtable. Liz Sandoe, Ned Rubenstein, Doug Scheidt, David Bloom, Jeff Dinwoodie, Katrina Wilson, Andrea Orr, Tory Crane and Josephine Tao. So thank you all very much from your hard work, and once again, thank you so much to all our panelists for your significant contributions today.

Thank you.

(Whereupon, at 3:59 p.m., the roundtable was adjourned.)

PROOFREADER'S CERTIFICATE

In the Matter of: SECURITIES LENDING & SHORT SALE
Witness: Roundtable
File Number: N/A
Date: Tuesday, September 29, 2009
Location: Washington, District of Columbia

This is to certify that I, Don R. Jennings (the undersigned), do hereby swear and affirm that the attached proceedings before the U.S. Securities and Exchange Commission were held according to the record and that this is the original, complete, true and accurate transcript that has been compared to the reporting or recording accomplished at the hearing.

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REPORTER'S CERTIFICATE

I, Jon Hundley, reporter, hereby certify that the foregoing transcript of 207 pages is a complete, true and accurate transcript of the testimony indicated, held on September 29, 2009, at 9:36 a.m. in the matter of: Securities Lending and Short Sale Roundtable.

I further certify that this proceeding was recorded by me, and that the foregoing transcript has been prepared under my direction.

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