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Securities Lending by Regulated Funds: FAQs

Frequently Asked Questions on Securities Lending by Regulated Funds

What is securities lending?

Securities lending is one of the myriad investment techniques used by funds to improve the return on their portfolios for the benefit of their shareholders. The term refers to the lending of a security by one party (sometimes called the beneficial owner) to another (the borrower) in exchange for collateral. In the United States, the collateral for securities loans is almost always cash.

Due to strict regulatory limits, securities lending is a relatively minor strategy for most funds in the United States, designed to add incremental returns with minimal additional risk.

What types of funds lend securities?

Not all investment companies registered under the Investment Company Act lend securities. Mutual funds, closed-end funds, and ETFs (collectively, funds) may engage in securities lending. UITs do not. [1]

Large funds with relatively low turnover, such as ETFs and index funds, often are the most likely types of funds to lend securities. The nature of their portfolios allow the funds to have more securities out on loan for longer periods of time, making them a favored counterparty and allowing them to obtain the best terms for their loans.

What are the economics of securities lending?

As noted above, the borrower posts cash collateral for the loan, which is invested to produce income. The income from the collateral investment pays for the securities lending program, with the net income (after expenses) directly benefitting the fund and its investors.

The cash collateral typically is reinvested in very high quality, highly liquid investments. These are often U.S. money market funds managed pursuant to Rule 2a-7 or other funds managed with very conservative short-term investment strategies.

All securities lending programs have related expenses, many of which are paid from the income from the collateral investment. The most common expense is the use of a lending agent. Most agents are independent, although some funds use affiliated lending agents subject to additional regulatory restrictions.

The investment of the collateral, as with any investment, also has related expenses. For example, if the collateral is invested in a money market fund, the beneficial owner pays the money market fund's expenses, including its management fee.

Regulatory Framework

A U.S. fund may lend securities only if it is permitted by its organizing documents, disclosed to investors in the fund's prospectus or statement of additional information (SAI), and subject to approval and oversight by its board of directors.

In addition, the Securities and Exchange Commission (SEC) staff has established guidelines for securities lending activities for funds registered under the Investment Company Act. Among other things, these guidelines restrict the types of collateral that are permissible and how that collateral may be treated, impose limitations on the amount of lending, ensure the ability of a fund to recall securities in a timely manner, and address potential conflicts of interest.

Specifically, the guidelines contain these investor protections:

- Limits on amount lent. Funds may not have on loan at any time securities representing more than one-third of the fund's total value.
- Full liquid collateral. A fund must receive 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. Because loaned securities must be available for recall on short notice, the collateral must be highly liquid, such as cash, government securities, or bank letters of credit.
- Daily mark to market. On a daily basis, if the value of the securities on loan increases, the borrower must add to the collateral.
- Investment of cash collateral in conservative and liquid investments. Although not a formal requirement, SEC guidance contemplates that cash collateral will be invested conservatively. Fund industry practice is to invest cash collateral only in highly conservative and liquid investments. As a result, the problems with commercial paper during the credit crisis did not cause the range of difficulties in funds' securities lending programs that it did for other parts of the financial markets.
- Reasonable interest. The fund must receive reasonable interest for the loan. The fund also must receive any income from the loaned securities, such as dividends.
- Board oversight. The fund's board approves the fund's securities lending policies, which generally establish the parameters for the lending program, such as approved borrowers and the terms of lending agent compensation. The board oversees the securities lending program by periodically reviewing the appropriateness of those policies as well as the program's performance and costs.
- Immediate recall. The fund must be able to terminate the loan at any time and recall the loaned securities within the ordinary settlement time. The fund must recall a security on loan in time to vote proxies if the fund knows that a vote concerning a material event (e.g., a merger) will occur.
- Full disclosure. The fund must disclose to shareholders that the fund will lend securities and lending must be consistent with the fund's fundamental investment policies and its disclosure.
- Restrictions on use of affiliated lending agents. A fund may not use an affiliate as its lending agent without approval from the SEC, either under a no-action letter or exemption. This approval, when granted, includes additional conditions to protect fund shareholders.

How are funds' securities lending activities disclosed?

Funds are required to provide a high degree of corporate disclosure to investors about their securities lending and repo activities. As noted above, a fund must disclose that it may lend securities. This disclosure appears in the fund's prospectus and SAI, both of which are available to investors, the SEC, and the public.

Twice a year, funds also 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. In addition to the semiannual financials in these shareholder reports, funds also file Form N-Q after the first and third quarters, which includes a detailed listing of the fund's portfolio. The filings on Form N-Q identify those securities out on loan.

Are funds indemnified against securities lending losses?

Many funds employ a securities lending agent, which is often independent but sometimes affiliated with the fund. Securities lending agents offer their clients limited indemnification. The precise terms of the indemnity are negotiated between the fund and agent, but generally, the indemnification is triggered only if the borrower fails to return the lent securities and the value of those securities exceed the value of the collateral. Given the daily marked-to-market overcollateralization of the securities loan, as described above, the potential for an indemnified loss is considered a very minor risk.

endnote

[1] A unit investment trust (UIT) is a fund with an unmanaged fixed portfolio of assets. It does not have an investment adviser and may only change the composition of the fund under limited circumstances (e.g., a UIT that replicates an index may adjust its portfolio when that index is rebalanced). It may not select or lend securities or otherwise engage in activities that require an investment adviser.

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