

Client Alert

A report
for clients
and friends
of the Firm September 2008

Monitoring Securities Lending Programs in Today's Market Environment

The recent instability, and extreme volatility, experienced by the financial markets during these past few weeks has been of some concern to our clients who are fiduciaries and investment advisors of private employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") — as well as to public employee benefit plans, foundations, mutual funds, insurance companies and other institutional owners of securities — which loan their securities. In just the past week alone, several unprecedented events have occurred in the U.S. and worldwide stock and fixed-income securities markets, which have had a severe adverse effect on a number of banks, insurers and other financial services institutions (and, of course, on the value of their securities). These developments, together with the continued extreme turbulence in equity and credit markets around the globe, should prompt plan fiduciaries, and financial services companies that either operate or participate in such programs, to consider whether there now may be unrecognized, heightened risks inherent in their Securities Lending Programs.

Nature of Securities Lending

For at least the past quarter century, securities lending has been utilized to augment investment income on securities held in security owners' investment portfolios by lending them to borrowers (many of whom typically use the securities to cover positions that are sold "short") on a fully collateralized basis. Where securities loans are secured by cash, the bank, trust company, custodian or other lending agent, on the owner's behalf, invests the cash and the return on the cash (less a negotiated rebate paid to the borrower and the agent's fee) to produce incremental earnings for the

lender. Where loans of securities are collateralized by other than cash, such as U.S. Treasury obligations or obligations of agencies or other government-sponsored enterprises, the lender's return is based on a negotiated loan fee collected from the borrower by the lending agent.

Fiduciary Duty to Prudently Monitor Securities Lending Programs

Fiduciaries of all private benefit plans subject to ERISA, and fiduciaries of many (if not most) public plans, are required by the law applicable to their plans to discharge their duties with respect to the plans for the exclusive benefit, and solely in the interest, of the plans' participants (and their beneficiaries) and, for ERISA plans, in accordance with ERISA's "prudent expert" standard of care. This standard of fiduciary prudence governs many actions the fiduciary takes (or omits) on behalf of such plans, and may include decisions involving the lending of plan securities.

As with other plan asset investments, each plan fiduciary should continually monitor its benefit plan's Securities Lending Program in accordance with a prudent procedure. Although all aspects of the program should be carefully reviewed, there are several criteria that may warrant your (or your investment advisor's) immediate attention, especially in the current volatile market environment, in order to ensure that:

- The collateralization of the loaned securities remains at a sufficiently protective level;
- The banks, brokers, dealers, and other financial services industry organizations who borrow the securities continue to be financially stable, and fully able to fulfill their obligations under their securities borrowing agreements;
- The investment vehicles into which the collateral generated by securities lending is placed is safe and remains prudent; and

- The lending agent(s) indemnifying the plan (or other entity) owning such securities against borrower defaults continue(s) to be financially sound.

Potential Risks Posed by Securities Lending in the Current Market Environment

While securities lending generally has been considered to be a relatively low-risk means of enhancing an institution's securities portfolio investment returns, it is by no means risk-free. Losses can occur both in connection with (i) the investment of cash collateral; and (ii) as a result of a counterparty default at a time when, due to relative overnight pricing movements of collateral vis-à-vis loaned securities, the institution is left in an under-secured position. The recent violent daily swings in the market value of certain stocks – across several market sectors – is precisely the type of environment that can lead to unexpected, and possibly very significant, under-collateralization (which, in turn, can lead to loss scenarios that can – under certain circumstances – be quite substantial).

Thus, among other cautionary measures that may need to be initiated, the investment vehicle into which the collateral generated by securities lending is placed should also be examined in order to determine whether it continues to be appropriate and prudent. In particular, money market funds that were previously regarded as virtually risk-free may no longer warrant that assumption (without conducting further due diligence).

Moreover, while many banks (and other lending agents) indemnify their securities lending customers against borrower defaults, *but not reinvestment risk*, that indemnity is only as good as the creditworthiness of the guarantor itself. Accordingly, plan fiduciaries should consider whether it is appropriate to undertake a careful evaluation of the creditworthiness of the custodian (or other lending agent) administering their Securities Lending Program and/or consider engaging more than one custodian (or other lending agent) with respect to such program in order to diversify risk.

Beyond the general concerns raised above, fiduciaries should consider, in consultation with their investment advisors, whether to analyze the following specific issues:

- **Nature of Counterparty.** Borrowers of securities are typically financial services institutions, either acting on their own behalf in connection with their proprietary trading or as agent on behalf of customers (through prime brokerage arrangements or otherwise). Given the unprecedented weakening of the creditworthiness of several major banks and broker-dealers within the past two weeks alone, you may want to consider an immediate re-evaluation of your Securities Lending Program's list of authorized borrowers in conjunction with both the plan's
- **Permitted Collateral.** Generally, collateral posted by a borrower in respect of a securities lending transaction consists of cash, U.S. Treasury obligations, Government National Mortgage Association issues and, occasionally, government-sponsored enterprises such as Fannie Mae and Freddie Mac. In light of the recent severe economic stress experienced by both Fannie Mae and Freddie Mac, and despite the fact that the U.S. Government is now more strongly standing behind each of these entities, fiduciaries should consider requesting the opinion of their investment advisor as to whether the advisor believes that it might be prudent, under the circumstances, to limit non-cash collateral (at least temporarily) to short-term *direct* obligations of the U.S. Government.
- **Required Collateralization.** Generally, loans of U.S. Government securities are collateralized at 102% of the value of the loaned securities, and certain other securities are collateralized at between 103% and 105% of their fair market value. Given the recent extreme volatility in securities trading and price movements within the market, reconsideration of the adequacy of the collateral cushion (*i.e.*, the degree of required over-collateralization) should be considered in consultation with your plan's investment advisors.
- **Mark-to-Market Policies.** Security loans are “marked-to-market” daily to maintain required collateralization levels. However, some lending agents employ an informal (or formal) procedure whereby they do not require the borrower to post collateral unless and until the value of the collateral actually falls below 100% of the value of the loaned securities, rather than falling below the initial prescribed collateralization level of between 102% and 105%. Fiduciaries should consider whether their agent employs such a practice and, if so, whether adherence to it in the current market environment may be exposing their investment portfolios to an inappropriate level of risk.
- **Cash Collateral Reinvestment.** The profit expected to be generated from cash collateralized securities loans obviously is dependent upon the income generated by the investment of cash collateral and the nature (and relative safety) of the investment vehicles into which it is placed. The permitted vehicles generally utilized for such investment should also be reviewed carefully to ensure that they continue to be prudent and are not subject to undue market risk or loss of principal. Typically, cash collateral is invested in one of the following short-term investment vehicles:

- Some type of group or commingled short-term investment fund (“STIF”) established by the plan’s custodial bank or an affiliate;
- A money market fund;
- Specific transactions, such as repurchase agreements (collateralized by U.S. Government obligations, with a counterparty meeting certain credit or risk parameters);
- Commercial paper having a specified rating; or
- Short-term bank deposits.

Given the recent disclosures in the marketplace concerning money market funds that heretofore have almost always maintained a share value of one dollar (i) that have either imposed unexpected moratoriums on customer withdrawals; and/or (ii) whose share value has fallen below one dollar, and amidst growing concern as to the obligors in respect of the underlying investments of such funds, a careful review of the investment criteria for securities lending cash collateral (including as to obligor, type of instrument, concentration, diversification, weighted average maturity, liquidity, volatility, and all other relevant criteria) should be undertaken by fiduciaries in conjunction with their professional advisors.

- **Short Sales.** As noted above, entities generally borrow securities to avoid failures-to-deliver or pursuant to permitted arbitrage or hedging activities. A significant portion of borrowings are by short-sellers—those who sell the security before they own it, borrow the security to settle the sale trade, and eventually hope to purchase the security in the marketplace to satisfy the borrowing (hopefully at a price less than that at which the security was initially sold). Many commentators have concluded that short-selling skews market volatility and exacerbates downward movements of the prices of targeted securities, akin to manipulation. The SEC has recently imposed a ban on the short-selling of financial services entities (very broadly defined). The extent to which specific securities available for loan should be restricted or withheld from lending in this environment should be considered by a securities lender (in conjunction with the lender’s advisors and the custodian).

* * * * *

You can also visit our Website at www.proskauer.com

**BOCA RATON • BOSTON • CHICAGO • HONG KONG
LONDON • LOS ANGELES • NEWARK • NEW ORLEANS
NEW YORK • PARIS • SÃO PAULO • WASHINGTON, D.C.**

Client Alert

The issues discussed above involve both investment and legal matters. Proskauer has a wealth (no pun intended) of experience in the securities lending area – both with respect to the banking, broker-dealer, hedge fund, insurance, mutual fund and private equity sectors as well as in the employee benefit plan arena. Should you have any questions, or require assistance, please do not hesitate to contact either:

Rory Judd Albert
212.969.3005 – ralbert@proskauer.com

Charles E. Dropkin
212.969.3535 – cdropkin@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

© 2008 PROSKAUER ROSE LLP. All rights reserved. Attorney Advertising.