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January 14, 2013

Via Electronic Submission

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Consultative Document on Strengthening Oversight and Regulation of Shadow Banking

Ladies and Gentlemen:

The Committee on Securities Lending of the Risk Management Association (the "Committee")[1] welcomes the opportunity to submit this letter to the Financial Stability Board (the "FSB") on behalf of several of its members, including The Bank of New York Mellon Corporation, BlackRock, Citigroup, Northern Trust Company, State Street Corporation and other financial institutions that are significant participants in the agency securities lending markets.

[1] The Committee acts as a liaison for Risk Management Association ("RMA") member institutions involved in agent lending functions within the securities lending industry, by providing products and services including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

This letter will address issues raised by the FSB's consultative document, *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (the "Consultative Document").[2] Section I of this letter addresses issues relating to reporting, disclosure and transparency, Section II addresses minimum haircuts, Section III addresses reinvestment of cash collateral, Section IV addresses collateral valuation standards and Section V addresses re-hypothecation. Appendix A lists the questions that the FSB poses in the Consultative Document, and cross-references the portions of the letter that address these questions. This letter is written from the perspective of members' agency role in the securities lending markets, and thus, our comments are directed primarily towards U.S. agents involved in securities lending activities on behalf of clients located in various jurisdictions, including the U.S., Canada, Europe, the Middle East, Southeast Asia and Australia. Although the letter addresses reverse repurchase agreements ("reverse repos") in certain specific instances, our comments generally should not be taken to apply to repurchase agreement ("repo") or reverse repo activities, unless otherwise stated explicitly.

We appreciate the opportunity to comment on the Consultative Document. It is evident that the FSB has undertaken a thorough analysis of the securities lending market in both the Consultative Document and its previous interim report,[3] and we commend the FSB for these efforts. Effective analysis of these important issues will require significant additional dialogue with market participants, and we stand ready to assist the FSB and other authorities in these efforts. We have a manifest interest in a financial system that is more stable and less susceptible to shocks, and we look forward to continued engagement with the FSB to achieve this objective.

As the FSB continues its analysis, we request that it remain cognizant of the fact that securities lending is subject to significant regulation in the United States and Europe, both with respect to market participants and securities lending activities themselves. For example, and as discussed in detail in this letter, U.S. banking organizations engaging in agency securities lending do so subject to extensive regulatory oversight and guidance.[4] International regulatory initiatives, such as the Basel III capital framework, will subject agency securities lending to additional, more stringent capital requirements and disclosure-based regulation. Several ongoing regulatory reforms required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which we discuss in detail below, have enhanced (and will further enhance) U.S. regulation of agency securities lending. In Europe, the European Securities and Markets Authority ("ESMA") has promulgated guidelines ("ESMA Guidelines") for exchange-traded funds and Undertaking for Collective Investment in Transferrable Securities ("UCITS"),

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[2] FSB, Consultative Document, *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (Nov. 18, 2012), *available at* www.financialstabilityboard.org/publications/r_121118b.pdf.

[3] FSB, *Securities Lending and Repos: Market Overview and Financial Stability Issues* (Apr. 27, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120427.pdf.

[4] The Federal Financial Institutions Examination Council, which includes each of the U.S. Federal banking agencies, has promulgated a policy statement governing securities lending by U.S. banking organizations. *See* Revised Policy Statement on Securities Lending, 62 Fed. Reg. 38,991 (July 21, 1997).

which mandate disclosure, stress testing, haircut and term limitation requirements for securities lending, repo and reverse repo transactions.[5]

Moreover, because the underlying objective of agency securities lending is to provide relatively low-risk, incremental revenue to the lender, agency securities lending programs are generally conservative in focus and operation. Our members observed that cash collateral in agency securities lending transactions is almost always invested in relatively high-quality, low-risk assets, such as overnight repos collateralized by U.S. Treasuries or money market funds. Under market-standard securities borrowing and lending agreements, (i) lenders maintain a security interest in and lien on collateral provided by borrowers with a value in excess of the value of the loaned securities, usually by a margin of 2 to 10 percent, or (ii) title to collateral, including the margin amount, is transferred outright to the lender. Outstanding loans are marked to market on a daily basis to ensure that appropriate excess collateral is consistently maintained. In addition, under current market practice, agents provide both borrowers and lenders with extensive disclosures as part of securities lending programs.

As we discuss in this letter, agency securities lending practices have generally become <u>even more</u> conservative since the 2008 financial crisis. The overall quality of securities on loan has increased, and the average duration of loans has decreased. Importantly, since the financial crisis, RMA members have commonly observed lenders increasingly viewing securities lending activities as an investment function, rather than as a standalone operational function. As a result, the common practice among lenders is to utilize their investment and risk management functions to assess the risks inherent in even the most conservative securities lending strategies as part of an analysis of their overall risk profile.

Given these baseline regulatory and market practice frameworks, as well as the more conservative practices observed since the 2008 financial crisis, we suggest that the FSB and other authorities consider the sheer number of new (and existing) regulations that are imposed on the securities lending industry, and work to integrate its recommendations with these, rather than recommend changes that would impose additional burdens on agency securities lending activities. At a minimum, the FSB and other authorities should refrain from recommending the imposition of additional material burdens on agency securities lending activities that are not integrated with the various regulatory reforms already underway (*e.g.*, enhanced disclosure requirements and implementation of the Basel III capital framework).

As the regulatory reform process continues, we stand ready to engage in dialogue with the FSB and other authorities as they continue to analyze agency securities lending, and the securities lending, repo and reverse repo markets as a whole.

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[5] *See* ESMA, *Guidelines for competent authorities and UCITS management companies: Guidelines on ETFs and other UCITS issues* (Dec. 18, 2012).

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I. Reporting, Disclosure and Transparency

Committee members are key participants in agency securities lending. As such, we are well-positioned to offer comments on reporting, disclosure and transparency-related issues arising in these markets. We look forward to continued collaboration and dialogue with the FSB and other authorities as they continue to analyze and consider these important issues.[6]

We support efforts to ensure that there is sufficient and appropriate transparency regarding securities lending activities made available to regulators and stakeholders, and support continued analysis of transparency-related issues. We urge the FSB, however, to carefully consider the substantial amount of existing transparency when developing its recommendations.[7]

To the extent the FSB concludes that any enhanced transparency regime is deemed necessary to detect and/or monitor systemic risks that could potentially be exacerbated by securities lending activities, we suggest that such a regime:

- take into account changes that are taking place in other contexts (*e.g.*, changes in accounting standards and regulatory reforms impacting securities lending);
- not create a competitive disadvantage for particular categories or classes of institutions, *i.e.* ensure a "level playing field";
- be operationally practical and not impose inordinately high compliance or administrative costs relative to perceived potential benefits; and
- protect the confidentiality of sensitive business information and confidential client information to the greatest extent possible.

A. Data Collection and Market Transparency

The Consultative Document discusses what market data authorities would find helpful to monitor the size and risk characteristics of the securities lending market. To that end, Box 1 of the Consultative Document lists data fields that market participants could potentially be obligated to report to authorities in order for such monitoring to take place. Box 1 appears to contemplate *inter alia* that as part of this enhanced reporting regime, market participants would report transaction-level data to Trade Repositories ("TRs").

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[6] The RMA does not represent end-borrowers and its members do not have direct visibility of the factors that drive demand for particular securities, or how securities are ultimately used by borrowers. Since we are not in the best position to address the perspectives of end-borrowers, we have elected not to do so. We respectfully request that our comments be considered in this light.

[7] To illustrate the transparency regarding securities lending activities already existing in the industry, we have attached as Appendix C an RMA letter to the Securities and Exchange Commission (the "SEC") describing existing best practices in transparency by securities lending agents.

As noted above, we believe the FSB should remain cognizant of the substantial amount of transparency that already exists in the securities lending market. If regulators conclude that an enhanced reporting regime is required, we believe that the underlying objective of such a regime, namely, whether and to what extent securities lending activities contribute to systemic risk, would be better achieved through position- (or exposure-) based reporting directly to regulators on a periodic basis, rather than via transaction reporting to a TR.[8]

"Position" (or "exposure") reporting refers to the reporting of settled, confirmed and open transactions, as opposed to pre-settlement/confirmation data provided under a transaction reporting regime. Given the open-ended nature of securities lending transactions, in which securities loans can remain outstanding for days, weeks or months, but for which the rates and valuations fluctuate on a daily basis, position reporting would provide more meaningful and relevant data to regulators regarding the securities lending market and the risks posed to individual participants and the markets more broadly.

Transaction reporting, on the other hand, would only capture the initiation of new loans and the termination of existing loans, which represents a fraction of overall securities lending activity. Transaction reporting would likely also provide excessively granular, and in certain cases, misleading data (*e.g.*, transaction-based reporting could reflect transactions which ultimately don't settle or the terms of which subsequently change). In contrast, an exposure-level reporting regime could likely be implemented in a more cost-effective manner. Indeed, because transaction data must be cleansed and reconciled with information from the other participants in the transaction flow, transaction-level reporting to a TR would be potentially costly, time-consuming and operationally burdensome as compared to exposure-based reporting.

Market participants already provide exposure data to third-party vendors as part of their normal-course activities, and these vendor relationships could be leveraged to create an exposure reporting system without the need to build a separate transaction reporting system. Indeed, the existence of these reporting systems evidences the potential usefulness of exposure data to market participants. For example, third-party vendors that currently receive exposure data from market participants include EquiLend, Markit, and SunGard, and market participants also provide the Depository Trust and Clearing Corporation with exposure data.

Appendix B lists the proposed information items for transaction- and firm-level disclosures listed in Box 1 of the Consultative Document, and our specific comments regarding certain of these proposed information items.

The Consultative Document also suggests that the collection and public dissemination of aggregated data on securities lending activities may be desirable. We question the utility of such an approach, given that much of this data is already provided to and aggregated by third-party

8 "Position" and "exposure" reporting are meant to be synonymous, *i.e.* both refer to reporting of settled and confirmed transactions, as opposed to pre-settlement/confirmation data provided under a transaction reporting regime.

vendors, who then disseminate it to market participants. Indeed, it is not clear how such approach would assist regulators or the public in analyzing potential systemic risks. Before recommending reporting of aggregate data, the FSB and other authorities should first focus on conducting a thorough and robust analysis of data already being reported by market participants.

B. Corporate Disclosures

The Consultative Document recommends that consideration be given to enhanced corporate disclosure requirements for financial institutions' securities lending, repo and collateral management activities. The FSB suggests specific disclosure items that could be part of such an enhanced disclosure regime, including counterparty concentration, maturity breakdown of trades and information on collateral margins.

As noted above, while we recognize and support the need for transparency, the FSB should be aware of the extensive rules that already govern this area from the Financial Accounting Standards Board ("FASB") for U.S. companies and the International Accounting Standards Board and International Financial Accounting Standards for global companies. In this regard, we understand that FASB intends to update the standards governing disclosure of securities lending transactions by publicly traded companies. In addition, the Basel III capital framework and ESMA Guidelines contemplate enhanced disclosures relating to securities lending and other activities. We strongly believe that any consideration of additional corporate disclosures for securities lending transactions take these deliberations into account and, if appropriate, defer to applicable financial accounting standard setting bodies as well as national regulatory authorities with responsibility for determining requisite corporate disclosures to stakeholders, such as the U.S. Department of Labor with respect to Employee Retirement Income Security Act ("ERISA") plans, so as to avoid unnecessarily duplicative analysis of the same issues. We also suggest that disclosures be tailored appropriately depending upon their usefulness to relevant stakeholders.

Three additional considerations should be taken into account when considering enhanced corporate disclosure requirements for securities lending. ***First***, enhanced corporate disclosure requirements should be subject to the same materiality standards that apply under current accounting standards, *i.e.* an enhanced reporting regime should not require disclosure of information that would not be considered sufficiently "material" to be disclosed under current standards. ***Second***, additional disclosure may not always be beneficial, and in certain contexts, may in fact be harmful or create market confusion. Materiality standards are but one example of rules based on the recognition that the desire for additional disclosure should be balanced against potential countervailing harms, including harms from "information overload" of excessive or excessively granular disclosure. ***Third***, enhanced corporate disclosures should be subject to cost-benefit analysis, so as to ensure that the administrative and compliance costs of gathering and reporting the additional information are not disproportionate to the potential benefits to relevant stakeholders.

C. Reporting by Fund Managers to End-Investors

The Consultative Document states that securities lending and repos are used extensively by funds, and that appropriate information on these activities should be disclosed by funds to investors "in order to allow those investors to select their investments with due consideration of the risks taken by fund managers."[9] To that end, the Consultative Document recommends that authorities review reporting requirements for funds to end-investors, and suggests specific items for such reporting.

Our previous statement regarding the need for a "level playing field" is particularly applicable to reporting by funds. Authorities should ensure that funds are not required to disclose specific information that could cause them competitive harm, *e.g.*, requiring a fund to disclose specific investment positions. It is also important for the FSB to consider the cumulative impact of various ongoing regulatory reform initiatives when issuing its recommendations. For example, the SEC intends to issue enhanced disclosure requirements for U.S.-based securities lenders under Section 984(b) of the Dodd-Frank Act, and, as noted, ESMA has issued enhanced disclosure requirements for UCITS funds that engage in securities lending. The latter proposal in particular contemplates disclosures that are more tapered than those suggested by the FSB. These changes, along with similar initiatives, will undoubtedly improve authorities' and investors' understanding of funds' securities lending activities. The FSB and other authorities should refrain from imposing new reporting requirements on fund managers until they have analyzed and internalized the information being reported pursuant to these ongoing reforms.

As with corporate disclosures, any additional changes to fund disclosure requirements should also take into account the materiality of disclosed information in the context of the other activities of the same fund. For example, it would be inappropriate for a fund to provide extensive disclosures regarding securities lending activities and risks if the activity only affected a small portion of the funds' assets or a small portion of the funds' risks. These disclosures should be considered in the context of consistency with disclosures surrounding other, more integral investment strategies, *e.g.* investing in fixed income vs. equity securities.

Finally, we note that when analyzing the costs and benefits of additional reporting by funds to end investors, consideration should be given to whether additional disclosure will be useful to the particular investor. As the FSB is aware, fund investors vary significantly in their sophistication and risk profile, and in certain cases (*e.g.*, pension funds), beneficiaries may not even control the ultimate investment decisions of the fund. Any enhanced reporting requirement for funds should account for these distinctions, and regimes that require unnecessary or duplicative disclosure should be avoided. In any event, boards of directors of funds that lend securities will very often have a fiduciary or other duty to perform due diligence with respect to agency securities lending programs, and directors' fulfillment of these duties will often require disclosure of material information to the fund and its investors.

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9 Consultative Document § 2.4.

II. Minimum Haircuts

We support the FSB's recommendation that there be a carve-out for cash collateralized transactions that are demand-driven. However, the RMA believes that it would be inappropriate to require minimum haircuts for agency securities lending and reverse repo transactions, regardless of whether they are collateralized by cash. Therefore, the RMA urges the FSB to expand the carve-out to also include any demand-driven securities lending or reverse repo transaction collateralized by liquid assets.

We explain the basis for our position below by first providing an overview of Committee members' current market and risk management practices with respect to agency securities lending and reverse repo activities. Second, we discuss regulatory reforms that are impacting or will impact these activities. Third, we discuss the implications of these current practices and reforms. As we discuss in detail below, current market risk management practices and regulatory reforms lead to the conclusion that it is neither necessary nor prudent to impose mandatory minimum haircuts on securities lending and reverse repo transactions at this time, and that such haircuts could potentially create market confusion and disruption.

A. Description of Current Market Practice: Securities Lending and Reverse Repos

Through securities lending programs, agents act as intermediaries to facilitate loans of securities on behalf of securities lenders to qualified borrowers. Securities are generally lent pursuant to a securities lending authorization agreement between the securities lender and the agent, and a securities borrowing agreement between the borrower and the agent acting on behalf of the securities lender. Pursuant to these agreements, the lender (and, directly or indirectly, the agent) has a security interest in and lien on, or outright title to, the collateral provided by the borrower in an amount in excess of the value of the loaned securities, usually by a margin of 2 percent to 10 percent, depending on the perceived risk of the loaned securities and the collateral (*e.g.*, U.S. or foreign sovereign obligations or equity securities). Collateral in securities lending transactions is marked to market daily to ensure that the value of collateral meets or exceeds the value of the underlying loan, and so that the borrower can quickly provide additional collateral if necessary.

As a matter of standard market practice and/or legal requirements imposed on the lender (market practice that has been further enhanced and reinforced in response to the crisis), agents often provide securities replacement guarantees, or indemnification for borrower default (which is typically defined by contract as the failure of the borrower to return the borrowed securities or to satisfy its obligation to deliver additional collateral to maintain the requisite amount of excess collateral) to the substantial majority of their lending clients pursuant to their securities lending authorization agreements. This practice is commonly referred to as "borrower default indemnification." Securities lending authorization agreements typically provide that lending clients are indemnified by the agents for any deficiencies in collateral in the event of borrower default. As discussed previously, because agency securities lending focuses on incremental revenue gains and risk minimization, lenders typically see securities replacement guarantees as providing both protection to their programs and a validation of the strength of agents' risk management systems. Moreover, many lenders are required under applicable law to receive borrower default indemnification by an agent in their securities lending program under defined circumstances.[10] In the experience of Committee members, the vast majority of certain classes of securities lenders mandate that agents provide borrower default indemnification, whether or not such indemnification is required by law or regulation.

Indemnifications provided in connection with agency securities lending transactions result in minimal actual exposure for agents. An agent's exposure is only the deficiency, if any, between the mark to market amount of the collateral posted and the repurchase price of the securities that the borrower failed to return (risk that is further reduced by any excess margin of collateral maintained). The likelihood of this exposure resulting in material losses to agents is low, since the borrower's obligation to return loaned securities is typically secured by an excess amount (generally 102/105 percent, and sometimes up to 110 percent) of cash or liquid securities collateral (often including U.S. and other foreign government securities), and because collateral is marked to market daily. In marking to market, the daily mark is set based on the prices at close of business on the prior day, and any additional required collateral is posted the same day. In the event of a borrower default, the agent would first look to the marked to market collateral posted, substantially reducing any risk of loss.

Because of the underlying similarities between agency reverse repo and securities lending transactions, risk management practices for both classes of transactions are similar. In agency reverse repo transactions, agents use cash collateral to purchase assets on behalf of lending clients, subject to an agreement for the seller to repurchase the assets at a higher price, reflecting a "haircut" on the asset. Cash collateral is generally invested in accordance with the client's underlying risk profile, with invested assets including U.S. Treasuries, and agency, municipal and corporate debt obligations. Purchased assets are generally reviewed, assessed, stress tested and managed on a daily basis. Through agency reverse repo transactions, lending clients can enhance returns on loaned securities, while agents ensure that the reverse repo transactions are undertaken in accordance with the agent's individual risk management practices and investment strategy.

[10] *See, e.g.*, Texas Government Code § 825.303(b)(3) (stating that in order for a bank to be eligible to lend securities on behalf of a Texas Public Fund, the bank must "execute an indemnification agreement satisfactory in form and content to the retirement system fully indemnifying the retirement system against loss resulting from borrower default."); ERISA Prohibited Transaction Exemption 2006-16, 71 Fed. Reg. 63,797 (Oct. 31, 2006) (requiring the fiduciary, *i.e.*, lending agent, to provide a borrower default indemnity to an ERISA plan, when loans are made to a foreign broker-dealer); UCITS Notice 12.5, Central Bank of Ireland (July 2011) (allowing Irish UCITS to lend to unrated counterparties if the UCITS is indemnified against borrower default).

B. Regulatory Framework and Reforms

As discussed, securities lending activities are subject to comprehensive regulation in the United States and other jurisdictions. Securities lending activities of U.S. banking organizations are subject to extensive regulation and supervision by the Federal banking agencies: the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC"). The Federal banking agencies impose minimum regulatory capital ratios on U.S. banking organizations that reflect the credit risk posed by securities lending activities, and recently issued proposed rules to implement the Basel III capital framework in the United States, which will likely further increase capital requirements for securities lending activities.[11] Indeed, because of a specific provision in the Dodd-Frank Act requiring U.S. banking organizations to measure regulatory capital against the most stringent of several calculations, increased capital requirements for securities lending activities could be substantial.[12]

In addition, several reforms to U.S. and foreign regulatory regimes significantly mitigate any systemic risks that might be presented by securities lending activities. First, regulators are seeking to limit credit exposures between financial institutions and counterparties. Section 165(e) of the Dodd-Frank Act imposes limits on credit exposures between systemically important financial institutions and unaffiliated counterparties, and the Federal Reserve has issued proposed rules that implement these required limits with respect to credit concentrations arising from securities lending transactions.[13] The proposal imposes burdensome limits between securities lending counterparties and collateral providers using a strict haircut methodology that does not recognize the correlation benefits between securities loaned and collateral received. Basel Committee Chairman Stefan Ingves has indicated that regulators are considering implementing similar limits on an international basis.[14]

Second, Section 610 of the Dodd-Frank Act provides that securities finance transactions conducted by national banks, regardless of size, must be included in single counterparty lending limits already applicable to those institutions. Under Section 610 and its implementing regulations, a national bank's credit exposure to a single counterparty from loans, derivatives and

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[11] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; 77 Fed. Reg. 52,888 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule; 77 Fed. Reg. 52,978 (Aug. 30, 2012).

[12] *See* Dodd-Frank Act § 171.

[13] *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

[14] *See* Stefan Ingves, Chairman, Basel Committee on Banking Supervision, Remarks at the 7th High-Level Meeting jointly organized by the Association of Supervisors of Banks of the Americas, the Basel Committee on Banking Supervision and the Financial Stability Institute: Current focus of the Basel Committee: Raising the bar (Nov. 15, 2012).

securities finance transactions may not in the aggregate exceed a specified percentage of the banks' capital. These limits will also help to prevent the build-up of significant credit concentrations from securities lending activities.

Third, Title II of the Dodd-Frank Act establishes a new resolution regime for systemically important financial institutions, the Orderly Liquidation Authority (the "OLA"). Almost all of the significant U.S. broker-dealers participating in agency securities lending would likely be resolved under the OLA in the event of their material financial distress or failure. The OLA provides specifically that the ability of a counterparty to close out collateral securing qualified financial contracts ("QFCs") (including securities lending, repo and reverse repo contracts) is subject to a maximum one business day stay. In addition, the OLA provides that the FDIC, the receiver of a financial institution subject to the OLA, may transfer QFCs to a bridge financial company, which will then assume all obligations under the QFCs.[15] Once transferred to a bridge financial company, a QFC would be subject to the same economic consequences as if a default by the company had never occurred. The OLA therefore reduces any systemic risks that could result from a failure of a major participant in the securities lending market. European regulators are also working to implement an OLA-like framework for the resolution of financial entities. In fact, the European Commission's proposed resolution regime, *Framework for the Recovery and Resolution of Credit Institutions and Investment Firms*, provides authorities the ability to impose a temporary stay on close-out and transfer contracts to a bridge financial institution.

Forthcoming regulatory changes will further increase regulation of securities lending activities. As noted, the Federal banking agencies have issued proposed rules to implement the Basel III capital framework, and as the FSB is aware, Basel III contemplates that both the quantity and quality of banking organizations' capital will increase significantly between 2013 and 2018. In addition, Section 984 of the Dodd-Frank Act provides U.S. regulators with authority to enhance regulation of various aspects of securities lending, including authority to promulgate rules relating to disclosure and the mitigation of potential systemic risks. In sum, lending activities are already subject to comprehensive regulation, and will likely become subject to additional regulation as a result of forthcoming regulatory developments.

C. Implications for the Consultative Document and Recommendations Regarding Minimum Haircuts

We submit that because of the market practices and current and forthcoming regulatory reforms discussed above, it would be inappropriate and unnecessary to require mandatory haircuts for securities lending transactions at this juncture. While we recognize and appreciate the need for the FSB to make "globally applicable" recommendations regarding minimum haircuts, it would be counterproductive for the FSB to impose such standards when current

[15] FDIC staff have stated that all of a company's QFCs will likely be transferred to the bridge financial company in the event the company is resolved under the OLA.

practices and existing regulatory frameworks make it unnecessary. For the same reasons, it would be inappropriate to require minimum haircuts for agency reverse repo transactions. At a minimum, authorities should refrain from adopting mandatory minimum haircuts until the cumulative impact of Basel III and other regulatory changes on securities lending and reverse repos is clear.

As noted above, in the event that minimum haircuts are mandated by regulators, we support a carve out from such requirements for all demand-driven transactions, whether collateralized by cash or non-cash collateral. Determining whether a transaction is demand-driven can be difficult to ascertain in certain instances; however, all securities lending transactions performed via an agent lender should be deemed to be demand driven and exempted from minimum haircut requirements. While we understand the concern around structuring trades for regulatory arbitrage purposes, the cost of such structures would likely make them prohibitive. Further, the Consultative Document's recommendations would result in many instances where securities lending transactions would require the lender to receive less than 100 percent collateral, which would deviate significantly from current market practice and legal and regulatory requirements. This would result in a sharp decrease in non-cash securities lending transactions, which have traditionally comprised a large percentage of transactions in many markets, such as European equity lending. By way of example, assuming the FSB's "high level" haircut approach were implemented, a transaction in which a lender loans an equity security against sovereign debt would appear to require the lender to receive collateral worth 89 percent of the value of the equity security (100 percent + (4 percent - 15 percent)). If the FSB intends for the lender to receive 111 percent collateral in such a transaction (100 percent + (15 percent - 4 percent)), this would introduce additional concerns. Under such an approach, haircuts for lower-grade collateral, such as corporate debt, would actually result in lower minimum haircuts.[16]

Although we believe it is inappropriate to require minimum haircuts, to the extent that such haircuts are deemed necessary, the "back-stop" approach would be preferable to the "high level" approach.[17] In any event, the "back-stop" approach haircuts should be adjusted to a five day holding period by dividing the proposed haircuts by the square root of two. This would align the holding period of repo and securities lending collateral with the current Basel II and III standards for these products. While the haircuts contemplated by the back-stop approach appear reasonably close to haircuts currently used by market participants, the natural consequence of adopting the back-stop approach would be a greatly reduced flexibility to lower margins during

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16 We also believe that certain of the proposed haircuts could potentially require agent lenders to account for securities lending transactions using "purchase and sale" accounting, rather than "secured borrowing" accounting. We do not believe that the FSB intends such a result.

17 Certain regulatory frameworks already required minimum haircuts, determined according to a back-stop approach, rather than a high-level approach. *See e.g.*, ERISA Prohibited Transaction Exemption 2006-16, 71 Fed. Reg. 63,786, 63,793-796 (Oct. 31, 2006) (requiring ERISA plans to be collateralized at 100 percent of the market value of securities lent in the case of dollar-denominated collateral, and between 100 and 105 percent in the case of foreign-denominated collateral); U.S. Internal Revenue Code § 512(a)(5) (requiring 100 percent collateralization in order for certain securities lending transaction income to be treated as tax exempt).

times of market stress, which could exacerbate systemic risk. By contrast, the high level approach would have a significant and immediate negative impact on the securities finance markets, and is therefore even less desirable than the back-stop approach.

III. Reinvestment of Cash Collateral

Prior to offering specific comments on the provisions of the Consultative Document relating to reinvestment of cash collateral, we again note that the fundamental objective of agency securities lending is to generate low-risk, incremental revenues for lenders. Thus, even prior to the 2008 financial crisis, cash collateral was predominantly invested in high-quality, low-risk assets, such as U.S. and foreign sovereign obligations and high-quality corporate debt obligations. These practices have become even more conservative since the crisis. Cash collateral is invested in more liquid investments, reflecting more conservative investment strategies on the part of securities lenders and other market participants. More fundamentally, post-crisis market practice has improved, since lending clients now largely view securities lending more as an investment function (*i.e.*, as a way of investing assets) rather than a purely operational practice. As a result, there is greater engagement by investment management and other risk management functions at lending clients, thus leading to more effective asset and liquidity management by lenders and agents. In sum, market participants have learned several lessons from the crisis, and have internalized these lessons to mitigate the overall risk of their cash collateral reinvestment functions by reducing the duration and increasing the quality of assets in which they invest.

A. Guiding Principles

The FSB has suggested high-level principles to guide cash collateral reinvestment strategies and guidelines. We support most of the FSB's suggested principles that are broadly consistent with Committee members' current practices, such as the principle that securities lending cash collateral reinvestment be consistent with stated and approved investment policies. However, other of the proposed principles emphasize a "one size fits all" approach to cash collateral reinvestment that is inappropriate in the securities lending context. Securities lenders seek lending programs that provide them with the ability to lend securities based on their own specific risk tolerance, the nature of securities being loaned, the types of securities in the applicable lending portfolio and the type of collateral that secures the loans.[18] In such an environment, a securities lending portfolio will not necessarily hold assets that "can be valued . . . on a daily basis and sold at a price close to [] pre-sale valuation,"[19] as different portfolios will vary in the expectations for return of collateral (*e.g.*, some may not require return of collateral on the same day), and many cash collateral reinvestment strategies (*e.g.*, term lending strategies) will not contemplate frequent valuation or return of collateral. Uniform WAL or WAM

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18 For example, it would be inappropriate for a portfolio with high turnover and high levels of volatility (*e.g.*, an active emerging markets fund) to be subject to the same guidelines for cash collateral reinvestment as a portfolio consisting of long-term U.S. Treasury securities.

19 Consultative Document § 3.2.3 (High-level principle 1.6).

requirements would unreasonably restrict market participants in their ability to provide securities lending programs tailored to clients' specific risk tolerances, and may arbitrarily constrain the diversification of these programs across the industry. The FSB should carefully consider the benefits of diversification and client-specific customization as it develops principles that impact the securities lending industry.

A key area of concern for Committee members is that the inappropriate imposition of the "one size fits all" standards contemplated by the Consultative Document could lead to harmful unintended consequences for the securities lending industry and broader financial markets. For example, overly prescriptive reinvestment requirements could drive lenders to relatively more flexible shorter-term lending programs (including overnight lending programs), which could itself cause market disruptions. Given that the securities lending program often represents an essential element of a lender's asset/liability management strategy, overly prescriptive or inflexible cash collateral reinvestment guidelines could disrupt this activity and potentially lead to unnecessary or unwarranted market disruptions. In addition, it is important for the FSB to consider whether its concerns about cash collateral reinvestment programs have been or will likely be addressed by ongoing regulatory reforms (*e.g.*, money market fund reform) in specific jurisdictions.

Although a "one size fits all" approach would be inappropriate, we support several of the FSB's proposed principles. For example, cash collateral reinvestment guidelines are, and should be, consistent with lenders' stated investment objectives. Indeed, the establishment of guidelines governing cash collateral reinvestment is one of the most crucial steps in the securities lending process, which helps agents incorporate the lender's risk preferences into their overall securities lending strategy. Similarly, cash collateral reinvestment guidelines generally establish concentration limits, recognizing that passive breaches of such limits could occur in the securities lending context due to temporary fluctuations in the value of cash collateral. In sum, we recognize the need for principled management and operation of cash collateral reinvestment programs, but urge that these principles recognize the variation among securities lending portfolios and programs, and the importance of tailoring cash collateral reinvestment programs to the risk tolerance and portfolios of individual lenders.

B. Liquidity Risk and Cash Collateral Reinvestment

Like the FSB, we recognize the importance of liquidity, both for effectively managed cash collateral reinvestment programs and for financial stability. With respect to liquidity considerations for securities lending, we note that the liquidity issues presented by cash collateral reinvestment programs may differ significantly from those in other contexts, *e.g.*, liquidity issues arising from redemptions of securities. Just as securities lending programs vary significantly in their characteristics, so too do the liquidity requirements associated with each program. It is essential that securities lending portfolios not be subject to "one size fits all" liquidity requirements that do not account for variations between and among programs. Consistent with the varying nature of securities lending programs, liquidity requirements for specific securities lending portfolios, including liquidity buffers, should be set by the investor and agent, as appropriate liquidity levels will vary depending on the specific securities on loan, the stability of demand for the particular asset, and the lender's need for future liquidity. Additionally, "one size fits all" liquidity requirements could potentially cause securities lenders to transact at negative spreads solely to maintain a certain level of liquidity, resulting in unnecessary financial loss to the lender.

We also note that lending programs generally require less liquidity than other short-term funding mechanisms, such as money market funds. Indeed, U.S. regulators have recognized that securities finance presents differing liquidity considerations than money market funds.[20] Because underlying collateral in securities lending programs can secure multiple loans via cross-collateralization, securities lending programs generally have access to greater amounts of short-term liquidity than funding mechanisms that cannot avail themselves of the benefits of cross-collateralization. This greater availability of short-term liquidity is yet another reason why it would be inappropriate to impose minimum mandatory haircuts on securities lending and reverse repo transactions.

C. Stress Testing

With respect to stress testing requirements, we support the FSB's recommendations and believe that while agents may in some cases be best equipped to stress test securities lending portfolios, stress testing would generally be most effective if performed by the securities lenders themselves, which are in the best position to analyze the precise factors that must be taken into account in order for the stress test to be effective. Any stress testing regime should account for the varying characteristics of individual securities lending portfolios and the differing liquidity characteristics of securities lending as compared to other transaction types (*e.g.*, underlying collateral is often available to secure multiple loans). In any event, we note that many of the most significant agent lenders are large U.S. banking organizations, and are therefore subject to extensive enterprise-wide stress testing requirements under Section 165 of the Dodd-Frank Act.[21] In addition, the ESMA Guidelines require European lenders that receive collateral above a certain threshold to conduct stress tests.

IV. Regulatory Standards for Collateral Valuation and Management

We support the FSB's proposed regulatory standards for collateral valuation and management. Several of the proposed standards, *e.g.* that collateral and loaned securities be marked to market daily, are consistent with Committee members' current practices. As the FSB continues its review and analysis of appropriate collateral valuation standards, we believe that special attention should be given to the use of publicly traded equity securities as collateral. Because these securities are generally traded in highly liquid markets and can easily be priced, they are the type of securities that fit squarely within the FSB's proposed standards. Yet, while

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20 *See* Short-Term Investment Funds, 77 Fed. Reg. 61,229 (Oct. 9, 2012) (stating that there are a "number of important differences" between short-term investment funds and money market mutual funds).

21 *See* Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62,378 (Oct. 12, 2012).

the European Union permits the use of publicly traded equity securities as collateral, the United States does not permit broker-dealers to use equities as collateral in transactions with "customers". This blanket prohibition under the SEC's customer protection rules should therefore be revisited as part of any initiative to establish minimum standards for collateral valuation and management.

We believe that the determination of what constitutes "acceptable" collateral should be based on the specific characteristics and risk tolerance of the lending client, as well as the availability of price data with respect to the particular collateral. A specific type of collateral should generally be permitted if it is acceptable to the lending client, permissible under that client's lending guidelines, and priced by a recognized third-party pricing service.

We seek clarification regarding Section 3.4.1 of the Consultative Document, which states that securities lending and repo market participants should only take collateral types that they are able to hold outright without breaching laws or regulations. We assume that this statement is not intended to prohibit agents from taking and liquidating collateral upon default, even when it might not be permissible for the agent to hold such collateral outright. For example, the Federal banking agencies have long permitted banks to hold equities in satisfaction of a default, even though banks are restricted in their ability to hold equities outright.

V. <u>Re-Hypothecation</u>

The FSB states in the Consultative Document that client asset regimes involving re-hypothecation are "technically and legally complex," and therefore require further analysis. Because of this technical and legal complexity, the FSB has apparently refrained from providing extensive recommendations regarding re-hypothecation.

While we agree that re-hypothecation regimes present technically and legally complex issues, we urge the FSB and other authorities to avoid approaches that seek to address such complexity by imposing costly, duplicative and administratively burdensome requirements. Authorities should take particular care to ensure that requirements do not duplicate restrictions that might already be imposed in other contexts (*e.g.*, concentration limits that apply to the securities being lent), or otherwise create overly prescriptive requirements that could cause market disruptions or other unintended consequences.

VI. <u>Conclusion</u>

We thank the FSB for the opportunity to comment on the Consultative Document, and to contribute to the ongoing dialogue about regulatory reform. We look forward to additional dialogue with the FSB and other authorities, and believe, as the FSB does, that healthy and robust collaboration between market participants and regulators is and continues to be an essential prerequisite for achieving effective and efficient reform. As the FSB considers our comments, and those of other market participants, we reiterate our view that the development of effective recommendations requires thorough consideration of the interactions between recommended changes and the existing regulatory framework, including pending changes still in the process of implementation. We submit that only through such a holistic approach can the FSB to make recommendations that will enhance the overall stability of our financial system, while still preserving the important economic and liquidity benefits that agency securities lending activities provide.

Sincerely,

Christopher R. Kunkle	*Jason P. Strofs*
Christopher R. Kunkle	**Jason P. Strofs**
Director, Securities Lending	Chairman, RMA Executive Committee
The Risk Management Association	The Risk Management Association

Appendix A

Q1. Does this consultative document, taken together with the earlier interim report, adequately identify the financial stability risks in the securities lending and repo markets? Are there additional financial stability risks in the securities lending and repo markets that the FSB should have addressed? If so, please identify any such risks, as well as any potential recommendation(s) for the FSB's consideration. Q2. Do the policy recommendations in the document adequately address the financial stability risk(s) identified? Are there alternative approaches to risk mitigation (including existing regulatory, industry, or other mitigants) that the FSB should consider to address such risks in the securities lending and repo markets? If so, please describe such mitigants and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress? Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe that would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment. Q4. Please address any costs and benefits, as well as unintended consequences from implementing the policy recommendations in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers, to the extent possible, that would assist the FSB in carrying out a subsequent quantitative impact assessment. Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks)?

The FSB's Consultative Document and previous interim report constitute a thorough and comprehensive analysis of financial stability issues in the securities lending markets. With respect to the question of whether the Consultative Document's proposed policy recommendations adequately address financial stability risks, the FSB should consider the extent to which baseline regulatory and market practice frameworks, as well as pending enhancements to these frameworks, already address these potential risks. As we discuss in detail throughout our letter, because these existing frameworks adequately address such risks, the FSB and other authorities should seek to integrate their recommendations into existing frameworks, rather than recommend changes that would impose additional regulatory burdens on securities lending activities. At a minimum, the FSB and other authorities should refrain from imposing additional material burdens on securities lending activities that do not integrate with various regulatory reforms already underway, *e.g.* implementation of the Basel III capital framework.

Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items. Q7. Do you agree TRs would likely be the most effective way to collect comprehensive market data for securities lending and/or repos? What is the appropriate geographical and product scope of TRs in collecting such market data? Q8. What are the issues authorities should be mindful of when undertaking feasibility studies for the establishment of TRs for repo and/or securities lending markets?

We have several concerns with the suggested information items listed in Box 1, which we discuss in detail in Section I.A and Appendix B of this letter. As we discuss, we do not believe that transaction reporting to TRs is the most effective way to collect market data. If regulators conclude that an enhanced reporting regime is necessary, it would be more appropriate to collect market data through position- or exposure-based reporting to regulators on a periodic basis, rather than via transaction reporting to TRs.

Q9. Do you agree that the enhanced disclosure items listed above would be useful for market participants and authorities? Would disclosing any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be disclosed instead.

While we recognize and support the need for adequate transparency and corporate disclosures for securities lending activities, any consideration of additional corporate disclosures for securities lending transactions should take into account deliberations by accounting standard-setters, regulatory authorities, and other bodies, so as to avoid unnecessarily duplicative analysis and provide for appropriately tailored disclosures. Please see Section I.B of this letter for detailed discussion of these issues.

Q10. Do you agree that the reporting items listed above would be useful for investors? Would reporting any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be reported instead.

While certain of the reporting items could be useful for investors, it is important for the FSB to consider the cumulative impact of ongoing regulatory reform initiatives when making recommendations regarding reporting by fund managers to end investors. Any required fund disclosures should not cause competitive harm and must take into account materiality of disclosed information in the context of a fund's other activities. In addition, the FSB should consider whether additional reporting will be useful to the particular fund's investors, as fund investors vary significantly in their sophistication and risk profile, and in certain cases, may not even control the investment decisions of the fund. Please see Section I.C of this letter for a detailed discussion of these issues.

Q11. Are the factors described in section 3.1.2 appropriate to capture all important considerations that should be taken into account in setting risk-based haircuts? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?

Section 3.1.2 of the Consultative Document appears to capture the factors that would be relevant to setting risk-based haircuts. It should be noted that capturing at least one stress event may be insufficient, as future stresses may vary significantly. In addition, while a longer time period for data adds value, too long of a time period may result in relevant stress events falling outside the prescribed confidence interval.

Section 3.1.2 also appears generally consistent with Committee members' current market practices with respect to the measurement of credit risk. However, we note that securities lending and repo transactions are generally "over-the-counter," *i.e.* one counterparty provides excess collateral and the other received excess collateral. If both counterparties utilize risk measurement methods described in Section 3.1.2, one counterparty will take on excess risk (*i.e.* the higher the collateral level the more risk is shifted to the excess collateral provider) by definition.

Market participants tend to set haircut levels using longstanding market practices; however, and as discussed in detail in this letter, haircut levels may be adjusted based on economic considerations, the credit profile of the counterparty, and the characteristics of particular collateral. Such adjustments are typically negotiated by transaction counterparties.

Q12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?

While numerical haircut floors could potentially limit competitive pressures to reduce haircuts during periods of economic growth, and therefore limit the amount by which haircuts increase during periods of stress, the negative impacts on overall economic activity and unintended consequences that would result from the imposition of floors far outweigh these potential benefits. Floors would further reduce overall activity in securities lending markets, which is still significantly below cyclical peaks. By placing further pressure on these markets, minimum haircut floors could actually exacerbate the problems they are intended to minimize.

The impact on specific securities lending markets would likely vary depending on the characteristics of the particular market. For example, resulting declines in the overall volume of securities finance transactions would likely be more pronounced in markets that place greater emphasis on non-cash collateral, such as Europe. In markets that place greater reliance on cash collateral, such as the United States, the imposition of floors could reverse current trends towards greater use of non-cash collateral, which could lead to increased risk in markets for short-term cash investments.

Although all asset classes potentially present procyclicality risks, one would expect that high-grade sovereign debt securities will generally be immune from material procyclicality risk. In this regard, and as discussed below, the proposed haircut framework may actually encourage the use of lower-quality sovereign debt, which could potentially increase procyclicality risk.

Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

As we discuss in detail in Section II of this letter, we believe it would be inappropriate to require minimum haircuts using either approach. On a comparative basis, however, the back-stop approach appears preferable. The high level approach could essentially eliminate all non-cash securities lending and repo transactions not collateralized by sovereign or short-term corporate debt. Given that demand for these types of collateral will likely increase in the future because of their use in derivatives transactions and CCP arrangements, the imposition of mandatory floors could in result in decreased investor appetite for repos collateralized by sovereign debt.

We also note that the back-stop approach should be adjusted to require a 5-day holding period, so as to ensure consistency with the Basel II and III methodologies.

Q14. Are there additional factors that should be considered in setting numerical haircut floors as set out in section 3.1.3?

The proposed methodologies do not take into account correlations between and among securities in the same netting set. In many securities lending transactions between large financial institutions, counterparties use master netting agreements to allocate counterparty risk and offset exposures arising from delivered and received securities. Any recommended haircut framework should account for correlations in the values of securities delivered and received as part of a single netting set in such transactions.

Q15. In your view, how would the numerical haircut framework interact with model-based haircut practices? Also, how would the framework complement the minimum standards for haircut methodologies proposed in section 3.1.2?

The proposed numerical haircuts would likely become the *de facto* industry standard, except during periods of market stress. Because the correlations discussed above have a significant impact on haircut calculations, in most cases the proposed numerical floors would likely be higher than haircuts determined under current market practices.

Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

As we discuss in Section II of this letter, while we agree with the FSB's proposal to exclude cash collateralized demand-driven transactions from the scope of any mandatory haircuts requirement. non-cash collateralized demand-driven transactions should be excluded as well. Agency securities lending transactions, which are demand-driven by definition, should be uniformly excluded from any numerical floors. While we recognize that market participants may use non-cash transactions to circumvent numerical floors, the high costs of entering into such transactions makes such circumvention unlikely. In addition, even without numerical floors applied to the non-cash leg of the transaction, market participants would still be required to provide market standard haircuts.

The FSB's proposal to set haircut floors for non-cash collateralized transactions equal to the difference between the two legs of a transactions could potentially require a securities lender to act as provider of excess collateral, which may be prohibited by current regulations. For example, a securities lender could be required to act as provider of excess collateral in a transaction involving a loan of equities against sovereign debt (a common transaction in the European market). In addition, such approach could lead to a situation where a lender would actually be subject to a lower numerical floor if lower quality collateral were received, a result that runs counter to principles of sound risk management.

With respect to the appropriate scope of application, as a general matter it would seem counterproductive and redundant to impose floors on regulated banking organizations in particular, given that as discussed in this letter, they are already subject to stringent capital and liquidity and leverage regulation. As discussed, the Basel III capital framework incentivizes banking organizations to robustly collateralize securities lending transactions, and since securities lending and repurchase transactions are generally bi-lateral in nature, one party is always a provider of excess collateral. In fact, given the current and regulatory environment, as well as the changes contemplated by the Basel III framework, imposing minimum haircuts on regulated banking organizations could raise the cost of capital for these institutions to prohibitively high level, potentially decreasing overall liquidity in the markets in which they are key participants.

In any event, securities lending transactions collateralized by high-quality sovereign debt issuances should be excluded from any haircut requirements, given that these securities are likely to increase in value during periods of market stress. In this regard, any debt issued by a country with an Organization for Economic Cooperation and Development Country Risk Classification of zero or one that has not defaulted or required aid from the International Monetary Fund during the past five years should be exempted.

Q17. Are there specific transactions or instruments for which the application of the numerical haircut floor framework may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.

A framework of numerical floors would cause particular difficulties for non-cash collateralized securities lending transactions. While the proposed framework would require market participants to subtract the prescribed haircut of the loaned security from the prescribed haircut on the collateral, this approach is inapposite with respect to a non-cash collateralized transaction where the loaned security has a higher prescribed haircut than the collateral (for example, a transaction where equities are lent against sovereign debt). In these instances, the proposed framework could require minimum haircuts of as little as 89 percent, which would be inconsistent with current market practice and would significantly increase risk for lenders. Even in less perverse cases, lenders would still have an incentive to minimize any differences in value between the loaned securities and collateral, potentially causing them to take higher-risk collateral, rather than the highest quality collateral possible.

Q18. In your view, how should the framework be applied to transactions for which margins are set at the portfolio basis rather than an individual security basis?

For entities that elect to apply minimum margin levels on a portfolio basis, the framework should apply at a netting set level, and the entity should be permitted to model minimum required excess collateral at the netting set level utilizing the standards set out in Section 3.1.2. Models used to determine netting set minimum excess collateral should be subject to approval by appropriate authorities, and should be periodically reviewed by regulators. Entities using a portfolio-based approach should be excluded from the numerical floor requirements in Section 3.1.3.

Q19. Do you agree with the proposed minimum standards for the reinvestment of cash collateral by securities lenders, given the policy objective of limiting the liquidity and leverage risks? Are there any important considerations that the FSB should take into account?

While we support certain of the proposed minimum standards that are consistent with our current practices, we believe strongly that it would be inappropriate to impose "one size fits all" standards for cash collateral reinvestment practices. There is significant variation between and among individual lenders and lending programs, especially with respect in risk profile, and it is essential for agents to tailor cash collateral reinvestment programs that take these variations into account. Given such variation, the imposition of "one size fits all" cash collateral reinvestment standards could have negative consequences for the securities lending markets and broader financial markets. Please see Section III of this letter for a detailed discussion of these issues.

Q20. Do you agree with the principles set out in Recommendation 9?

We generally defer to the views of other commenters who we understand will be providing extensive and detailed comments on Recommendation 9 and related issues. We note, however, that we agree with and support the Global Financial Markets Association's comment that client assets subject to restrictions on re-hypothecation are non-cash assets carried in brokerage or custodial accounts, and therefore would not include assets transferred by the client in or as security for securities lending transactions.

Q21. Do you agree with the proposed minimum standards for valuation and management of collaterals by securities lending and repo market participants? Are there any additional recommendations the FSB should consider?

We support several of the proposed minimum standards for collateral valuation and management that are consistent with our current practices. In general, whether or not collateral is acceptable in a particular context should depend on the specific characteristics and risk tolerance of the lending client, as well as the availability of pricing data with respect to the particular collateral. We also believe the FSB should give special attention to the use of publicly traded equity securities, and seek clarification that securities lending and repo agents will not be prohibited from taking and liquidating collateral upon default, even when it might not be permissible for the agent to hold such collateral outright. Please see Section IV of this letter for detailed discussion of these issues.

Q22. Do you agree with the policy recommendations on structural aspects of securities financing markets as described in sections 4.1 and 4.2 above?

We believe the FSB should proceed cautiously before recommending CCP arrangements for securities lending transactions, as significant additional analysis would be required before such arrangements could even be considered a feasible option. As the RMA discussed in a recent comment letter,[22] there are significant legal and market impediments to conducting securities lending transactions through CCPs, and these impediments must be resolved before CCPs can be given serious consideration in the securities lending context. Indeed, as currently contemplated, CCP arrangements would not appear to provide benefits to either agent lenders or beneficial owners, and agent lenders would not be in a position to support CCP arrangements until such benefits can be demonstrated. We therefore believe the FSB and other authorities should further analyze whether CCPs are even a desirable policy option for securities lending transactions, and, if so, how CCP arrangements can be implemented in a way that benefits beneficial owners and agent lenders while minimizing cost, administrative burden and market disruption.

With respect to the FSB's recommendations regarding changes to the bankruptcy law treatment of securities lending transactions, we agree with the FSB's conclusion that any changes would involve "substantial practical difficulties" and therefore "should not be prioritized for further work" at present. In any event, certain of the proposed changes, such as the exemption from the automatic stay for certain contracts, would likely create additional complexity and market confusion without corresponding benefit. We therefore agree with the FSB's decision to defer further analysis of these issues, and note that U.S. and European authorities continue to analyze related issues arising under the OLA and other resolution regimes.

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[22] *See* Letter from the Committee on Securities Lending of the RMA, to the Board, the FDIC, and the OCC (Oct. 19, 2012), *available at* http://www.rmahq.org/File%20Library/Securities%20Lending/Regulatory%20-%20Legal/dpny-23731206-v7-RMA---Basel-III-Comment-Letter.pdf.

Appendix B

Proposed Information for Enhancing Transparency/Disclosure in Securities Lending

Transaction level data (could be collected by a TR for each transaction):

i. Principal amount

Comment: We assume this is the market value of the loaned securities.

ii. Currency

Comment: We could report in any currency requested, whether the currency of the security being lent, of the lender, of the transaction, or other.

iii. Type and value of collateral (cash vs. non-cash; breakdown of non-cash by asset type)

Comment: Authorities must clearly define "asset type." In the alternative, it may be easier to report a specific Security Identifier (*e.g.*, CUSIP, SEDOL, ISIN). We also note that the form of collateral, the particular securities and the asset type may change over the life of a transaction.

iv. Securities lending fee or rate, including breakdown of fee and cash reinvestment return

Comment: We note that the securities lending rate or fee will typically change over the life of a transaction, and frequently on a daily basis.

v. (Ultimate) counterparty

Comment: We assume you mean the party designated as the borrower or lender in the securities lending agreement or purchaser or seller in a repurchase agreement.

vi. Haircut

Comment: As noted above, the form of collateral, the particular securities and the asset type can change over the life of a transaction and thus the haircut or margin will change depending on the collateral in use.

vii. Maturity date

Comment: This concept would be relevant to only a small fraction of outstanding securities lending transactions, with most securities lending transactions opened until terminated voluntarily by either party upon notice to the other.

viii. First callable date

Comment: This concept also is not relevant to securities lending transactions, and would not be relevant to overnight loans.

Firm-level data (could be collected through an official survey or regulatory reporting where a TR does not collect transaction level data):

Comment: We understand "firm" to refer to the principal lender of securities. We also assume that authorities will require similar information from each participant in a multi-step transaction in order to get a complete picture of exposures.

i. Volume and value of securities on loan

Comment: We assume "volume" means the number of shares/bonds on loan.

ii. Volume and value of securities available for lending

iii. Currency breakdown

Comment: It is unclear what this term refers to: is it the currency of the security, of the lender, of the collateral, or something else?

iv. Breakdown of counterparties by type and concentration

Comment: It would be easier and more straightforward to report the identity of counterparties using a standard legal identifier. In addition, authorities will need to define "type" consistently. Broker-dealers represent the substantial majority of borrowing counterparties in the U.S.

v. Tenor composition

Comment: Please define this term.

vi. Collateral composition (cash vs. non-cash; breakdown of non-cash by asset type)

Comment: Authorities must clearly define "asset type." In the alternative, it may be easier to simply report the relevant Security Identifier (*e.g.*, CUSIP, SEDOL, or ISIN). In addition, we again note that the form of collateral, asset type, and particular securities can change over the life of the transaction.

vii. Breakdown of fee and cash reinvestment return

Comment: The rate or fee can change over the life of a transaction.

viii. Haircut ranges

Comment: As noted previously, the form of collateral, the particular securities and the asset type can change over the life of a transaction, and thus the "haircut" or margin will change depending on the type of collateral.

ix. **Re-use and re-hypothecation data: share of collateral received that is re-used or re-hypothecated, compared to the maximum authorized amount if any, and whether it is restricted to some type of securities only**

x. **Number of custodians where received collaterals are kept and the value of collateral assets held by each**

xi. **The way securities received by the counterparty are held, i.e. in segregated accounts or pooled accounts**

Comment: We can only provide the identity of the direct counterparty and the custodian/depository/broker that receives the security. The way the securities are held is unknown to the lender. If authorities plan to collect data from each participant in a transaction chain, securities borrowers could provide this information.

Appendix C

RMA
COMMITTEE ON SECURITIES LENDING

STATEMENT ON BEST PRACTICES FOR DISCLOSURE AND TRANSPARENCY BY SECURITIES LENDING AGENTS

1. INTRODUCTION

The RMA Committee on Securities Lending promotes standards of best practice for securities lending agents ("Lending Agents"). This discussion paper furthers that goal by encouraging the communication of key information regarding securities lending transactions and agency securities lending programs by Lending Agents to their principal securities lending clients ("Principal Lenders") as well as to their borrower counterparties ("Borrowers"). The recommended disclosures to Principal Lenders are intended to provide Principal Lenders with a framework to better understand and evaluate the key considerations relating to engaging in, and monitoring their on-going participation in, an agency securities lending program in light of their own risk-reward profiles.

To provide context for the broader discussion, this paper first provides a brief overview of customary agency securities lending arrangements in the United States, including a description of the key parties and some of the main risks involved in such arrangements. After this brief introduction, the paper sets forth recommended practices for disclosure and transparency by Lending Agents in today's U.S. securities lending markets.

2. DESCRIPTION OF THE PRIMARY PARTIES IN AGENCY SECURITIES LENDING ARRANGEMENTS

As illustrated in the diagram below, customary agency securities lending arrangements involve three primary participants: (1) Principal Lenders, the beneficial owners of securities, engage (2) Lending Agents to lend their securities to (3) various principal Borrowers. In the event a Lending Agent does not provide custodial services, a separate custodial bank would be involved as the fourth primary participant. The Principal Lenders (often collectively referred to as the "supply side") are typically institutional investors, such as registered investment companies (including mutual funds and exchange traded funds), governmental and corporate pension funds, ERISA plans, endowment funds of non-profit institutions and insurance companies. Some types of Principal Lenders, such as mutual funds, pension funds or ERISA plans, have underlying beneficiaries or shareholders who hold an interest or units in the Principal Lender for investment or retirement benefit purposes but do not (and could not) actively participate in or direct investment decisions made by the Principal Lender.

In light of the array of operational and risk services needed to run a securities lending program, Principal Lenders commonly hire a Lending Agent to administer their program. Lending Agents consist of: 1) custodial banks that arrange the lending of securities on behalf of their custody clients; 2) investment managers that provide securities lending agency services as an adjunct to their advisory function; and 3) third party Lending Agents that provide securities lending agency services without having either a custodial or investment advisory relationship with its clients.[23] Some custodial banks and investment managers also provide lending services to Principal Lenders that are not otherwise their clients on a third party basis. Principal Lenders can retain a single Lending Agent or use a combination of Lending Agents, for different asset classes, markets, funds or for benchmarking purposes. Lending Agents have a contractual relationship with the Principal Lenders, but do not have any relationship, contractual or otherwise, with a Principal Lender's underlying beneficiaries or shareholders, nor could the Lending Agent normally identify such beneficiaries or shareholders.

Borrowers in the United States are primarily brokers or dealers, but may also include banks or offshore entities. Borrowers may have underlying clients or relationships with end users, such as hedge funds, proprietary traders, market makers, arbitrageurs, specialists and other investors. For example, prime brokers, who provide a variety of services such as settlement, custody and financing services to their clients, borrow securities from Principal Lenders primarily for the purpose of making delivery in the case of short sales, fails to receive securities or similar circumstances and thus serve as intermediaries between the Agent Lenders and the investor end users. In such a case the prime broker is the Borrower and the Principal Lender's counterparty in the securities lending transaction, and neither the Principal Lender nor the Lending Agent has a relationship, contractual or otherwise, with the Borrower's clients, and thus does not know (and has no reason to know) the identity of the Borrower's clients.

Upon negotiation of a lending transaction with a Borrower, the Lending Agent instructs the Principal Lender's custodian to deliver securities to and receive collateral from the Borrower, in many cases on a "deliver versus payment" basis. If the collateral is cash, which is the predominant form of collateral for securities lending transactions in the U.S., the cash will be invested in a commingled investment fund (pool) or a separately managed account (SMA), consistent with guidelines approved by the Principal Lender. The cash collateral pool or SMA may be managed by the Lending Agent or an affiliate of the Lending Agent, by the Principal Lender itself, or by a third party. For securities loans that are collateralized with non-cash collateral, collateral may be delivered to a Principal Lender's account at a triparty collateral agent (most common structure) or to the Principal Lender's custody account.

In addition to the primary participants noted above, there are also other service providers, such as consultants and market data service providers, who specialize in securities lending services. Consultants are sometimes hired by a Principal Lender to assist with the selection of a Lending Agent or the structuring of a lending program. Consultants may also seek to help the Principal Lender evaluate the performance of the Lending Agent and the program on a regular basis.

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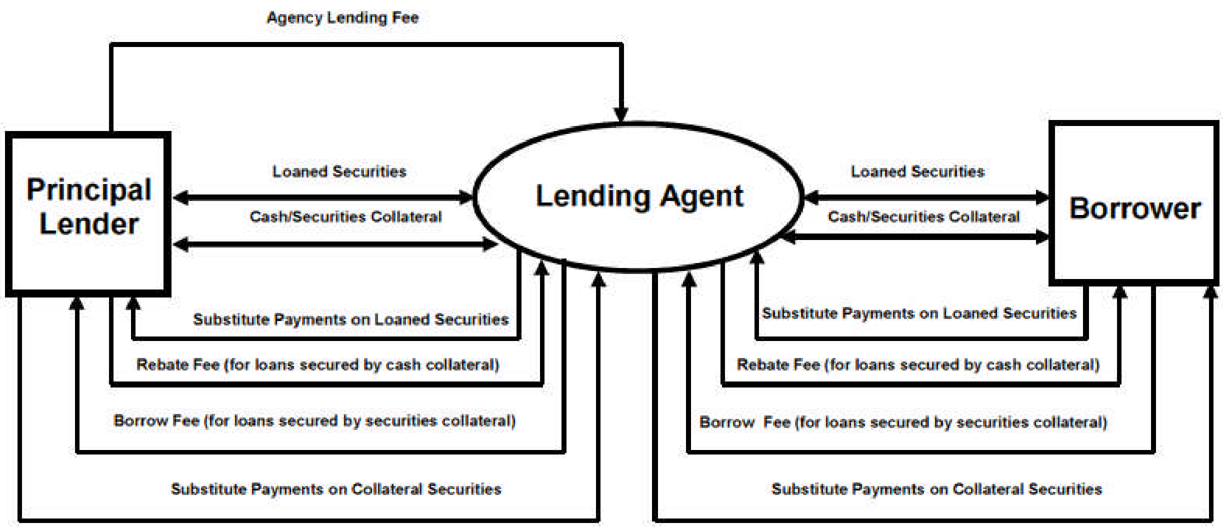
[23] This discussion paper does not address the borrowing by broker-dealers of securities they hold in customer brokerage accounts (i.e. "fully paid lending") or the borrowing by broker-dealers of securities from other broker-dealers. Although such arrangements represent a significant portion of the securities lending market, the rules which apply and the nature of the relationships between the parties are significantly different from those for traditional agent securities lending as described herein. Further, this paper does not address proprietary securities lending programs designed to raise cash to engage in proprietary trading as those types of programs are quite different in design and purpose from the traditional agent securities lending programs described herein.

Specialist market data service providers collect securities lending data from market participants (both Borrowers and Lending Agents) and offer access to the aggregated data for a fee.

The diagram below illustrates the key participants and flows involved in a typical agency securities lending arrangement.[24]

Agency Securities Lending: Key Participants and Flows



3. DISCLOSURE AND TRANSPARENCY BY LENDING AGENTS GENERALLY

The securities lending industry has evolved and matured since its inception in the 1970s (particularly in the last five to seven years), and the level and frequency of disclosures and transparency for securities lending participants, especially to Principal Lenders, has increased significantly. Securities lending has emerged from its origins in securities operations as an independent asset class often overseen by a Principal Lender's investment professionals. This, together with technological developments, have prompted more sophisticated and frequent disclosure and reporting comparable to that provided to participants in the short-term fixed income market.

In agency securities lending programs, disclosure can be achieved through a variety of communication channels and methods, including via verbal presentations, written presentation materials, responses to "requests for proposals" or RFPs, contractual provisions, formal disclosure documents, and on-going periodic reporting. This paper does not recommend any specific communication channel or method, but indicates when there is a common market practice to use a particular protocol to communicate specific types of information.

[24] For ease of presentation, this diagram does not illustrate the involvement of other relevant parties, such as a third party manager of cash collateral pools or SMAs, a third party tri-party collateral agent, a custodial bank that is a separate entity from the Lending Agent, a clearing house, central counterparty, depository, or a consultant or other service provider. Further, for information regarding the Agency Lending Fee, see the description under the heading "Treatment of Securities Lending Revenues and Fees" in Section 4.c.

The Sections that follow describe the current recommended practices for disclosure and transparency by Lending Agents in today's securities lending markets. These practices give Principal Lenders significant transparency with respect to their securities lending programs, and enable them to create a framework to effectively structure, manage and assess their programs. Although we expect industry participants to continue to enhance their transparency, particularly as technology further evolves, we provide a description of the current recommended practices to help enable Principal Lenders to take an active role in tailoring their programs to their own risk-reward profiles.

4. RECOMMENDED DISCLOSURE AND TRANSPARENCY BY LENDING AGENTS TO PRINCIPAL LENDERS

a. Disclosure about the Basic Flows of Securities Lending Transactions, and the Structure of and Primary Parties in an Agency Securities Lending Program

Agent Lenders should describe to those Principal Lenders who have not previously engaged in securities lending activities or utilized a securities agency lending program, or who otherwise seem unfamiliar with securities lending, the basic flows of securities lending transactions, and the structure of and primary parties in an agency securities lending program.

b. Risk Disclosure to Principal Lenders and their Acknowledgement of Risk

It is essential that Lending Agents disclose to Principal Lenders the risks related to securities lending conducted via an agency securities lending program, that Principal Lenders understand and accept such risks and that Principal Lenders understand how those risks may be addressed.

The major segments of risk associated with securities lending are:

- (i) Counterparty and Credit risk;
- (ii) Cash Reinvestment Risk;
- (iii) Operational Risk; and
- (iv) Legal, Tax and Regulatory Risk.

While the relationship between the Lending Agent and its Principal Lender clients typically promotes open communication regarding lending activities and issues, these risks should be clearly disclosed to the Principal Lenders. Commonly it is the terms of the contractual agreement between the Agent Lender and its Principal Lender client (the "Client Agreement") and the terms of the securities lending agreement with the Borrower (the "Loan Agreement") that together serve as the means by which the roles of the parties are described and the method by which these risks are addressed.

(i) Counterparty and Credit Risk

Counterparty and credit risk is the risk that the Borrower will not perform its contractual obligations to the Principal Lender. The Loan Agreement typically defines this risk by outlining the obligations of the Borrower. The main obligations of the Borrower are to provide collateral and meet collateral calls, to return loaned securities to the Principal Lender and to pay/transfer to the Principal Lender any distributions made on the loaned securities while the loan is open. If the Borrower fails to satisfy these obligations, the Loan Agreement typically outlines the available rights and remedies of the Principal Lender to address this risk. In addition to the remedies outlined in the Loan Agreement, the Client Agreement may specify or disclose additional methods to control counterparty and credit risk. These controls, which may be individually determined by each Principal Lender or which may apply generally to the Agent Lender's program, reflect a particular level of risk tolerance and specific concerns. To address counterparty and credit risk, the Client Agreement may include or disclose controls such as the process for the approval of Borrowers, Borrower concentration limits, collateral maintenance margins and limitations on types of acceptable collateral or the process for adjusting margins and the types of acceptable collateral. Lastly, many Lending Agents offer or arrange for indemnification against losses due to borrower default, pursuant to which the Principal Lender allocates some of the counterparty and credit risk to the indemnification provider while accepting this risk exposure against the indemnification provider (as more fully described in Section 4.c. below).

(ii) Cash Reinvestment Risk

As noted above, the Client Agreement will typically specify the party that is responsible for reinvesting the cash collateral, which may be the Lending Agent, the Principal Lender or a third party cash manager. As such, although reinvestment is a risk of lending securities versus cash collateral, it may or may not be part of the relationship between the Principal Lender and the Lending Agent. Cash reinvestment risk can be broken down into interest rate risk, liquidity risk, and credit risk. Interest rate risk is the risk that the cash collateral investments do not generate adequate interest to pay Borrowers the agreed upon rebate. Interest rate risk generally arises from a mismatch between the duration of the investments and the duration of the loans. A reinvestment portfolio should include processes and oversight for asset/liability management to mitigate interest rate risk. The key mitigants to interest rate risk are limiting the duration of loans and investments as well as limiting the gap between the duration of loans and investments.

Liquidity risk is the risk that the portfolio of investments purchased with the cash collateral does not have enough liquidity to fund flows for daily mark-to-markets, loan terminations due to Borrower returns or recalls by the Principal Lender, or in the event of a Borrower default. As mentioned above in reference to interest rate risk, duration limits and asset liability management are the most effective means to mitigate liquidity risk. The weighted average life of the loan book should be relative to the reinvestment portfolio based on the risk profile of the Principal Lender. Further, the guidelines for a cash collateral pool or SMA can specify that a certain amount or percentage of the total portfolio be invested on an overnight basis, so that cash is available the next day to meet any liquidity needs. A cash collateral pool or SMA may also adopt other strategies to generate more liquidity on a short term basis.

Credit risk refers to the loss of value of an investment either due to market price impairment during the life of a fully performing investment or nonperformance, including default. In most Client Agreements, the Principal Lender specifically acknowledges that it bears this risk and that the Lending Agent (or cash manager) is not responsible for any shortfall in principal value resulting from the investment of cash collateral. As cash collateral will be invested in either a commingled pool or SMA consistent with guidelines accepted by the Principal Lender, these guidelines act as a mechanism to control or mitigate credit risk. Specifically, in a SMA structure the Principal Lender can establish individualized cash reinvestment guidelines/parameters which may include restrictions on specific permissible investment types, minimum credit quality ratings on investment issuers, diversification limits on issuers and limits on maximum duration. In a pooled investment vehicle, such parameters are pre-determined and the Principal Lender selects the pooled investment vehicle which meets its requirements. In either case, Principal Lenders should be provided with reports indicating the details of each of the above parameters and a detailed listing of how such cash has been invested, as described in Section 4.d. If the Lending Agent is not involved in the management of the cash collateral, the Principal Lender should arrange to receive such reporting in a form and with a frequency sufficient for its needs.

In addition, some Lending Agents may offer or arrange for an indemnification in the event of a loss of principal on the investment of cash collateral. If provided, this indemnification is typically limited to covering certain counterparty risks in connection with reverse repurchase investments.

If non-cash collateral is accepted, there is no interest rate risk but there is still liquidity risk and credit risk in the event of a borrower default. In addition, there is an extra layer of operational risk due to the use, in most cases, of a tri-party custodian to receive, hold, and value the securities received as collateral and to take action quickly and accurately in the event of a borrower default. The Lending Agent should specify or disclose the selection and procedures used for interaction with a tri-party collateral custodian.

(iii) Operational Risk

One form of operational risk is recall risk, which is the risk that a Borrower is unable to return a security that has been recalled from loan by a Principal Lender in the standard settlement cycle for the security in the market it trades. The Principal Lender should be clearly informed of and accept its obligations with respect to the timing of sales notifications in order to mitigate against trade failures resulting from securities not being returned from loan by settlement date. The Client Agreement or the operational documentation for the Principal Lender's program is commonly the document that defines the settlement cycle and applicable notification requirements for each security type by market. All parties should be informed of the timing requirements and agree on a method of notification. The sales notification requirements in the Client Agreement or relevant operational documentation should match the settlement cycles typically outlined in the Loan Agreements and the risk of any mismatch should be disclosed.

Settlement risk is the risk that when executing a loan (transferring securities and accepting collateral) the Principal Lender is left with an unsecured or uncollateralized position. The Loan Agreement should specify that collateral should be received at the time of or prior to the delivery of loaned securities.

Other operational risks to be disclosed include risks associated with the mark-to-market process, such as improper or late valuation, the manufactured distribution process, the failure to timely receive notice or elect on corporate actions, and force majeure events such as natural disasters.

(iv) Legal, Tax and Regulatory Risks

This segment encompasses a fairly broad range of risks, including risks with regard to lending non-US securities. Examples or risks to be disclosed include the potential inability of the Principal Lender to take immediate action against collateral in the event of a default by the Borrower because of legal or regulatory reasons, the risk that certain unique economic rights may not be capable of being exactly manufactured by Borrower, and the potential loss of the current tax treatment for securities loans. In addition to disclosure of the risks, the Client Agreement will typically describe how these risks are controlled and who bears responsibility for any losses due to these risks.

c. Recommended Disclosure Regarding the Rights and Responsibilities of the Lending Agent and the Principal Lender

As noted above, Lending Agents and Principal Lenders enter into Client Agreements. These Client Agreements establish a general agency relationship between the Lending Agent and the Principal Lender whereby the Lending Agent is authorized to lend securities on behalf of the Principal Lender. The Client Agreement may be a separate, free-standing agreement related solely to securities lending, or the authorization to lend securities may be included with other authorities in a trust agreement, a custodial agreement or an investment management agreement. However the Client Agreement is structured, it provides that the Principal Lender appoints and authorizes the Lending Agent to lend its securities and provides direction to the Lending Agent with respect to the parameters of the client's lending program and, if utilized, for the reinvestment of cash collateral. Client Agreements typically contain specific provisions with respect to the areas described directly below. Although this Section of the paper refers to disclosure commonly included in a Client Agreement, a Lending Agent could use a different means in which to provide the Principal Lender with disclosure regarding the Lending Agent's standard program which addresses each of the areas below (in which case the Client Agreement may not contain the same specific information).

<u>Lendable Securities</u> – The Client Agreement should provide for a process to identify securities that are available to loan and how that designation may be changed from time to time.

<u>Administration of Securities Lending Program</u> – The Client Agreement provides that the Lending Agent is authorized to act on behalf of the Principal Lender and may include a description of the lending process.

<u>Approved Borrowers</u> – Typically, the Lending Agent will make available to the Principal Lenders a list of Borrowers with which the Lending Agent may transact. There are at least two possible options for a Principal Lender to approve Principal Borrowers:

1. The Principal Lender may designate in the Client Agreement the Borrowers to which it chooses to lend (or elect to lend to any Borrower in the Lending Agent's program).

2. Alternatively, the Lending Agent discloses the Borrowers currently available for its lending program and the process used by the Lending Agent to add and delete

Borrowers and to determine credit limits and the Principal Lender agrees to the disclosed process.

Specific disclosure should be included in Client Agreements if the Lending Agent or any of its affiliates are also Borrowers, and consent from the Principal Lender to lend to such Borrowers if required. Also, the Client Agreement should specify a process whereby the Principal Lender can restrict or limit lending or otherwise change its choice of approved Borrowers.

Loan Agreements – The Client Agreement authorizes the Lending Agent to enter into Loan Agreements with Borrowers, typically in the form of an industry template such as the Master Securities Loan Agreement (2000) published by the Securities Industry and Financial Markets Association (or one of its predecessors) or a Lending Agent's equivalent bespoke agreement, on the Principal Lender's behalf.

Collateral – Principal Lenders should instruct the Lending Agent as to the forms of cash collateral (i.e., currency types) and non-cash collateral that the Principal Lenders will accept for its securities lending program. Initial margin levels, valuation and daily mark-to-market obligations should also be described in the Client Agreement. Alternatively, the Lending Agent may disclose the forms of collateral, the margins, and the mark-to-market process currently approved for its lending program, along with the process used to make changes to each of them, and the Principal Lender agrees to the disclosed arrangements.

Cash Collateral Reinvestment – If applicable, Principal Lenders will specify their desired reinvestment program, guidelines or strategy (which may include pooled investment structures, SMAs or the use of external or other cash managers) in the Client Agreement. The Client Agreement should also clearly disclose, and the Principal Lender should acknowledge, (i) that the Principal Lender bears the reinvestment risk (i.e., assumes the market or investment risk of loss on their cash collateral reinvestments) and (ii) if the Lending Agent (or an affiliate) serves as investment manager of the cash collateral, the advisory and other fees earned by the Lending Agent (or an affiliate) in connection with the reinvestment of cash collateral. Alternatively, the Lending Agent will disclose the cash collateral reinvestment strategy and cash collateral reinvestment funds used along with other relevant disclosures, and the Principal Lender agrees to the disclosed arrangement. If an external cash manager is used, then the roles and responsibilities of the parties should be specified.

Distributions on Loaned Securities – The Client Agreement should state that the Principal Lender is entitled to receive distributions (whether interest, dividends or other distributions) on the securities during the term of the loan, known as "substitute or manufactured payments." The Client Agreement may also specify the party responsible for the collection of those payments, which may not be the Lending Agent but a service provider working for the Principal Lender.

Voting Rights on Loaned Securities – The Client Agreement should disclose that the Principal Lenders will not be entitled to vote securities that are out on loan over the applicable record date.

Ability to Recall Securities on Loan – The Client Agreement should specify or disclose a process and timeline for recall of securities on loan. For example, a Principal Lender may recall securities that it has sold or to vote proxies.

Termination Provisions – The Client Agreement should contain termination provisions that outline the conditions or process for termination of the agency lending relationship by either party.

Treatment of Securities Lending Revenues and Fees – The Client Agreement should specify or disclose the negotiated fees to be paid by the Principal Lender to the Lending Agent for its services. Such fees are often in the form of a "fee split", typically expressed as a percentage, which dictates how loan earnings are to be divided between the Principal Lender and the Lending Agent. When loans are collateralized by cash, loan earnings are the net of the income from cash collateral reinvestments and the rebate paid to (or in the case of negative rebates, received from) the Borrower. When loans are collateralized by securities, loan earnings are equal to the negotiated loan fee paid by the Borrower. If the Lending Agent's fee is not paid pursuant to a fee split, the Client Agreement will specify or disclose how the fee is calculated.

Limitation of Liability and/or Allocation of Costs – The Client Agreement should provide or disclose who will be responsible for certain costs and/or fees associated with the Principal Lender's lending program (such as custodial charges and transaction costs) and specify any liability limitations applicable to the Lending Agent.

Client Reporting – The Client Agreement may also describe the types of reports (such as loan level and lending income reports) that will be provided to the Principal Lender. See Section 4.d. below for further discussion of transparency through reporting.

Borrower Default Indemnification – It is common for Lending Agents to provide Principal Lenders with Borrower default indemnification (or arrange for the provision of such an indemnification). This means that following a default by a Borrower, in the event that the collateral held from the Borrower is insufficient to pay for the repurchase of the securities that were lent to that Borrower (and not returned to the Principal Lender), after all claims have been settled, the Lending Agent or other party providing the indemnification will compensate the Principal Lender for the difference. The Client Agreement or a separate indemnification agreement should specify or disclose (i) events constituting a Borrower default and the party responsible for determining a default has occurred, (ii) the obligations of the Lending Agent or the Principal Lender relating to a Borrower default, (iii) which losses, expenses or costs are included in the Lending Agent's indemnification, and (iv) a description of the process to be used for determining the "loss" to be indemnified after a Borrower default.

SIPC Disclosure – The Principal Lender must acknowledge that the provisions of the Securities Investor Protection Act of 1970 may not protect the Principal Lender with respect to loans of securities. This disclosure is mandated by the U.S. Securities and Exchange Commission (SEC) if securities are being lent to SEC-registered broker-dealers. The point of the disclosure is to inform Principal Lenders that the collateral held (along with borrower default indemnification, if provided) is the main protection should a Borrower fail to return a borrowed security.

d. Client Reporting: Disclosure and Transparency to Principal Lenders

An important element of providing transparency to Principal Lender clients can be achieved through client reporting of such clients' securities lending activity. Detailed reporting that is available at frequent intervals is critical to the Principal Lender's ability to monitor its counterparty exposure, to determine whether the Lending Agent is operating within the Principal Lender's guidelines, to monitor and evaluate risks and performance, and to make changes to their lending guidelines and parameters as needed.

Following is a description of reports that may be made available by Lending Agents to their Principal Lender clients. Each Principal Lender may determine whether to receive any particular report, the frequency of any such report, and the format to be used. In some cases, a Principal Lender may decide to utilize a consultant or other third party to help it evaluate the information that is provided to it.

(i) *Borrower Counterparty Exposure*. All loans to a Borrower, including all asset types across all markets to reflect the total exposure to a Borrower, should be reported to a Principal Lender. This report may be at a legal counterparty or a parent counterparty level depending on the Principal Lender's needs or preferences.

(ii) *Loan-level Transparency*. Transaction details may include the following for each loan to a Borrower:

- Security name and identifier
- Number of shares or securities on loan
- Market price and collateralized price
- Collateral type
- Rebate rate (if cash) or fee (if non-cash)
- Yield on collateral investments (if available to the Lending Agent)
- Gross earnings
- Any fees, costs, or charges deducted from the gross earnings
- Net earnings to Principal Lender calculated in accordance with the terms of the Client Agreement

(iii) *Collateral Types and Collateralization Levels*. These may be reported on both per loan and per Principal Lender (i.e., per fund/account) bases. This may also include information about each piece of collateral if non-cash collateral is held, or each lending fund/account used if more than one.

(iv) *Rates*. The following information may be reported regarding rates, as applicable:

- Rebate per loan
- If non-cash, fee per loan
- Net earnings per loan

(v) *Collateral Reinvestments*. Information about the investment of cash collateral is typically provided by the cash manager. This function may be managed by an external third-party manager, the Principal Lender itself, or by the Lending Agent. If the Lending Agent manages the cash collateral pool or SMA in which a Principal Lender is invested, the details of cash reinvestment may include the following at the Principal Lender (i.e., fund/account) level or the collateral pool level:

- Instrument type
- Issuer
- Description
- Identifier
- Weighted Average Life (as measured to stated final maturity date or unconditional demand date)
- Weighted Average Maturity (as measured to interest rate reset)
- Credit ratings
- Yield
- Par value and amortized cost

(vi) *Benchmarking/Comparison to Market*. Some Lending Agents may provide benchmarking information to Principal Lenders, as discussed in more detail in Section 6 below.

5. RECOMMENDED DISCLOSURE AND TRANSPARENCY BY LENDING AGENTS TO BORROWERS

U.S. broker-dealers who borrow securities from Lending Agents acting on behalf of one or more Principal Lenders are required to obtain adequate information about the Principal Lenders to initially approve them as a counterparty, and to monitor their exposure on an ongoing basis. This information is shared among counterparts in common formats through a standardized information technology process agreed by the Agent Lender Disclosure Taskforce (the ALD Taskforce) in 2006. The ALD Taskforce consisted of representatives of Borrowers, Lending Agents and vendors that support securities lending market participants. The ALD Taskforce developed a uniform set of processes and procedures, and related infrastructure to facilitate disclosure of information sufficient to identify the Principal Lenders. This includes the Principal Lender's legal name, tax identification number (or another unique identifier for lenders who do not have a U.S. tax identification number), address, place of incorporation, and industry classification (common referred to as "entity type"). Financial data such as lendable assets and the net asset value of those assets which can assist broker-dealers in performing their credit risk reviews may also be provided in the Lending Agent's discretion.

In addition to the information required to pre-approve Principal Lenders, broker-dealers also have an obligation to monitor their credit exposure to each Principal Lender. The SEC has determined that SEC-registered broker-dealers that borrow through agency securities lending transactions generally should (i) maintain books and records of their loan activity with each Principal Lender, and (ii) monitor credit exposure to each Principal Lender, and calculate regulatory capital exposure with respect to each such lender. Consequently, Lending Agents provide broker-dealers with the details of each lending transaction on a daily basis, no later than the close of business on the next business day after the transaction settles.

Principal allocation information, which enables broker-dealers to determine which Principal Lenders are involved in each transaction, is provided for each Principal Lender in addition to the information with respect to lent securities and collateral described below.

Information provided to broker-dealers regarding lent securities includes a security identifier, such as the CUSIP, SEDOL or ISIN, and the amount of securities loaned. Collateral details should include the type of collateral (cash or non-cash) received on behalf of the Principal Lenders, the amount of cash (if any) received and the identifying information for non-cash collateral received. Standardized data file formats such as those developed by the ALD Taskforce should be used to convey the information regarding Principal Lenders, loaned securities and collateral.

The operational infrastructure and systems of Lending Agents and Borrowers reflect long-established, and in many cases standardized, processes related to securities lending, such as settlement, accounting, asset servicing, billing and reconciliation functions. The infrastructure and systems of these market participants enable them to share large volumes of detailed information on outstanding loans and enable each market participant to maintain an accurate, complete and current account of its lending book. An example of this is the contract comparison process, which entails the sharing of relevant data by Lending Agents and Borrowers relating to open contracts or contracts pending settlement at pre-agreed times. This can be done bi-laterally, but is more commonly done using a contract compare service provider. Through this process, Lending Agents and Borrowers are able to identify discrepancies in lending contracts on a daily or regular basis throughout the life cycle of a loan transaction, and to resolve differences as quickly as possible. This not only increases transparency, but also facilitates the mark-to market and the billing process in connection with such transactions.

6. ANCILLARY MARKET INFORMATION

The disclosure and transparency to Principal Lenders and to Borrowers described in Sections 4 and 5 above relates solely to the particular transactions and relationships in which those Principal Lenders or Borrowers participate. This permits Principal Lenders and Borrowers to monitor their own lending activities with the respective Lending Agent. Additionally, many Lending Agents and Borrowers choose to provide detailed information regarding securities loan transactions to third-party data vendors that cleanse, aggregate, and make the data and resulting analyses available to them and other market participants for a fee. This information may be used to benchmark performance and evaluate the effectiveness of securities lending trading teams, trading strategies and other program aspects at an individual security level, asset class level, and portfolio/program level. Lending Agents may also choose to complement their reporting to their Principal Lender clients by furnishing this vendor data and analyses to them.