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The Facts on Mutual Funds and Securities Lending

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Recent stories in the press have addressed the issue of securities lending, particularly in the context of 401(k) plans. For example, a March 16 story in the *Wall Street Journal* ("Disclosure Sought on Fund Lending") suggests that securities lending' in 401(k) plans "prevented some employers and investors from withdrawing their money during the financial crisis."

A few clarifications are in order. The *Journal* article correctly states that mutual funds, like many investment pools, lend securities (typically to broker-dealers). Doing so allows mutual funds to generate incremental income and improve total returns with a reasonable amount of additional risk. Securities lending also provides liquidity to the market by enabling brokers to cover failed trades or short positions.

But when the *Journal*'s story refers to plan sponsors being restricted from withdrawing from an investment option that participated in securities lending, it is *not* referring to mutual funds, but rather to non-registered investment pools offered to retirement plans.

Indeed, to our knowledge, no registered mutual fund restricted redemptions during the credit crisis because of its securities lending. The law prohibits mutual funds from suspending redemptions (or taking more than seven days to pay redemption requests) unless authorized by the Securities and Exchange Commission or unless an emergency exists (as defined by the SEC).

Since 1972, the SEC has set out conditions governing mutual fund's securities lending programs. For example, as noted in a recent Government Accountability Office report on securities lending in retirement plans, mutual funds may not have on loan at any time securities representing more than one-third of the fund's total value. A fund must receive from the borrower at least 100 percent collateral in exchange for loaned securities. (In practice, funds require 102 percent collateral for domestic securities and 105 percent for international securities.) Loaned securities must be available for recall on short notice, in case the fund needs to sell the securities or cast votes on proxy proposals. So the assets used for collateral must be highly liquid—typically, cash, government securities, or bank letters of credit. In addition, the borrower must add to the collateral on a daily basis if the value of the securities on loan increases.

This framework provides important protections to mutual fund shareholders, including those investing through a 401(k) plan. One key effect: these conditions tend to reduce the amount of securities lending mutual funds do. In connection with the hearing on March 17, the Senate Special Committee on Aging released a staff report detailing results from a survey on securities lending from employers that sponsor 401(k) plans and banks in the securities lending market. The report found that "for mutual funds that lent securities indirectly in 2010 through the surveyed employers' 401(k) plans, the average percent of the investment option's assets that was lent out was 3.35 percent. The range for these mutual funds was 0.04 to 28.3 percent."

In contrast, for non-registered collective investment trusts that lent securities indirectly in 2010, "the average percent of the investment option's assets that was lent out was 17.33 percent. The range of percentages for these collective investment trusts was 0.10 to 97 percent." In other words, the committee found at least one collective investment trust that lent out almost all of its securities. A mutual fund can't do that.

As noted in the *Wall Street Journal* article, the Senate Special Committee on Aging's report recommends that companies in the business of lending securities report information to the SEC and bank regulators. Mutual funds already disclose information regarding their securities lending practices to the SEC and shareholders in two important ways:

- A mutual fund must publicly disclose that it may lend securities. If securities lending is a principle investment strategy for the fund, that disclosure must appear in the fund's prospectus. Otherwise, it is in the fund's statement of additional information.
- Twice a year, funds prepare financial statements that are filed with the SEC and sent to shareholders. The fund's financial statements identify securities out on loan, investment of cash collateral received, a liability reflecting the obligation to return the cash collateral at the conclusion of the loan, and income earned from securities loans.

Such disclosures flow from the core principles of investor protection that are embedded in the structure and regulation of mutual funds and other registered investment companies. You can learn more about those principles in ICI's *Investment Company Fact Book*.

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