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SECURITIES LENDING IN RETIREMENT PLANS: WHY THE BANKS WIN, EVEN WHEN YOU LOSE

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING

UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

WASHINGTON, DC

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SECURITIES LENDING IN RETIREMENT PLANS: WHY THE BANKS WIN, EVEN WHEN YOU LOSE

WEDNESDAY, MARCH 16, 2011

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The Committee met, pursuant to notice, at 2:02 p.m. in Room SH–216, Dirksen Senate Office Building, Hon. Herb Kohl, Chairman of the Committee, presiding.

Present: Senators Kohl [presiding], Manchin, Blumenthal, and Corker.

OPENING STATEMENT OF SENATOR HERB KOHL, CHAIRMAN

The CHAIRMAN. Good afternoon. I would like to welcome our witnesses and welcome everyone attending today's hearing.

In recent years, most workers have seen their savings take a hit, leaving many to wonder if they will ever be able to retire. The gap between what Americans will need in retirement and what they will actually have saved is estimated to be a staggering $6.6 trillion.

Now more than ever we need to strengthen and protect our pension and 401(k) systems. That is why we are examining securities lending within retirement plans.

In simple terms, securities lending is when a plan lends some of its stocks and bonds to a third party in exchange for cash as collateral that is then reinvested. Many plans participate in securities lending to generate a little extra revenue. For many years, it seemed that there were only benefits to these arrangements for all sides. The economic downturn showed that securities lending is not a free lunch.

It was upsetting to hear reports about some 401(k) participants actually losing money within their 401(k) accounts due to these practices. Some employers were restricted from accessing their worker's retirement savings in investments that lent securities. This is troubling because employers are required by law to be able to change the investment options offered in their 401(k) plans.

Securities lending is a complex financial transaction that goes on every day, often without employers and employees even knowing it is going on within their plans. And if they are aware, many do not understand the added risk, and ultimately that risk lies with 401(k) participants because banks share the cash collateral profits, but not the losses, so the banks always win.

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Last November, this committee began an investigation of the securities lending market, which is being released today. We surveyed employers that sponsored the 30 largest 401(k) plans, and found that all had at least one investment option that engaged in securities lending at some time in the previous five years. However, after the downturn, five of these employers stopped participating in securities lending. The committee also surveyed the seven largest banks in the securities lending market. In 2010, these seven banks provided services to 570 different employer-sponsored plans with a total of roughly $1.3 trillion in assets.

I hope today's hearing and our committee report will shed some light on securities lending within retirement plans, and the benefits and the risk associated with it.

We'll start our hearing with a review of the findings of a new GAO report showing that securities lending is not widely understood by employers or workers. We'll then hear experts on securities lending and the reason why employers are reconsidering their participation in securities lending within their 401(k) plan. Finally, we'll hear from one of the major providers of securities lending services.

We thank you all again for being here today. We look forward to your testimony and a productive dialogue.

And at this point, we'll turn to my colleague, the ranking member, Senator Corker.

STATEMENT OF SENATOR CORKER

Senator CORKER. Thank you, Mr. Chairman, and thanks for calling this meeting. And to all of you who are going to educate us here in just a moment, we thank you for being here, and looking forward to your testimony.

We are here today to talk about securities lending and 401(k) plans and the events that occurred during the crisis of 2008.

Because of liquidity constraints in the marketplace, gates were put in place essentially to protect people from having immediate access to funds being held in 401(k) plans. And unfortunately some people did not understand why they could not access their funds when they wanted to.

Defined contribution plans are taking over as a major source of revenue for our retiring Americans, and so it is important to understand how they work in a properly functioning marketplace, and also to understand what happened during the financial crisis to understand what may or may not have gone wrong.

As is typical in the aftermath of a financial crisis, the industry has improved. The leading agents and collateral managers have largely self-adjusted since the crisis. They have learned to adjust client investment objectives in collateral so that they are more liquid, less exposed to interest rate and credit risk by using more conservative investment models.

One of the things we need to be careful about is not to overregulate, but to preserve competition and choice in retirement savings plans for beneficiaries. If we overregulate, there is a danger that the only options for beneficiaries will be lower yielding options. And there is always risk obviously involved when you try to seek those higher returns.

A better informed consumer is good, but we need to make sure that we are not just piling on more disclosures that consumers do not understand or read. We need to make sure that we are not needlessly regulating where the market is already corrected or where other laws and rules may be already addressing concerns. More disclosure is not always better, but certainly more meaningful disclosure could be very good.

I am here today to learn from the witnesses testifying before us. I look forward to reading the majority report on securities lending. I think it is being released right now, as a matter of fact.

I urge all of us to take time to consider the majority's report, the GAO report, being publicly released today, as well as all of the laws we recently passed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Law.

Securities lending may pose risk, but it can increase yield. So let us be careful about how we proceed forward in order to preserve competition in the marketplace, allow functioning markets to flourish, and promote choice for all participants.

And, again, thank all of you for being here.

The CHAIRMAN. Thank you very much, Senator Corker.

Our first witness today will be Charlie Jeszeck, who is acting director in the Government Accountability Office, Education, Workforce and Income Security team. Throughout his 26-year career at GAO, Mr. Jeszeck has focused on health care, unemployment insurance, private pensions, and social security.

Next, we will be hearing from Anthony Nazzaro, who is principal of A.A. Nazzaro Associates, a securities lending manager and consulting firm in operation since 1987. Mr. Nazzaro has worked in the securities lending industry for 35 years.

The third witness will be Ed Blount, Executive Director of the Center for the Study of Financial Market Evolution. The organization works with practitioners, academics, trade groups, and regulators to analyze practices in capital market sectors that have developed ahead of formal disclosure and reporting standards.

The fourth witness today will be Allison Klausner. Ms. Klausner is the Assistant General Counsel–Benefits for Honeywell International. Ms. Klausner is responsible for legal matters relating to employee benefits at Honeywell within the United States and also worldwide.

Finally, we will be hearing from Steve Meier, Chief Investment Officer, Global Cash Management, for State Street Global Advisors. Mr. Meier joined State Street in 2003. He has more than 27 years of experience in the global cash and fixed income markets.

We thank you all for being here today. And we will start with you, Mr. Jeszeck.

STATEMENT OF CHARLES JESZECK, ACTING DIRECTOR, EDUCATION, WORKFORCE AND INCOME SECURITY, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. JESZECK. Mr. Chairman and members of the committee, thank you for inviting me here today to discuss the practice of securities lending with cash collateral reinvestment. My comments will focus on how these transactions occur in the context of 401(k) plans. While this practice appears to be an easy way for plans to

make money, these transactions are complex and pose challenges both to plan sponsors and participants.

Before I continue, it is important to note that 401(k) plans are now the dominant retirement savings plan in the United States with over 49 million participants and plan assets of $2.8 trillion. In our view, to foster national retirement security in the 401(k) model, both sponsors and participants, at a minimum, need to have the information necessary to enable sound, prudent decision making.

Securities lending in 401(k) plans is a transaction where assets held in 401(k) investment options are lent to third parties, typically in return for cash, which is held as collateral. The idea is that by reinvesting this cash, greater returns can be earned for plan participants.

Many 401(k) investments that engage in securities lending pool their money into commingled or pooled accounts. These accounts are designed to combine assets of unrelated plans to facilitate diversification and gain the cost advantages of larger plans. While larger 401(k) plan sponsors may maintain separate investment accounts and can choose directly to participate in securities lending, it is the commingled account manager, not the plan sponsor, that makes that decision for commingled funds.

The figure to my left provides a basic example of a securities lending transaction with a commingled account. First, a plan sponsor sends contributions to the service provider or account manager administering a commingled account. The account manager then negotiates with the securities lending agent the terms of the transaction, including the split of any gains. The securities lending agent then negotiates with a broker-dealer who is seeking to borrow securities for a client. The broker-dealer provides cash as collateral for the borrowed security to the securities lending agent for the length of the agreement. The broker-dealer earns a rebate or interest on the cash collateral being lent.

The securities lending agent then works with a cash collateral pool manager, who may be affiliated with the lending agent, to reinvest the cash. The pool manager earns a fee for investing this cash. When the transaction is completed, the assets are returned to the original parties.

As shown in the figure on my right, after the broker-dealer and the cash collateral pool manager have received their fees, the securities lending agent and the commingled fund split any gains from the transaction. For the participants, these gains are reflected directly in the values of the shares in the commingled account.

It is important to note that the split is asymmetric. While the gains are shared between the plan participant and the securities lending agent—in our example, the split is 80/20 in favor of the participant—the investment losses are borne only by the participant; thus, a symmetry can also create an incentive for the cash collateral pool manager to seek riskier investments as they do not bear the investment loss.

Securities lending transactions poses challenges for plan participants and sponsors alike. Participants may be unaware that their plan investments are utilized in securities lending transactions. We found that information about such transactions is often buried

deeply within investment option documents, documents which, in many cases, may not even be received by participants. New disclosure regulations by Labor may not be helpful because they focus on information about investment options, such as information on fees paid, and not the practices employed by those options, like securities lending.

Plan sponsors may also be unaware or not fully understand the risks involved in securities lending transactions. This might be particularly the case for smaller plans with commingled funds who may not be as sophisticated as larger plan sponsors. This view is echoed by industry experts with whom we spoke.

The SEC, FINRA, and the industry itself are already taking steps to address issues related to securities lending. GAO has made recommendations to Labor that we believe will enhance disclosure and transparency for both sponsors and participants, and assist in a negotiation of these transactions.

That concludes my statement, Mr. Chairman. I am happy to answer any questions that you or other members may have.

[The prepared statement of Mr. Jeszeck appears in the Appendix on page 28.]

The CHAIRMAN. Thank you very much, Mr. Jeszeck.

Now we'll hear from Mr. Nazzaro.

STATEMENT OF ANTHONY NAZZARO, PRINCIPAL, A. A. NAZZARO ASSOCIATES, YARDLEY, PA

Mr. NAZZARO. Good afternoon. My name is Anthony Nazzaro. I am the principal and owner of A. A. Nazzaro Associates. We are a securities lending manager and consulting group in operation since 1987.

I would first like to thank Chairman Kohl, Ranking Member Corker, and the members of the committee for the opportunity to appear before you today. It is a wonderful honor and a privilege for me to do so.

I believe I was invited to appear and give testimony because of my experience and the longevity of my career in the securities lending industry. My participation in this industry spans some 35 years in roles ranging from an in-house lender at Yale University, to a custodian agent lender for the pension funds of the Commonwealth of Pennsylvania, to a present status as an independent manager for university and foundation endowments. It is my hope that I can offer some perspective, insight, and constructive counsel for pension funds, which represent a large segment of the beneficial owners participating as lenders of securities.

Many large pension funds that participate in securities lending choose to do so through an agent lender, such as their custodian bank. It is my sense that, when a fund enters into an agreement with its agent lender, the fund may not fully appreciate or understand that it has also hired an investment manager. Many times the fund may be focused upon the lending of securities side of the equation and less upon the reinvestment of cash collateral. As a result, the focus or scrutiny is more heavily weighted toward the counterparty risk of the borrower and overshadows or obscures the reinvestment risk. This may result in less scrutiny of the cash collateral investment guidelines proffered by the agent lender. In ad-

dition, given the wide ranging of authority of the agent lender over all lendable assets and the reinvestment of cash collateral, the size of the assets held in the cash collateral portfolio may grow to become the largest portfolio in the funds universe, and the agent lender may become its largest investment manager.

The omission or failure to perceive an agent lender as an investment manager may result in a lack of sufficient reporting and oversight of the cash collateral portfolio, and an assumption that the reinvestment of cash is part of the agent's custodial function in the management of the securities lending program. The danger and risk in this perception was brought to light and exposed during the recent financial crisis and brings us here today.

The reason I'm highlighting this issue is because I believe there are some basic steps that can be taken to protect pension funds and limit their risk.

Step one, documentation. In addition to the execution of a securities lending agency agreement, which is standard documentation, pension funds should execute an investment manager agreement. This elevates the duty and standard of care by the agent lender/investment manager. The investment reports would receive a heightened degree of visibility and are more likely to come within the purview of those persons or committees with oversight at the pension fund.

Step two, investment guidelines for cash collateral. Implementation of stringent guidelines for the reinvestment of cash collateral similar to those of a Rule 2a–7 money market fund. This would limit holdings in the portfolio to only securities of high credit quality, high liquidity, shortened duration, or weighted average maturity.

Step three, reporting and valuation. Receipt of daily reports as to the valuation of the cash collateral corresponding to the securities lending loan balances. The value of the cash collateral portfolio report should be equal to or close to the 102 percent collateralization required for loans and received from counterparty borrowers.

Step four, limits upon program participation. Implementation of a limit or cap upon the amount or value of securities which may be loaned in order to reduce exposure of a portfolio. This limit may be expressed as a specific dollar amount or as a percentage of the total assets.

The above recommendations are four steps that pension funds can implement that I believe would be both constructive and prudent. It is my opinion that implementation of some or all of these steps could have mitigated the problems that funds experienced during the financial crisis.

Thank you.

[The prepared statement of Mr. Nazzaro appears in the Appendix on page 56.]

The CHAIRMAN. Thank you very much, Mr. Nazzaro.

Mr. Blount, we would like to hear from you.

STATEMENT OF ED BLOUNT, EXECUTIVE DIRECTOR, CENTER FOR THE STUDY OF FINANCIAL MARKET EVOLUTION, WASHINGTON, DC

Mr. BLOUNT. Chairman Kohl, Ranking Member Corker, and members of the committee, thank you for the opportunity to share a few thoughts with you today.

I approach this issue with the perspective gained from 35 years of varied roles in the securities lending community, and the experience gained from having built and then sold a profitable business that pioneered the analysis of performance measurement for securities lending programs.

On the surface, the problems cited by the GAO report appear to be a lender side issue; that is, the cash collateral lock ups that froze the assets of 401(k) defined contribution participants and others during and for up to a year after the crisis. However, this is really an issue for the entire investment community.

The effect of restrictions on the supply of lendable securities could quickly degrade the liquidity and efficiency of U.S. capital markets by raising the risks of settlement failures and increasing the capital charges for brokers with customer segregation deficits.

In particular, restrictive actions of regulators affecting the lendable supply of securities could well impair the ability of pension plan sponsors to offer passive index funds and to hedge actively managed portfolios. The reduced availability of index funds and hedges in turn would increase portfolio risks and threaten the investment returns that pension beneficiaries need and expect.

At a very fundamental level, securities lenders help to make the markets more efficient. This has been documented in a number of reports by international regulators.

And the supply of lendable securities is highly sensitive to the actions of Federal regulators. I would cite the 1981 decision of the Department of Labor to amend the prohibited transactions exemption as one example of this.

But let me pause here for a minute. If I say that securities lending is important, I do not mean to say that problems do not exist in the lending community, nor do I intend my comments to be taken as a defense of the status quo such that pensioners might once again be deprived of access to their own funds in the uncertain days of financial crisis.

However, the cause of the lockups was the illiquidity of certain asset-backed securities, which were included in the cash collateral pools of those funds that lent out their securities. In that regard, the problems of securities lenders and their investor beneficiaries are the same as those of many other commingled funds in the United States during the recent market crisis. During that crisis, the suddenly illiquid individual beneficiaries of defined contribution plan accounts absorbed the effects of investment choices made by others; that is, their plan sponsors and cash managers. Unfortunately, DC plan sponsors, unlike defined benefit plan sponsors, have no financial incentive to increase investment revenue, such as securities lending income for their participants.

Plan participants gained the income from securities lending while their administrators merely gain more work and more risk. As a result, it is easier for DC plan sponsors to simply reject as

investment options those mutual funds which lend rather than learn how to evaluate the ways in which risks and securities lending evolve as market conditions change, so as to help participants fine tune their exposures.

Such a decision appears now to have been made by many plan sponsors, whose management mandates routinely reject the possibility of income from securities lending services. As a result, the investment performance of DB plans is exceeding that of DC plans, even when offered by the same corporate plan sponsor. In effect, we are creating a yield deviation between DC and DB plans where there is not a good reason for it.

Going forward, however, it will be necessary to construct a framework which more closely aligns the interests and responsibilities of all those in the DC plan securities lending community without unnecessarily impairing the ability of the market system to contribute to the welfare of both DC and DB plan beneficiaries.

Among the changes that I believe are necessary are an improvement and extension of the disclosure regime for securities lending cash managers. Furthermore, I believe that an expert council should be established to define the limits of prudence for collateral cash managers, one that is based on close monitoring of changing market conditions. I do not—or I do believe that educational programs should be funded by the securities lending community, not the government, through incentives, such as capital charge credits, and then provide it to DC plan sponsors and participants as a way of improving the awareness of their own responsibilities and those of their service providers.

In conclusion, if all members of the service provider community fulfill their responsibilities, I do not believe that new legislation or regulatory actions will be necessary. The cash lockups of the financial crisis were not attributable to a failure of securities lending.

Thank you.

[The prepared statement of Mr. Blount appears in the Appendix on page 59.]

The CHAIRMAN. Thank you very much, Mr. Blount.

Ms. Klausner.

STATEMENT OF ALLISON KLAUSNER, ASSISTANT GENERAL COUNSEL–BENEFITS, HONEYWELL INTERNATIONAL, INC., MORRISTOWN, NJ

Ms. KLAUSNER. Thank you.

My name is Allison Klausner, and I am the Assistant General Counsel–Benefits for Honeywell. On behalf of Honeywell, a Fortune 50 company, I want to express Honeywell's appreciation of Chairman Kohl's and Senator Corker's desire to understand the practice of securities lending in the context of employer-sponsored defined contribution plans.

I understand that my testimony today has been requested to provide the Senate Special Committee on Aging with insight into how one plan sponsor's fiduciary committee has addressed securities lending issues.

Over the years, securities lending has provided tremendous value to participants and beneficiaries of employer-sponsored DC plans, including those with employee deferrals and contributions. I en-

courage the Senate Special Committee on Aging to recognize that, if unnecessary actions are taken to restrict fiduciaries from offering securities lending funds in defined contribution plans, plan participants and retirees may lose valuable opportunities, now and in the future, as they strive to maximize retirement security.

Honeywell's primary defined contribution plan is a fairly typical 401(k) plan. Participants are permitted to direct the investment of their deferrals and contributions, as well as their vested matching contributions. They have the opportunity to select from a robust range of asset classes with varying potential risks and rewards.

The Honeywell Savings Plan Investment Committee is a fiduciary committee consisting of five professionals at Honeywell. Two of the current committee members dedicate significantly all of their time addressing issues relating to ERISA plan assets, one of whom does exclusively for the company's defined contribution plans. All the members have fiduciary education and are counseled on an ongoing basis with regard to their fiduciary duties.

The Honeywell committee members understand that satisfaction of their fiduciary duties is critical to supporting a long-term retirement security of the plan's participants and the company's retirees. The company members recognize they must engage in a prudent process, which considers many factors when selecting and evaluating investment funds, including, but not limited to, whether it has a securities lending component.

I encourage the Senate committee to consider that the matter of whether defined contribution plan assets are invested in securities lending funds is one that should be evaluated in the context of the fiduciary process.

A fiduciary's process in selecting a fund will be based on many considerations: fees to be charged by the investment manager, the type of fund, the asset class, the past performance, and the plan's complete fund line-up.

Securities lending funds in the Honeywell defined contribution plans fund line-up has in fact supported many participants' retirement goals as those investment funds typically charge lower fees than comparable non-securities lending funds and historically had investment gains that contributed to the investment returns for the assets invested in such funds.

The take away is that, depending upon facts and circumstances, offering defined contribution plan participants the opportunity to invest in securities lending funds can indeed be a prudent decision.

Notwithstanding the potential benefits, the Honeywell Savings Investment Committee did determine in October of 2008 to transition from securities lending funds to nonsecurities lending funds. The committee recognized that the then economic climate, and that which was anticipated in the then near future, and the gatekeeping measures which were being implemented, weighed against continuing to offer securities lending funds for investment of defined contribution plan assets.

Although the plan's fiduciaries understood that the gatekeeping measures were purportedly designed to stem the possibility that there would be a run on the bank within the sec lending programs, and that the gatekeeping measures did, in fact, achieve such goal, the gatekeeping measures did handcuff plan fiduciaries and re-

stricted them from making decisions, which could have impacted plan participants' opportunity to maximize retirement security.

Today's legislative and regulatory framework permits fiduciaries to offer defined contribution plan participants access to investment funds with securities lending features. I encourage the Senate committee to recognize the importance of maintaining the flexibility currently available. Fiduciaries should not be required to operate in a rigid environment which prohibits them from providing plan participants and retirees with valuable opportunities to achieve retirement security.

Securities lending employer-sponsored DC plans is a topic that is worthy of your attention. However, we must take care not to study the issue in a vacuum or elevate the matter of securities lending over other issues of equal or greater importance to define contribution plan participants and retirees.

Plan administrators and fiduciaries, as well as third party providers, are in the process of implementing new legislation and regulation, all designed to protect participants. But there does not appear to be an urgent need to address the issue of employer-sponsored defined contribution plans and securities lending features. Perhaps this is a time to rest and allow the new rules to take hold before we consider any new rules or requirements.

I want to thank you for asking me to be a witness today, and I would be happy to address any questions you may have.

[The prepared statement of Ms. Klausner appears in the Appendix on page 70.]

The CHAIRMAN. Thank you, Ms. Klausner.

Mr. Meier, we would like to hear from you.

STATEMENT OF STEVEN MEIER, CHIEF INVESTMENT OFFICER, GLOBAL CASH MANAGEMENT, STATE STREET GLOBAL ADVISORS, BOSTON, MA

Mr. MEIER. Chairman Kohl, Ranking Member Corker, and members of the Special Committee, thank you for the opportunity to appear today.

My name is Steven Meier, and I am the Chief Investment Officer of Global Cash Management at State Street Global Advisors, the investment management arm of State Street Corporation. I hope my testimony will assist you in your important work.

At State Street, we believe that securities lending can play an important role in a balanced investment program for professionally managed retirement plans. As you know, employee retirement plans typically earn dividends and interest income from the plan's investment portfolio.

If participants choose to invest in a plan option that engages in securities lending, the investment portfolio can earn additional incremental income. While the amount of income varies by portfolio and depends upon a number of factors, it can be significant and may be used to either offset expenses or supplement the plan's investment return.

An investor like a 401(k) plan can earn this incremental income when it lends a security it owns to a borrower, who uses the security to settle another transaction, often in connection with a short sale. The borrower provides collateral to the lender for the bor-

rowed security, typically in the form of cash. During the course of the loan, as the market value of the borrowed security changes, the lender either collects or returns collateral based on changes in the value of the security. If the lender has received cash collateral, it invests the cash to earn investment income. When the loan terminates, the lender returns the borrower's collateral, along with an additional payment known as a "rebate." The lender shares the remaining income with the securities lending agent as compensation for its services administering the program, such as matching lenders to borrowers, reassigning loans when the lender sells a security, and revaluing the securities on loan and marking to market the collateral daily.

The lending agent's share of the securities lending income also compensates it for indemnifying lenders against the failure of a borrower to return a security if the borrower defaults on its obligations.

As this Committee is aware, the events of the recent global financial crisis were unprecedented and created challenges for the securities lending business. State Street acted cautiously and thoughtfully before and during the financial crisis to protect the interests of our securities lending clients. Due to our prudent management, none of our cash collateral pools realized credit losses.

In addition, we maintained 401(k) plan participants' full, unrestricted ability to make withdrawals from our lending funds. Investors in our lending funds did not incur any realized losses in connection with cash collateral reinvestment unless they chose to take an in-kind distribution of securities and sell them at a loss.

State Street believes that it acted in the best interest of our securities lending clients and significantly mitigated the potential adverse impacts from the financial crisis.

Our securities lending clients are generally long-standing clients for whom securities lending is just one of many services State Street provides. We believe our interests are appropriately aligned with those of our clients. We are committed to best practices in disclosure and risk management. We also welcome the opportunity to learn more from you today about how the industry can better serve its clients, and particularly retirement plans.

Thank you for the opportunity to be here today. I will be pleased to answer any of the Committee's questions.

[The prepared statement of Mr. Meier appears in the Appendix on page 74.]

The CHAIRMAN. Thank you, Mr. Meier.

I would like to start out with a question and ask for a response from each of you.

What are the risks for both the retirement plan and the individual participants of participating in a securities lending program? Do you think that both employers and their workers are aware of the risks? We will start with Mr. Jeszeck and then move to his left.

Mr. JESZECK. In our firm, what we have found is that there is an asymmetry. While the gains are shared between the securities agent and the lending agent and the plan, the losses are completely borne by the participant. So in that sense, there is an asymmetry there, and, as I mentioned earlier, we think it also creates an in-

centive for pool managers, because they do not bear any of the loss, to possibly invest in more risky assets.

As to whether participants and sponsors are aware of securities lending with cash collateral reinvestment, our work has found that in general there may be some savvy participants who know, but in general, participants, frankly, have no idea what securities lending is, much less whether they are aware of whether it is going on in their 401(k) plan.

The other area, while an argument could be made that plan sponsors should be aware of securities lending, during our work in our report, we found a number of plan sponsors who were not aware of securities lending with cash collateral reinvestment, or securities lending at all going on in their plan. So that was a disturbing finding.

The CHAIRMAN. Thank you.

Does anybody substantially disagree with Mr. Jeszeck's description? Yes, Ms. Klausner.

Ms. KLAUSNER. Thank you, Chairman.

In our experience at Honeywell, the fiduciaries are extremely well aware of which funds are able to have securities lending activity in the fund. We also are aware that we have disclosure in our summary plan description and in other places, perhaps like on our website and in other informal communications, that identify in their description of the funds that securities lending does in fact exist. So I would not necessarily characterize all plan participants as not being aware. I understand that disclosure doesn't always bring awareness, but there are certain populations in Honeywell, as well perhaps in other organizations where the sophisticated professionals and other well-educated individuals do know that it exists and understand it.

In terms of loss and risk, I also think they understand that the varying funds that are available all have the opportunity to go down in their account balance and not just up. And so, this is something that I think in terms of recognizing the variation between what is available to individuals is true, and perhaps the bar needs to be raised. But I would not characterize our plan participants as not having the information readily available.

The CHAIRMAN. Does your company, Honeywell, take time and make the effort to see to it that everybody involved understands this transaction?

Ms. KLAUSNER. May I ask, when you ask everybody involved, do you mean at the plan sponsor/plan fiduciary level?

The CHAIRMAN. Yes, as well as those who are in the plan itself.

Ms. KLAUSNER. At the plan sponsor/plan fiduciary level, the answer is absolutely yes. As to the plan participants at that granular level, I would hesitate to say yes. Just like with all aspects of the investment, they have high-level information about the character of the asset class and the different activities that might go on in terms of the fund. As to whether or not they understand the granular level of securities lending, I would say that is probably not likely.

The CHAIRMAN. Okay. Yes, sir, Mr. Blount.

Mr. BLOUNT. Senator, I think the issue of comprehension by participants and the disclosure by their service providers is com-

plicated. The service providers, I believe, attempt to provide as much information as possible. Plan participants in many cases are no different from the board members of defined benefits plans. And I find when meeting with plan sponsors that there are different levels of comprehension even at the board level. There are members of the investment committee that might have an extremely good understanding. Others are more concerned with retirement issues and leave the investment matters to other board members and directors.

I think when you start to talk about individuals who are investing in any investment program, there is a presumption of trust that they believe protects them. They will assume that if they are being offered a program—an option—that it has been thoroughly vetted, and there is, in effect, an imprimatur to it. Whether they fully understand the details, I think, is actually impossible for most of them. There are many—and I say this with a smile—there are many contemporaries of mine who have been in the business for three decades or more, very closely in the securities lending world, and still don't understand it all. It is an extremely complex and opaque area, so there is a level of trust that I think goes beyond that.

The CHAIRMAN. Thank you. Mr. Meier.

Mr. MEIER. Senator, at State Street, we are completely committed to transparency in terms of all of our investment strategies, including our securities lending activities, as well as our cash collateral reinvestment pools.

In terms of our outreach, we tend to spend a lot of time with plan sponsors and their consultants to go through our program to make sure that there is that level of understanding.

I would say from an industry perspective, one of the frustrations may be that we do not have the ability to actually reach down and communicate directly with the plan participants. Again, our activities are with the plan sponsors and their consultants.

In terms of the characterization about a potential misalignment of interests, I will say that our interests at State Street are completely aligned with those of our clients. We have been in the securities lending business since 1974. It is a core competency of ours as a custodial bank, and we have committed many resources to making sure that we continue to manage those programs in a prudent manner.

We at State Street actually have a little bit of a unique business structure in that we have a division of responsibilities. For example, we have one division that is responsible for lending the securities, and another division, the investment managing arm that I work for, that actually manages the cash collateral. In terms of the fee structure and the revenue sharing, we actually work for a modest set fee on the investment management side, of typically anywhere between one to three basis points, to manage those portfolios.

We are acting as a fiduciary. We are not incented to take on additional risk to increase the return so that State Street Bank, for example, would earn a higher level of income off of those activities.

The CHAIRMAN. Thank you. I will ask Mr. Jeszeck a question, and then we'll turn to Senator Corker. And I think you have alluded to it, but I would like to ask you directly.

Your report shows that the risk of securities lending with cash collateral reinvestments are all borne by the participants, while the rewards are spread around, as you indicated. In fact, some of those involved in the transaction, including securities lending agents, broker-dealers, and collateral pool managers always win and never lose. Does that make you nervous?

Mr. JESZECK. Well, certainly from our work we have found that participants and sponsors are not favored compared to other actors in these transactions. Having said that, we continue to believe that securities lending with cash collateral reinvestment could benefit 401(k) participants if it is managed responsibly. And I think that means getting more information to plan sponsors so that they can negotiate these transactions more prudently, for plan participants to be aware of the existence of securities lending, the implications of securities lending with cash collateral reinvestment for their portfolios so they can make an informed decision consistent with their general preference towards risk. Some individual participants like risk. They like more risk and will be comfortable with securities lending transactions. Others may not like risk as much. And so for these reasons and others, we made the recommendations in our report to the Department of Labor.

The CHAIRMAN. Okay. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Mr. Jeszeck, I am not the most sophisticated investor in the world, but I have been fortunate and do do some investing. I do not know if I have ever seen a scenario where it was different than what you just said. I mean, typically when investments are made, the investment manager participates in the gain, and they do not participate—I mean, that is the way hedge funds operate. It is the way most funds operate. I have not been aware of managers who participate in gains as a way of making fees, participating in losses. So I do not find anything unique about that. Is there something—I could ask Mr. Blount—but is that not standard that usually when people are making investments, they participate in gains and incentive, but do not participate in the losses? As a manager, is that not kind of standard/typical in the industry?

Mr. BLOUNT. I would say it is, Senator, yes.

Senator CORKER. I know you have to have had involvement in this industry other than just this report, right?

Mr. JESZECK. Well, Senator, I—I've been at the Government Accounting Office for the last 26 years, so in that sense I have worked on pension issues. I have worked on issues involving the industry. I have had interactions with the industry, but I have not had any direct involvement myself in the industry.

Senator CORKER. Well, let me just state that as a guy who is certainly no professional that it is a very standard typical arrangement that you are describing, and there is nothing—I mean, that is typical of the way it is. It is very asymmetric. Is there anybody that disagrees with that? I mean, so I just find you making a point out of that odd when, you know, just for the little bit of looking into

what is happening in the industry you would understand that that is the way the industry operates.

Mr. JESZECK. Well, sir, I think the point—what we come away from here is that it is unclear whether plan sponsors know that there is an asymmetry here. In some other cases——

Senator CORKER. Yes. Yes.

Mr. JESZECK [continuing]. Many other transactions there may be—both sides may have some skin in the game. When we looked at these transactions in this instance, in the case dealing with cash collateral reinvestment, the losses are borne by the participants.

Now, the other issue here is, is that the participants, at least from the work that we have done, are not aware—they are not even aware of securities lending in general, much less the fact that they are bearing an additional risk here. And I think that is the issue. It may be typical in the industry, but I think in general, it would be—I think it would be more—I think it would be nice—I think it would be helpful for plan participants, who, after all, it is their money, and we are placing the responsibility on plan participants to invest prudently, to have information about these transactions and the implications of these transactions. And it may be in that case that many plan participants may choose to assume the risk of these transactions and go forward. We know that risk preferences for individuals vary across the board. But I think for us, the key thing is that plan participants should be aware of the particular relationship—the dynamics of these agreements.

Senator CORKER. I appreciate what you are saying. I have to tell you that I would go back to one of the earlier witnesses. I think plan participants sign up more on a sort of global basis of what they think the fund does. I would assume that Honeywell has hedge funds in their fund, and I would assume that there is all kind of long, short, all kinds of activities taking place that a standard typical plan participant would have no idea what that means, nor the risk involved in that. But they would assume that the plan sponsor is making a prudent allocation of resources there.

I can assure you that if I had to know all of those things myself—signing up for a defined contribution plan—again, I am not the most sophisticated person. I do not want to know all that, and I do not know that you are really doing the participant a lot of good in knowing that. I assume a long disclosure form would be okay, but, again, I do not see—I think we are barking up the tree.

Mr. Blount, do you want to add to that?

Mr. BLOUNT. Senator, I think we can even go beyond the mutual fund or the investment world. People buy stocks for airlines, and airlines engage in hedging strategies to protect their cost as fuel prices change. Some do, some do not. If you buy an airline stock, you do not necessarily understand what the hedging strategy is.

Senator CORKER. You might not know that Southwest made inordinate profit for years because they had a great hedge that was going to disappear in a month, right?

Yes, ma'am.

Ms. KLAUSNER. Thank you. I just wanted to make sure I made sure the record was correct. I am not confident that we actually have hedging or hedge funds specifically in our Honeywell 401(k) plan funds.

Senator CORKER. But you might.

Ms. KLAUSNER. We clearly—it is possible. What I wanted to note was that we certainly have many funds that are index based and some that are actively managed. And our participants do understand, through a lot of disclosure, not only through our summary plan description, which I discussed or noted before, but through what we call our fund fact sheets, which are very dense pieces of information about all aspects of each fund, including with charts so that those that are better to understand things through, you know, a description of whereas others through an illustration. There are varying ways to understand what is there.

In terms of getting to the granular level of talking about securities lending and how that may or may not impact the fees of a fund manager, I think that goes to your earlier question, does that provide meaningful information to the individual, or is it just piling on additional information so that the salient points that you want them to know about actually get lost in the density and the volume of information being provided.

Senator CORKER. Now, I know that I have used a lot of time. I just—we did some calculations yesterday, and for a young person beginning to invest in a defined contribution plan and not having the option of lending securities as part of that portfolio, it makes a huge difference at their time of retirement. We looked just on a sort of an ordinary, very conservative basis that if that option were not available to an individual starting out at age 25 and working, that it is likely they would actually have to work a minimum of a year longer, if not more, if that option is not readily available to them. Would any of you all like to comment on that? So, in essence, if we sort of regulate it out and make it so it is very difficult for that to occur, what we are really doing is hurting individuals from the standpoint of amassing a retirement that allows them to retire at an age they would like to retire.

Yes, sir.

Mr. NAZZARO. Senator, I would say that just by that fact, securities lending has merit. The issue before me as I looked at this is really about how much risk one is willing to accept. Done in its basic form, it should be as low risk as possible, and that is how securities lending has always been. I think it got away from us a little bit in the 2003 to 2008 period. All we are really talking about, from my perspective, is reining that in a little so that it becomes the modest, low-risk activity that it should be. It is only meant to hit singles, not home runs, and that is what I would like to see it get back to.

Senator CORKER. Do you think the industry, as Mr. Blount mentioned, has the ability to take care of that themselves and learn from what has just occurred?

Mr. NAZZARO. Yes, Senator, I do, and I think they are already moving in that direction, to their credit.

Senator CORKER. Thank you. Somebody wants to speak. I do not know if I have taken too much time.

The CHAIRMAN. No, go right ahead.

Senator CORKER. Thank you. Mr. Meier.

Mr. MEIER. Thank you, Senators.

I would just like to comment. I agree. I do think that securities lending is a very viable, long-term strategy. I think it is an excellent source of low-risk incremental income. I think you have to look at the risks associated with securities lending in light of the unprecedented financial crisis that we have been through and potentially are still in, hopefully at the tail end of it.

But I think what we saw over the last three and a half to four years is really a perfect storm in terms of excess leverage in the marketplace. Credit spreads are very tight. I do not think what we saw happen over the last few years is going to happen again, and I would hate to see us eliminate securities lending as a viable investment strategy for individual plan participants as a result of that. And, again, I would agree with your assessment. It can make a significant difference in a young person's retirement savings over a period of time.

Senator CORKER. Thank you, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you, Senator Corker.

Senator Blumenthal.

Senator BLUMENTHAL. Thank you, Mr. Chairman. And I want to express my appreciation to you for holding this hearing on a very profoundly important topic. And I apologize for my lateness, but like many of us, I had several hearings and meetings at the same time, and I have been following your testimony. I want to thank everyone who is here today to educate us for the very important testimony that you have given.

And it is important because obviously this issue is of profound and growing importance. We have made great progress in fighting poverty among our seniors. The rate is down from 50 percent in 1939 to 10 percent now, largely because of Social Security, which is one of the reasons why I have strongly opposed any measures to cut Social Security. But in 2009, 49 million Americans were active 401(k) plan participants—many thousands in Connecticut as well—dependent on these plans for their financial well-being, and, in fact, for many of them, a primary way to save for retirement. And I understand your point, Mr. Meier, and others here, that the recent crisis—the near collapse of our economy—may have been a perfect storm, but there remains the possibility that there may be similar storms, perhaps not of the same severity, but equally impactful on the lives and livelihoods of people saving for their retirement.

So, my first question is to you. I understand that State Street has effectively managed securities lending funds during even this very difficult time. In terms of disclosure, you mentioned that you went above and beyond the Federal guidelines to keep your clients informed. But do you believe that more clear Federal banking regulations are appropriate and necessary to assure that others—other service providers follow that lead?

Mr. MEIER. Thank you for that question, Senator. As I intimated earlier, we are completely committed to transparency. And I do think transparency certainly helps level set expectations. I think as an investment manager, it sets for a clear discussion around investment goals and objectives. I, for one, do not want to be in a conversation with a client that is suddenly surprised at the outcome. So, again, we are committed to transparency.

In terms of the specific Federal regulations or changes that you are talking about, Senator, I am not familiar with those. I would be happy to look at them and perhaps come back, if that is appropriate, and give you some feedback on whether I think that would help the situation. But I just have not seen them at this point.

Senator BLUMENTHAL. So, your answer would presumably be—and I do not mean to put words in your mouth, but what I hear you saying is in spirit, yes, and you would want to see the specifics before you either approve or disapprove of the particular regulation.

Mr. MEIER. Yes, sir. That is correct.

Senator BLUMENTHAL. Anyone else have a—yes, sir.

Mr. BLOUNT. Senator, I think that if we draw a line between the crisis problems that we are discussing here and Federal banking regulations, at the moment—and I am not a lawyer, so there this probably needs to be vetted—if a bank were to guarantee the investments of any securities lending pool, there would be 100 percent risk capital charge to the bank, which would basically put it off the table. It would make it too expensive. But when the banks—State Street, I think, in particular—applied for a work around to that, the FED was pretty flexible in saying, well, it depends on what you invest in. If you were to invest in overnight treasury repos, then there is a way to reduce those capital charges.

Now, the unfortunate part of that is that you really cannot make any money in the securities lending pool if that is what you are investing in. But the concept of reducing the capital charges as a result of a more conservative investment strategy is, I think, a direction that might be explored further. And I believe that it is possible to create incentives for the banks and brokers relative to their capital charges, especially as Basel III comes in, that would encourage either more conservative—not implying that the current strategy is too aggressive—but more conservative implementation of strategies, as well as disclosures that help cash managers themselves know where they are.

One of the problems in the securities lending cash management world is there is virtually no contemporaneous information. You do not know what is happening at other pools, so if you are to protect your competitive position, there is an incentive to try to be a little bit more aggressive. So a little bit more information perhaps combined with an incentive in the capital charges might be worth exploring.

Senator BLUMENTHAL. Well, I really welcome that comment insofar as it says that more information, in effect, more education might be welcome and specific incentives for the kind of steps that you would recommend. Do you have more specifics about the kinds of incentives, to use your word, that might be provided?

Mr. BLOUNT. Well, I tend to think in terms of metrics, having run a data business, rather than information. So I would—which is a calibrated form of information—write the metrics that allow you to compare where you are to others.

I think the SEC looks at these matters, among other directions, in terms of systemic risk. So the capital charge credits or the capital credits might be somehow tied to some reduction and overall

systemic risk through a conversation between the FED and the SEC, but that is beyond my pay grade.

Senator BLUMENTHAL. Well, whether it is within your pay grade or outside it, I would welcome additional specific thoughts you may have. You may want to consult with some of your colleagues and anyone else now or afterward. I think normally we keep open the record for additional comments, so I would welcome specific responses, both Mr. Meier, to the question I asked you and others. We do not always have all of the answers at our fingertips, as I know from having been on your side of the table. So if you want to follow up, we would welcome it.

Mr. BLOUNT. I would be happy to do that, Senator.

Senator BLUMENTHAL. Thank you very much, Mr. Blount.

Mr. Nazzaro, your suggestions to protect pension funds and limit their risk include increased documentation, and more stringent guidelines for cash collateral reinvestment, and more reporting requirements and loan limits. What do you think the effect would be on loan servicers? And I apologize if you may have covered this point in part. And would that kind of increased regulation be too much of a burden, in your view?

Mr. NAZZARO. I do not know if it would be too much of a burden on loan servicers. What I am trying to—the message that I am trying to get across is that securities lending is a short-term, overnight, week, day activity, and there is an imbalance when corresponding cash collateral investments are five, six, and seven years. There is no correlation there. So what I am suggesting is the maturity ranges of the cash collateral portfolio should be much shorter than the broader guidelines that had been in place. But as we mentioned a few minutes ago, the industry has recognized that because of what has happened in 2008, and I believe there has been self-correcting in that regard. So I think the large providers of this service are shortening their maturity guidelines and tightening up their regulations and their investment portfolio, and that is what I think is important to protect retirees and pension plans.

Senator BLUMENTHAL. Do you think the self-correcting has been sufficient?

Mr. NAZZARO. That I don't know because it is not possible for me to monitor industrywide the banks. But some of the larger providers, I believe, have moved in that direction, but I cannot speak for all of them.

Senator BLUMENTHAL. Where would be the best place to get that information?

Mr. NAZZARO. I don't have the answer to that. I do not know. You would have to be privy to the programs within each individual provider. I am not privy to that.

Senator BLUMENTHAL. So if we asked each individual provider, that would be the best way.

Mr. NAZZARO. I suppose so. Yes, Senator.

Senator BLUMENTHAL. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Blumenthal.

To Mr. Nazzaro and Mr. Blount, both of you have been in the securities lending business for over 30 years. Could you explain some of the problems that pension funds experienced during the financial

crisis with respect to their securities lending programs? And based on that experience, what might you recommend that we do to prevent these things from happening again?

Mr. NAZZARO. I would be happy to start.

The CHAIRMAN. Mr. Nazzaro.

Mr. NAZZARO. As I stated in my prepared remarks, Chairman, the guidelines are the first place I would start. I think that the large providers of securities lending services to the plan sponsors and pension funds, because it is a worthwhile activity, as we have agreed upon, but I think because of the profit that has been in there from 2003 to 2008, I think it was easy to extend maturity guidelines and to just go a little bit far out on the risk curve and the yield curve, and I think that needs to be reined in a bit. So, the shorter the maturity of these investments would reduce the risk and exposure. I think that is probably the single most important point.

Also I would—many times it is easier to think about this as an equation. You have the securities lending side of the equation, then you have the cash collateral reinvestment side of the equation. Banks, custodian lenders, very large entities have done a wonderful job on the securities lending side of the equation. They have protected their clients' assets. They have demanded 102 percent from the counterparty borrowers and marked that to the market every single day. That side of the equation I think has done extremely well. What I am talking about is now that you have the 102 percent from counterparty borrowers, it is the preservation of that 102 percent at all times. And I think you can do that well as long as your maturity range is short. If you are going to then take that cash collateral and go out three years, four years, five years, six years, I think you are adding risk as you go further out with those investments. That was the lesson, I believe, we learned a couple of years ago, and that is why it is part of my recommendation.

The CHAIRMAN. Thank you. Mr. Blount.

Mr. BLOUNT. Senator, I would affirm what Mr. Nazzaro says in general. But I think there are a couple of lessons that can be taken from the crisis. I think historically it has been very easy for pension funds and their consultants to look at income projections expected from securities lending programs and the revenue split as the primary metrics when you evaluate different service providers. Those are easy, either 70/30 split or 80/20. You take the 80/20. Sounds great. Income of an expected $10 million a year versus $5 million a year, take the 10. But there has to be a greater focus on what I call a holistic review of the risk within a lending program.

Historically the industry has corrected very well. In 1982, there was a default by a firm called Drysdale, which caused Chase Manhattan to step up and write a $200 million check to cover its customers. After that, the industry decided that they had to market all the loans, so that was a self-correction. There were several others, and I will not go through all the details. But the industry corrects constantly.

Holistically, the big risks in a lending program, if you assume that the collateral margin of 102 percent is enough to cover defaults, the big risks come from the difference between the assets and the liabilities, just like a bank. So on the liabilities side, it is

what the lending program owes to the borrowers because the borrowers, being brokers, will return the securities that they have borrowed and say, give me back my cash collateral. That is a huge risk. That is like the risk of depositors coming to a bank and saying, give me back all the money that I have deposited.

Just like a bank, securities lending programs have invested with a gap—a maturity gap that generates a profit, so pensions have to look at what those redemption patterns are, the possibility that depositors may come back. The consultants have to take this look, too. They have to look at the assets, so not just focusing on the assets and the quality of the assets, but the potential for a run on the bank, the risk of the liabilities coming in and making it illiquid. And I think that has been missing by most of the pension funds and their consultants up till now.

I think the service providers have been saying it, but most of the focus from the consultants to the pension community has been on give me a better split and come up with a better income projection, and really now has to be given more balance holistically.

The CHAIRMAN. Yes, Mr. Nazzaro.

Mr. NAZZARO. I think we are saying the same thing on that side—securities lending side of the equation. If all of the counterparty borrowers were to return the securities at the same time, i.e., a run on the bank, you would have to have the liquidity in that cash collateral portfolio to repay all the counterparty borrowers. If you did not, you would be in default and it would be a huge default. So if your collateral portfolio had to be liquidated quickly, unless it were in short-term securities or longer-dated securities, such as we found in 2008, large losses would have been realized.

And, Chairman, we only look to the example of AIG. That was, in fact, what happened. All of the counterparty borrowers wanted their money back at the same time. AIG did not have the liquidity to give them their money back; hence, the bailout and the $20 some odd billion infusion that went to cover counterparty collateral. So we know what that looks like, and that is a very—that is a doomsday scenario. And Mr. Blount is right; we want to learn from that.

The CHAIRMAN. Mr. Meier.

Mr. MEIER. Senator, if I can comment. I work at a very conservative firm. We manage our assets prudently. We managed through this crisis. If I can give you a couple of data points. From June of 2008 to December of 2008, we saw a 50 percent reduction in our securities lending balances. We were not a forced seller of any securities and in the liquid market throughout the crisis. And I think it is important to remember that prudent management doesn't mean taking unnecessary risks.

If you look at our portfolios, irrespective of whether they can invest a little further out on the curve, certainly not five or six years, at the heart, all of our portfolios—our cash collateral portfolios or money market portfolios—was what I refer to as a spread product overlay where we might buy unsecured debt in a 1- to 3-year space or asset-backed securities in the 1- to 3-year space. And those investments typically provide diversification benefits away from unsecured credits, away from M&A risk, and risks of downgrades associated with rating actions.

So I do think when you look at risks, you look at the management of these portfolios, they need to be managed prudently. They do need to be managed to a very high standard of liquidity.

There is also the concept in these portfolios of latent liquidity, where a lender has the ability to simply put out more loans as opposed to sell assets in a declining market. And, again, we use those tools in terms of managing that very important asset liability mismatch.

Mr. BLOUNT. And I think there is one more point, to extend Mr. Meier's point, that it has been overlooked that during the fourth quarter of 2008, which was the worst of the crisis, that the securities lenders recognized the risk that they were dealing with, and they increased the rebates to the borrowers in order to hold those balances in place. And it got to a point where they were paying out what amounted to negative rebates. They were encouraging the broker-dealers to keep the funds in place, and it was pretty effective. It kept the balances until the worst of the crisis was over. So it was a holistic approach.

The CHAIRMAN. Yes, Ms. Klausner.

Ms. KLAUSNER. I would just like to add a comment to try and maybe put this all in a bit of perspective. Clearly I am not an investment specialist, and my knowledge is based upon my personal experience in being counsel to the Savings Investment Committee and learning a great deal from them.

However, we are talking about liquidity, and we are talking about whether or not there should be potentially new rules or new guidance in terms of how the securities lending funds should be managed in terms of their liquidity, and whether or not, you know, there is undue risk in the event of certain doomsday events occurring and there being a potential run on the bank.

But those concepts exist at varying levels in a defined contribution plan. So, again, just to put this in perspective, here's my example. We have a Honeywell common stock fund. Now, we are very clear that it is not 100 percent stock. There is a cash buffer there. I believe our cash buffer is targeted to be about 3 percent. It allows that there would be daily trades and to be liquidity.

There are some individuals who actually will be disappointed that there is cash in the fund in order to allow for liquidity and daily trades because they caught a drag on the market when the Honeywell common stock is going up. On the other hand, there are people who are disappointed that there is not enough cash when stock is going down.

The point here is that at all levels, not just with regard to the small portion of the fund that has securities lending, is liquidity issue. It is an issue that we look at as a fiduciary at a larger level as well. So, in terms of take-aways, the question might be, do we have to or should we create a situation where we are creating rules about liquidity specifically only for securities lending feature, or are there basically prudent rules that are already out there today with regard to the investment funds as a whole, including the securities lending feature.

And so, I caution, again, not to look necessarily in a vacuum——

The CHAIRMAN. Sure.

Ms. KLAUSNER [continuing]. But to look at the larger picture as well.

The CHAIRMAN. Well, that brings me to a question for you, Ms. Klausner. When your company, Honeywell, reviewed the securities lending practices within your own 401(k) plan, Honeywell decided to transition out of securities lending within your plan. What happened?

Ms. KLAUSNER. A couple of things. One is we had our doomsday. We had our crisis, so there were a lot more issues to be reviewed at a very high level. When we were looking at what was going on with Lehman Brothers and all of the other players that were showing signs of collapse, one of the things that we looked at was whether or not the securities lending funds and the collateral there were at risk. Not my personal review, but the review of the investment managers who brought the information back to us, said the answer was no. As long as we allowed the collateral to stay put and we did not try and cash in on it and then ultimately realize a loss, we would not be at risk.

So why did we move out? We recognized that because securities lending relationships were going to change, we would no longer in the future have an opportunity to get the benefit in the same manner as we did before. Securities lending would no longer be as—I do not want to use the word aggressive—but maybe not as conservative. We knew that the fees that were going to be charged and the differentials between non-securities lending funds and securities lending funds would be a smaller differential.

And so at some point, the potential benefits of having those funds would not really necessarily outweigh the risks, coupled with the idea that we were in a gatekeeping situation, as Mr. Meier pointed out, not at a participant-directed level. Participants at each level were able to make their daily trades if they so chose or if they wanted to rebalance on a quarterly basis. They were welcome to do that, and there was no impact to them.

But should we want to, from a fiduciary perspective, add perhaps a different investment manager in the same asset class, or if we wanted to put a competing one, which was a nonsec lending fund, we would have had adverse impact because of the gatekeeping measures.

So given that then economic environment and the one that we expected in the then near future, we really believed it was not going to be in the best interests of our plan participants. We do, however, want to have the door open because, as with everything, there is a lot of learning that goes on. There is change in our economic environment, our financial environment, as well as our regulatory and legislative. And we want to leave open the door that should it be prudent to allow people to get the benefit as the landscape continues to change, to go back in and provide that opportunity to our participants and our retirees so they can maximize retirement security.

The CHAIRMAN. Okay. Senator Blumenthal, any other thoughts?

Senator BLUMENTHAL. No thank you, Mr. Chairman.

The CHAIRMAN. I would like to thank all of our witnesses for your presence here today and for your very informative testimony. I think we have had a very productive conversation. In light of to-

day's hearing and the findings of our committee investigation on securities lending, I would like to make some common sense recommendations.

First, employers, I believe, should increase their knowledge on securities lending within their defined contribution plans. The committee report outlines a few simple questions that all employers should know the answer to. For example, employers should ask their fund manager, "Do the investment options within my plan participate in securities lending?" They should. I'm not saying we should have a law. They should know.

Number two, the Labor Department should help employers better understand this practice by developing basic information and tools for them on securities lending within their retirement plans.

Three, participants should be given easy to understand information about securities lending to help them make informed decisions when selecting investments within their plans.

And, four, there is currently no comprehensive public data available about securities lending, including securities lending in retirement plans.

Therefore, we recommend that companies in the business of securities lending report information about their business practices to the Federal Government.

I notice you were all writing it down as I was talking. Before we conclude the hearing, would anybody have any disagreement on those recommendations?

Yes, Mr. Blount.

Mr. BLOUNT. Senator, just to reiterate a point I made earlier, I think the—if I was an editor, I would offer changing the word information into metrics.

The CHAIRMAN. Okay.

Mr. BLOUNT. Something that is a little bit more precise, relative rather than piling on information.

The CHAIRMAN. Good suggestion.

Mr. BLOUNT. Thank you.

The CHAIRMAN. Yes, Ms. Klausner.

Ms. KLAUSNER. The only additional comment I would make is when you talk about giving participants easy to understand information, and I completely concur that any information they are provided must be easily understood.

I have suggested in other hearings and platforms, I think that there is an opportunity here, even as an aging committee, to recognize that there should be some coordination so that employers, employer plans, employer sponsors, third party administrators, you know, do not bear the full brunt on educating our community—our society—on what it means to invest, whether it's invest through a plan, invest a plan with assets that are or are not with a securities lending feature.

And if there is an opportunity here to recognize, as you said before, that our youngest workers need to understand from the first day they start working and the first day they start earning pay, an opportunity to make investments. You know what is out there in terms of the current landscape. And that that opportunity is not something that should be a burden on employers, plan sponsors, third party providers, that we should be players in that oppor-

tunity. But perhaps, you know, other departments and other regulatory agencies could participate in getting individuals in society prepared so that, when we give them information or disclose to them information as workers, they are ready to receive it.

The CHAIRMAN. Well said.

Mr. JESZECK. Senator, I would say——

The CHAIRMAN. Yes, Mr. Jeszeck.

Mr. JESZECK [continuing]. This would be consistent with the findings of our report. We would support all of those suggestions. I think in particular, something we did not talk a lot about in the report, but the issue of data. One of the handicaps we had in doing our work here was the lack of data, really getting our arms around the world of securities lending. How much is going on? Who does it involve? How much does it involve defined contribution plans? And I think that would be—data in this would certainly, I think, make our understanding of the issue and coming out with some solutions to the extent that there are problems there much more easy.

The CHAIRMAN. Yes, you are right. As I am sure you know, we refer and cover that in our final recommendation, the accumulation of data, so we understand what the dimensions of this whole issue are.

Yes, Mr. Meier.

Mr. MEIER. Senator, my only comment or suggestion would be, to focus on informed disclosure or data information with context, because I do think it is dangerous, for example, to simply publish a list of holdings without context in terms of the benefits of the portfolio, or the structures that underlie those specific securities.

I can give you an example, the Rule 2a-7 disclosure requirement. We are required to post our holdings in a money market fund on a weekly basis. We do it on a daily basis. But the issue is, if a client looks at a holdings report and sees an asset-backed commercial paper conduit, they do not necessarily know who the liquidity support provider is, or the due diligence that we have done in the assets. They do not understand whether it is an appropriate and reasonable investment. And, frankly, that was what, I believe, started or was a considerable contributing factor, to the liquidity crisis in August of 2007. It was investors in money funds pulling out of money funds because of asset-backed commercial paper holdings without context—they had knowledge that they had those holdings, but they didn't have context around the risks associated with those conduits.

The CHAIRMAN. Thank you. Good comment.

Mr. MEIER. Thank you.

The CHAIRMAN. Yes, Senator Blumenthal.

Senator BLUMENTHAL. Yes. Thank you, Mr. Chairman. I think those suggestions or recommendations are excellent as a starting point, and certainly we may want to consider going beyond them based on what we've heard and what we may find out. But I think the Staff Report, combined with the GAO Report, provide a really important source of information and a beginning point. And I would support those recommendations as well.

Thank you.

The CHAIRMAN. Thank you very much, guys. You have been great.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

APPENDIX

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United States Government Accountability Office

GAO

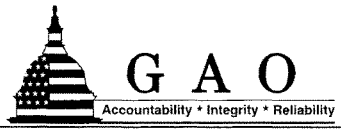
Testimony
Before the Special Committee on Aging,
U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EDT
Wednesday, March 16, 2011

401(K) PLANS

Issues Involving Securities Lending in Plan Investments

Statement of Charles A. Jeszeck, Acting Director
Education, Workforce, and Income Security



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Highlights

Highlights of GAO-11-359T, a testimony before the Special Committee on Aging, U.S. Senate

March 16, 2011

401(K) PLANS

Issues Involving Securities Lending in Plan Investments

Why GAO Did This Study

Securities lending can be a relatively straightforward way for plan sponsors and participants to increase their return on 401(k) investments. However, securities lending can also present a number of challenges to plan participants and plan sponsors. GAO was asked to explain how securities lending with cash collateral reinvestment works in relation to 401(k) plan investments, who bears the risks, and what are some of the challenges plan participants and plan sponsors face in understanding securities lending with cash collateral reinvestment.

In this testimony, GAO discusses its recent work regarding securities lending with cash collateral reinvestment. GAO is making no new recommendations in this statement but continues to believe that the Department of Labor (Labor) can take action to help plan sponsors of 401(k) plans and plan participants to understand the role, risk, and benefits of securities lending with cash collateral reinvestment in relation to 401(k) plan investments. Specifically, GAO recommended that Labor provide more guidance to plan sponsors about fees and returns when plan assets are utilized in securities lending with cash collateral reinvestment, amend its participant disclosure regulation to include provisions specific to securities lending with cash collateral reinvestment information, and make cash collateral reinvestment a prohibited transaction unless the gains and losses for participants are more symmetrical.

View GAO-11-359Tor key components.
For more information, contact Charles Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

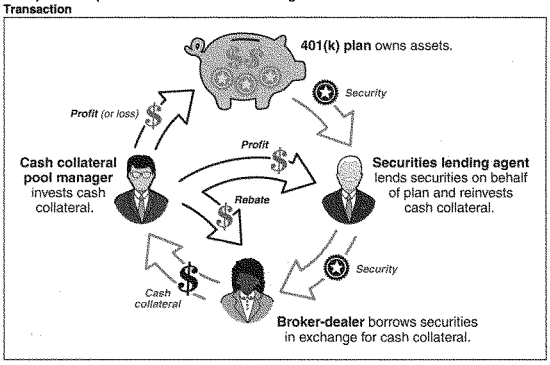
What GAO Found

Some 401(k) investment options that hold assets on behalf of plan participants lend out those assets for a period of time to a third party in exchange for collateral. In the United States, cash is the primary form of collateral taken in these securities lending transactions. When cash is received it is typically reinvested in a cash collateral pool to earn a greater return for participants. Many investment options offered by 401(k) plans engage in securities lending with cash collateral reinvestment, and the structure of the investment options offered by the plan affects the type of securities lending the plan engages in—direct or indirect securities lending—and the way the gains and losses are allocated to plan participants.

401(k) plan participants share any gains but fully bear any losses from cash collateral pool investments in the case of securities lending with cash collateral reinvestment. As shown in the figure below, 401(k) plan participants only receive a portion of the return when the reinvested cash collateral earns more than the amounts owed to others engaged in the transaction. In the past few years, risky assets in the cash collateral pool, which lost value and were difficult to trade, caused realized and unrealized losses to 401(k) plan participants.

Participants and some plan sponsors are often unaware that 401(k) plan investment options are engaged in securities lending with cash collateral reinvestment and that these arrangements can pose risks to plan participants. Current disclosures on these transactions are often not transparent, although certain government and private sector entities are taking steps to make these arrangements more transparent and less risky. GAO recommended that Labor also take action to assist plan sponsors in understanding, among other things, the potential gains and losses associated with the cash collateral pools, and to provide better guidance to plan sponsors and participants.

Example of a Separate Account Securities Lending with Cash Collateral Reinvestment Transaction



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

United States Government Accountability Office

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss securities lending with cash collateral reinvestment in the context of 401(k) plans. Many of the investment options offered by 401(k) plan sponsors, including money market funds,[1] stable value funds,[2] and equity funds,[3] engage in securities lending where some of the assets held in these investment options on behalf of plan participants are lent out for a period of time to a third party. In the United States, cash is the primary form of collateral taken in securities lending transactions, and in this testimony, I will be discussing investment options that lend plan assets to third parties in exchange for cash as collateral that a fund reinvests, or securities lending with cash collateral reinvestment. At first glance, the practice of securities lending with cash collateral reinvestment appears to be a relatively straightforward and potentially easy way for plan sponsors and participants to increase their return on 401(k) plan investment options. But beneath the surface, securities lending with cash collateral reinvestment can also pose challenges and risks to both plan sponsors and plan participants. In our view, transparency and disclosure are important preconditions to assist plan sponsors and participants in understanding the risks and rewards of such transactions and in making prudent decisions about them.

My statement will focus on the practice of securities lending with cash collateral reinvestment in relation to 401(k) plan investments. Specifically, I will discuss (1) how it works with 401(k) plan investments, (2) who bears the risk of loss, and (3) what are some of the challenges plan participants and plan sponsors face and actions that can be taken. My testimony is

[1]Money market funds are open-end management investment companies that are registered under the Investment Company Act of 1940, and regulated under rule 2a-7 under that act. Money market funds invest in high-quality, short-term debt instruments such as commercial paper, treasury bills, and repurchase agreements. Generally, these funds, unlike other investment companies, seek to maintain a stable net asset value per share (market value of assets minus liabilities divided by number of shares outstanding), typically $1 per share.

[2]Stable value funds are a fixed income investment option, designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns set in the contract.

[3]Equity funds consist of pooled investments—including mutual funds and collective investment funds (a bank-administered trust that holds commingled assets that meet specific criteria)—that are primarily invested in stocks.

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based on our March 2011 report, which is being released today.[4] Our work was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), plan sponsors are permitted to offer their employees two broad types of retirement plans, defined benefit and defined contribution.[5] Plan sponsors that offer defined contribution plans do not promise employees a specific benefit amount at retirement—instead, the employee and/or his or her plan sponsor contribute money to an individual account held in trust for the employee. The employee's retirement income from the defined contribution plan is based on the value of his or her individual account at retirement, which reflects the contributions to, performance of the investments in, and any fees charged against the account.

The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pretax compensation to the plan under section 401(k) of the Internal Revenue Code.[6] According to estimates by industry researchers, 49 million Americans were active 401(k) plan participants in 2009 and, by year end, 401(k) plan assets amounted to $2.8 trillion.[7] In most 401(k) plans, participants bear the risk of their investments' performance and the responsibility for ensuring they have adequate savings in retirement.

[4]GAO, *401(k) Plans: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood*, GAO-11-291 (Washington, D.C.: Mar. 10, 2011).

[5]Plan sponsors that offer defined benefit plans typically invest their own money in the plan and, regardless of how the plans' investments perform, promise to provide eligible employees guaranteed retirement benefits, which are generally fixed levels of monthly retirement income based on years of service, age at retirement and, frequently, earnings.

[6]In 2010, the federal limit for pretax contributions to 401(k) accounts was $16,500, and for those 50 and over, an additional $5,500 "catch-up" contribution.

[7]Employee Benefit Research Institute. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009*, Issue Brief No. 350 (Washington D.C.: November 2010).

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Plan sponsors that offer 401(k) plans have responsibilities under ERISA, which establishes that a plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets.[8] Typically, the plan sponsor is a fiduciary under this definition. ERISA requires that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries.

ERISA allows plan sponsors to hire companies that will provide the services necessary to operate their 401(k) plans. Service providers are various outside entities, such as investment companies, banks, or insurance companies that a plan sponsor hires to provide the services necessary to operate the plan such as

- investment management (e.g., selecting and managing the securities included in a mutual fund);
- consulting and providing financial advice (e.g., selecting vendors for investment options or other services);
- record keeping (e.g., tracking individual account contributions);
- custodial or trustee services for plan assets (e.g., holding the plan assets in a bank); and
- telephone or Web-based customer services for participants.

Labor's Employee Benefits Security Administration (EBSA) oversees 401(k) plans,[9] educates and assists plan sponsors and participants, investigates alleged violations of ERISA, responds to requests for interpretations of ERISA through advisory opinions and rulings, and makes determinations to exempt transactions that would otherwise be

[8]Labor's proposed regulations, as of October 2010, would amend the definition of an ERISA fiduciary, reducing the number of conditions that need to be met to be deemed an ERISA fiduciary. As such, the proposed regulation, if finalized, would encompass a greater number of entities assisting plan sponsors with selecting investment options. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

[9]IRS also oversees various aspects of 401(k) contributions under the Internal Revenue Code.

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prohibited under ERISA.[10] However, the specific investment products commonly offered in 401(k) plans fall under the authority of the applicable securities, banking, or insurance regulators. These regulators include the Securities and Exchange Commission (SEC), federal and state banking agencies, and state insurance commissioners as follows:

- SEC, among other responsibilities, regulates securities markets and issuers, including mutual funds under various securities laws.
- Federal agencies charged with oversight of banks—primarily the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), and state banking agencies—oversee bank investment products, such as collective investment funds (CIF),[11] which are trusts that pool the investments of retirement plans or other institutional investors.[12]
- State insurance agencies generally regulate insurance products. Some investment products may also include one or more insurance elements,

[10]Labor regulations specify that participants must be offered at least three different investment options so that they can diversify investments within an investment category, such as through a mutual fund, and diversify among the investment alternatives offered.

[11]A CIF is a bank-administered trust that holds commingled assets that meet specific criteria. Each CIF is established under a "plan" that details the terms under which the bank manages and administers the fund's assets. The bank acts as a fiduciary for the CIF and holds legal title to the fund's assets. Participants in a CIF are the beneficial owner of the fund's assets. While each participant owns an undivided interest in the aggregate assets of a CIF, a participant does not directly own any specific asset held by a CIF. CIFs are designed to enhance investment management by combining assets from different accounts into a single fund with a specific investment strategy. Many banks establish CIFs as investment vehicles for employee benefit accounts, including 401(k) plans. The operation of CIFs by national banks is subject to regulation under OCC regulations. While certain CIFs offered by state banks must comply with OCC regulations in order to qualify for tax-exempt treatment (*See* 26 U.S.C. § 584) these CIFs generally are not limited to employee benefit assets. CIFs offered by state banks that consist solely of employee benefit assets such as retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income tax must only comply with applicable state law requirements (which may include a cross-reference to OCC regulations) and are not required under the tax code to comply with OCC regulations. 12 C.F.R. § 9.18(a)(2).

[12]An institutional investor is an organization that pools large sums of money and invests those sums in securities, real property, and other investment assets. Institutional investors include banks, insurance companies, retirement or pension funds, hedge funds, foundations, and mutual funds.

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which are not present in other investment options. Generally, these elements include an annuity feature and interest and expense guarantees.[13]

Investment options offered by 401(k) plan sponsors, including money market funds, stable value funds, and equity funds, may engage in securities lending with cash collateral reinvestment.[14] SEC staff, by no action letters, effectively limit the percentage of assets in mutual funds and money market funds that can be utilized in securities lending programs. Other 401(k) investment options that are not registered with SEC, such as some equity, bond, and stable value funds, are generally not limited in the percentage of assets that can be utilized by securities lending programs.

Institutions engaged in securities lending for a 401(k) plan subject to ERISA are supposed to take all steps necessary to design and maintain their programs to conform to an ERISA exemption that authorizes securities lending transactions that might otherwise constitute "prohibited transactions" under ERISA.[15] In general, ERISA prohibits parties-in-interest—such as service providers, plan fiduciaries, the employer, the union, owners, officers, and relatives of parties-in-interest—from doing business with the plan[16] but provides various exemptions to these

[13]In the United States, an annuity contract is created when an insured party, usually an individual, gives an insurance company money that will later be distributed back to the insured party over time. Annuity contracts traditionally provide a guaranteed distribution of income over time, until the death of the person or persons named in the contract or until a final date.

[14]There are many types of 401(k) investment options, including real estate, mutual funds, money market funds, CIFs, balanced funds, and stable value funds. Labor reports that, in recent years, there has been a dramatic increase in the number of investment options typically offered under 401(k) plans. ERISA does not prohibit a plan from offering any type of investment to its participants, but it gives plan sponsors flexibility to choose the investments to be offered through their 401(k) plans. Specifically, Title I of ERISA does not proscribe or prohibit types of investment products or options, but plan sponsors must conduct due diligence and prudently select the investment options they want to offer their participants.

[15]Prohibited Transaction Exemption (PTE) 2006-16; Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006).

[16]29 U.S.C. § 1106. Prohibited transactions under ERISA include a sale, exchange, or lease between the plan and party-in-interest; lending money or other extension of credit between the plan and party-in-interest; and furnishing goods, services, or facilities between the plan and party-in-interest, among other prohibited transactions. Labor may grant administrative exemptions from the prohibited transaction provisions of ERISA.

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prohibited transactions.[17] Some of the exemptions provide for dealings with banks, insurance companies, and other financial institutions essential to the ongoing operations of the plan. Labor issued Prohibited Transaction Exemption (PTE) 2006-16 to allow the lending of securities by employee benefit plans to certain banks and broker-dealers and to permit the payment of compensation to a lending fiduciary for services rendered in connection with loans of plan assets that are securities.[18]

Securities Lending with Cash Collateral Reinvestment Is Utilized with 401(k) Plan Investments

Securities lending is a transaction where some of the assets held in 401(k) investment options on behalf of plan participants are lent out for a period of time to a third party.[19] Investment options offered to 401(k) plan participants can earn greater returns if these investment options temporarily lend out their underlying securities and invest the cash received as collateral for the loan.[20] For example, a 401(k) investment option that mimics the S&P 500 index fund will hold the same stocks in approximately the same ratio as they are included in the S&P 500, in an attempt to approximate the return of the S&P 500. There will always be a gap between the S&P 500 and a 401(k) index fund that tries to approximate the returns of the S&P 500 by buying and selling stocks to maintain the same values as are held in the S&P 500.[21] These index funds may try to decrease the gap by earning a greater return on the stocks they hold by temporarily lending out the securities and then investing the cash

[17]ERISA provides a number of detailed exemptions to its prohibited transaction provisions and permits Labor to establish additional ones. 29 U.S.C. §1108.

[18]PTE 2006-16. This exemption permits the lending of securities owned by an employee benefit plan to persons who would otherwise constitute a "party in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities and permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. However, according to Labor, the exemption does not address or provide any relief for the reinvestment of cash collateral.

[19]Participants also still retain all the benefits of ownership of the lent securities, including rights to dividends, interest payments, corporate actions (excluding proxy voting), and market exposure to unrealized capital gains or losses.

[20]Collateral for the loan could also be securities; however, throughout the testimony we describe securities lending when cash is taken as collateral for the loan since it is the primary form of collateral accepted in the United States.

[21]This gap, also known as "tracking error," is caused by, among other things, fund expenses, such as investment advisory fees, and brokerage expenses, that the index itself would not have.

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collateral they receive. Table 1 defines the various parties involved in a typical securities lending transaction.

Table 1: Various Parties Involved in a Typical Securities Lending Transaction with Cash Collateral Reinvestment

Entity	Role
Plan participants	Plan participants contribute to their 401(k) and direct that contribution to certain investment options. In 401(k) plans, the assets are held in trust for participants.
Plan sponsor	A plan sponsor chooses which investment options to offer to its participants and, when making that choice, may decide whether to offer investment options that engage in securities lending.
Plan service provider	A plan service provider purchases securities on behalf of 401(k) plan participants. May act as securities lending agent.[a]
Securities lending agent	The securities lending agent may coordinate loans of securities, hire a manager to invest cash collateral, and often takes on counterparty risk—or the risk that the borrower will fail to return the securities—on behalf of the plan. May be an affiliate of the custodian, i.e., an entity, usually a bank, that has legal responsibility for safekeeping a plan's securities.
Borrower	The borrower contracts with a broker-dealer to acquire the securities it needs to cover its obligations. The broker-dealer can also be the borrower. There are many reasons why an entity might seek to borrow securities, including for "short" sales, i.e., borrowing a security from a broker and selling it, with the understanding that it must be bought back and returned to the broker. Short selling is a technique used by investors who try to profit from the falling price of a stock.
Broker-dealer	The broker-dealer borrows securities on behalf of its customers, providing cash as collateral to the securities lending agent.[b] A broker-dealer is a company or other organization that trades securities for its own account or on behalf of its customers. Although many broker-dealers are "independent" firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer.
Cash collateral pool manager	The cash collateral pool manager invests the cash provided as collateral for the borrowed securities in order to earn additional return for the securities lending agent during the period of time that the securities are borrowed. The securities lending agent can be the cash collateral pool manager, but usually it is an affiliate of the securities lending agent.

Source: GAO

[a]Custodial banks commonly provide securities lending services to defined benefit and defined contribution plans.

[b]If the price of the lent security increases while the loan is outstanding, the borrower will be required to increase the corresponding amount of cash collateral in order to ensure a certain percentage coverage of the security's value. The lender also has responsibilities with respect to the cash collateral. These terms are generally described in a Master Securities Lending Agreement, which is entered into between the lending agent and the broker-dealer.

Securities lending with cash collateral reinvestment can be done through separate or commingled funds. Many investments offered under 401(k) plans pool the money of a large number of individual investors into funds called commingled or pooled accounts, which include CIFs or mutual

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funds, which are designed to combine the assets of unrelated retirement plans to enable participants to diversify and gain the advantages that being part of a larger fund affords, such as greater profits and lower costs. With these accounts, the manager of the commingled account makes the decision to engage in securities lending, so the plan participates in the lending activities indirectly. Larger 401(k) plans, however, are more likely to structure their investments as separate accounts. With separate accounts, it is the plan sponsor who chooses whether or not to participate directly in a securities lending program by lending out the plan assets held in the separate account. Figure 1 shows how securities lending with cash collateral reinvestment is done through a commingled fund, or when the plan sponsor is not directly engaging in securities lending. A securities lending arrangement follows certain steps:

1. Plan participants invest in a CIF or mutual fund. With these commingled accounts, the plan participants own a share in a pool of assets held in the account, and the commingled account owns the assets in the account. The commingled account manager (or mutual fund provider in the case of a mutual fund) makes the decision about whether to engage securities lending.

2. The securities lending agent, the keeper of the commingled account's securities (sometimes the plan's service provider), sets up an agreement with the account manager of the commingled account (or the mutual fund provider in the case of a mutual fund) specifying many things, including the split of the gains from the transactions.

3. The securities lending agent also sets up a Master Securities Lending Agreement with a broker-dealer, who is seeking to borrow securities on behalf of a client.

4. The broker-dealer provides cash as collateral to the securities lending agent, for the length of the agreement, which would specify, among other things, that the lending agent has responsibility with respect to the cash collateral.[22]

[22]The amount of collateral provided by the broker-dealer may depend on the type of security being lent. For U.S. securities a typical collateral rate is 102 percent, for international securities, it is 105 percent of the value of the securities being lent out.

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5. The securities lending agent, then, reinvests the cash received from the broker-dealer to earn an additional return. The lending agent selects and purchases investments within any guidelines set out in its lending agreement with the commingled fund. Guidelines for reinvestment of cash collateral could include the types of investments allowed and other parameters, such as the credit quality of those investments. The securities lending agent may reinvest the cash in a separate account that it or an affiliate manages, or it may reinvest the cash in a commingled collateral pool managed by a cash collateral pool manager, which could also be an affiliate of the securities lending agent. If the lending agent chooses to reinvest the cash in a commingled collateral pool, the cash collateral pool manager chooses the investments included in the pool within the investment parameters of the pool. However, plan sponsors that offer investment options that engage in securities lending with cash collateral reinvestment are responsible for ensuring that the investment option is prudent for their participants and may take steps to monitor the gains and losses.

6. When the broker-dealer returns the security, the lending agent returns the funds to the broker-dealer on behalf of the plan. Any gains from the cash collateral reinvestment are split between the securities lending agent and the plan participant. With a commingled account, gains and losses from cash collateral reinvestment are passed through to the participant by increases and decreases in the value of the participant's shares in the commingled account (i.e., through the net asset value of the mutual fund shares in the case of a mutual fund). Before the plan participant receives any return from the cash collateral pool investments, however, the securities lending agent, broker-dealer, and cash collateral pool manager will each receive either a fee or a rebate for their part of the transaction.

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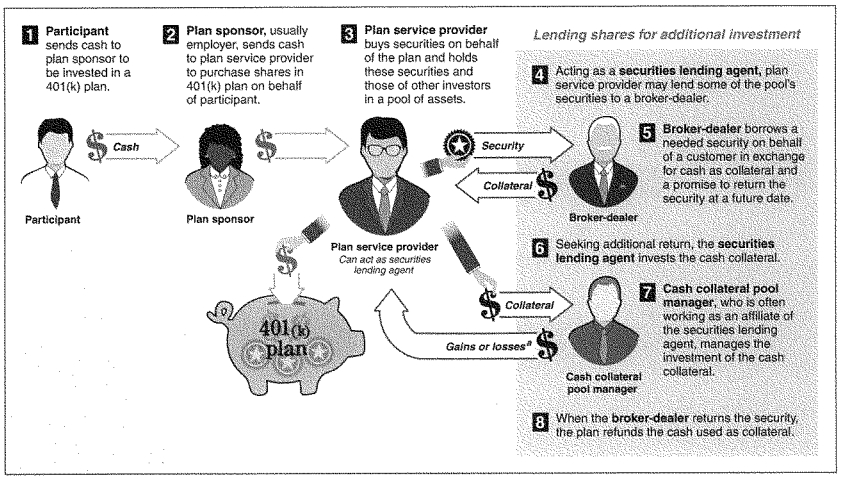
Figure 1: Example of a Simple Securities Lending with Cash Collateral Reinvestment Transaction



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

A direct securities lending arrangement works in a similar manner as an indirect securities lending arrangement, except that the plan sponsor or designated fiduciary has a more direct role. In a direct securities lending arrangement, such as when a plan offers an index fund through a separate account for its 401(k) plan participants, the plan sponsor engages directly with the securities lending agent, selects investment guidelines for the cash collateral reinvestment, and monitors the securities lending agent and the gains and losses from cash collateral reinvestment. Also, the gains and losses are realized directly by participants, since they own the assets of the separate account, again after the securities lending agent, broker-dealer, and cash collateral pool manager have received their fees or rebates.

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Cash Collateral Pool Losses Are Borne By Plan Participants in Securities Lending Programs While Gains Are Shared

Participants bear the ultimate risk of loss from the cash collateral pool investments in the case of securities lending with cash collateral reinvestment.[23] While securities lending agents may bear counterparty risk from securities lending activities with cash collateral—i.e., they may reimburse plan participants for losses caused by borrower default—they generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer. This risk remains with plan participants. Figure 2 illustrates a breakdown of the losses and returns that participants receive, as well as how and when the securities lending agent, broker-dealer, and cash collateral pool manager are paid.

[23]Participants ultimately bore the risk of loss from market risks of the cash collateral portfolio—the potential for portfolio losses resulting from the change in value of stock prices of the portfolio's assets, interest rates, foreign exchange rates, and commodity prices—but were only provided with a portion of the return generated as a result of the risks taken on their behalf.

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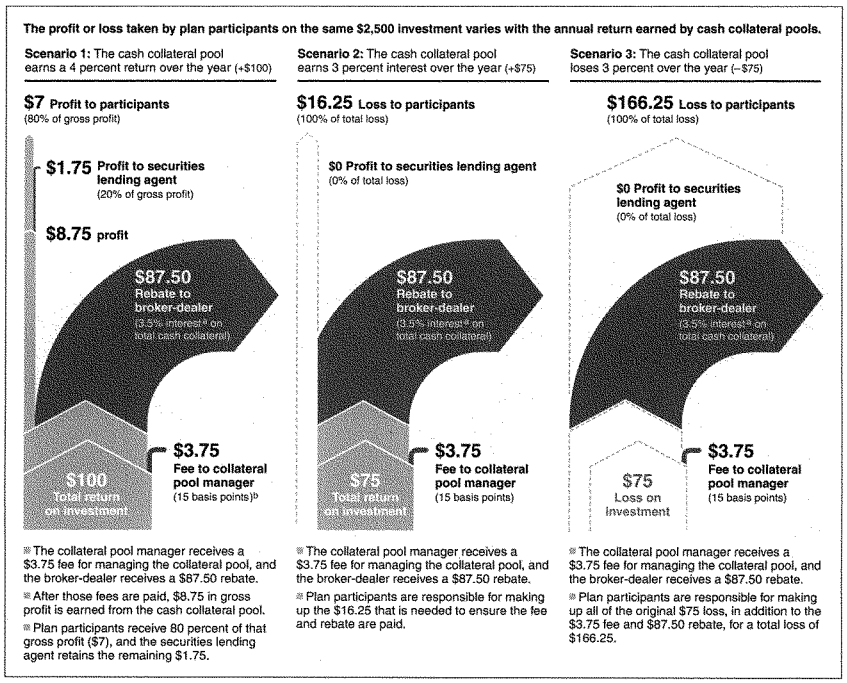
Figure 2: Gain or Loss Earned on Reinvestment of Cash Collateral from Securities Lending in Differing Market Scenarios



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

Note: All of these scenarios are based on certain assumptions. The rates were chosen to depict a situation that may have been in effect in the years/months prior to and at the beginning of the crisis in 2008. While today's rates may vary from the rates depicted here, the distribution of gains/losses will not likely differ materially for the same type of securities loan. Thus, in this example,

- The securities lending agent contracts with (1) the plan sponsor to allow the plan's assets to be lent and (2) with the broker-dealer to lend the assets,

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- The security lent is not a "special" security—or a security that is sought after in the market by borrowers,
- The total amount of cash collateral as a result of the securities lending transaction, $2,500, is provided by the broker-dealer at the beginning of the year and the securities lending transaction remains in effect throughout the year,
- The securities lending agent reinvests all of the cash collateral provided by the broker-dealer in a cash collateral pool managed by the collateral pool manager, who charges 15 basis points of the total amount of cash collateral to manage the pool ($3 75),
- The broker-dealer is promised a rebate—an annualized return of 3.5 percent interest on the total amount of cash collateral they provide over the year ($87.50), and
- The plan sponsor agrees to an 80/20 revenue sharing split between plan participants and the securities lending agent, which means that participants get 80 percent, and the lending agent gets 20 percent of the revenue earned from the cash collateral pool after fees are paid.

[a]Typically, the rate promised to the broker-dealer as a rebate is based on a benchmark rate, such as the federal funds rate or LIBOR and is not typically provided in a one-time payment as shown in the graphic, but more likely paid on a daily or monthly basis. The greater the demand for the security being lent, the lower the rebate paid to the broker-dealer. "Special" securities that have an extremely high borrowing demand, or that are in short supply and therefore hard to borrow, can obtain "negative" rebates, requiring the borrower to not only pledge cash, but also pay a fee to plan participants.

[b]15 basis points is the same as 0.15 percent.

In the last few years, risky assets in securities lending cash collateral pools caused realized losses for participants.[24] These losses occurred because the cash collateral pools' assets lost value and became difficult to trade.[25] As a result of the losses in the cash collateral pool investments, the pools were not worth the amount that the investment option needed to return the cash collateral and pay rebates to borrowers.[26] A recent industry publication estimated that unrealized losses in securities lending cash collateral pools affected most pension plans and many defined contribution plans, but some 401(k) plans also experienced realized cash

[24]These assets may not have been perceived as risky when they were acquired and, in fact, may have complied with the plans' or the investment options managers' investment guidelines covering cash collateral reinvestment. While lending agreements between sponsors and securities lending agents are typically set up to specify investment guidelines for investing the cash collateral, some investment guidelines were very broad and therefore provided some discretion to the lending agent or cash collateral pool manager.

[25]Losses may have been realized or unrealized. Realized losses are generally reflected as a decline in the value of the investment option, whereas unrealized losses are generally not reflected in the value of the investment option until realized.

[26]This is known as a "collateral deficiency" and, as used here, occurs when the securities lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption.

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collateral pool losses in 2008.[27] For example, some 401(k) investment options that were registered with SEC, such as mutual funds, experienced realized and unrealized cash collateral pool losses, where the realized losses were included in the net asset value of the registered investment option.

In addition, some cash collateral pool managers invested in assets that increased the risk of the cash collateral pool investments. These assets were of questionable credit quality or required a longer duration of investment than the typical plan assumed were in the cash collateral pool. For example, prior to September 2008, some pools had invested in Lehman Brothers Holdings, Inc., securities that became almost worthless in 2008.[28] Furthermore, we found that plan sponsors may have also had the incentive to offer investment options that lent securities more aggressively because those investment options offered higher returns, yet were still marketed as relatively "risk free." Thus, in trying to offer participants investment options that provided competitive returns, plan sponsors may have searched out investment options that may have, as a result of securities lending with cash collateral, increased participant risks in seeking higher returns.[29]

Securities lending agents also typically do not bear the risk of loss of the collateral pool, yet they gain when the collateral pool makes money and, as a result, may have been encouraged to take more risks with the underlying assets of the investment options—both by investing in riskier assets and by delaying the sale of those assets. Broad cash collateral reinvestment guidelines specified by the plan sponsor or commingled account manager in the lending agreement with the securities lending

[27]Christine Williamson, "Pension Funds Stung By Securities Lending Mess," *Pensions and Investments* (New York, N.Y.: Feb. 9, 2009).

[28]While Lehman may have had a high credit rating immediately prior to its bankruptcy, that rating may have been based on materially misleading periodic reports. In fact, the report of the Examiner in Lehman's bankruptcy proceedings stated that "unbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse-engineered the firm's net leverage ratio for public consumption."

[29]Many investment options, by design, invest in securities with some risk. If the securities are lent out, and the cash collateral is then invested in risky securities, it creates a leveraged situation where $1 invested in the fund is exposed to more than $1 of risk. To the extent that returns on the two sets of risky assets are correlated, a market downturn could result in both the lent securities, and the collateral investments, suffering losses at the same time.

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agent may have allowed some securities lending agents to choose more aggressive reinvestment strategies when more conservative approaches were available. Some securities lending agents have reported large portions of their annual revenues from the returns earned by cash collateral reinvestment activities for their institutional investors, including 401(k) plans.[30] For example, in 2008, one of the largest securities lending agents reported that its revenues from such lending were over $1 billion.

Participants can also earn a return in a securities lending transaction with cash collateral, but it is not symmetrical to the loss that participants can incur from cash collateral pool investment losses. As shown in figure 2, participants only receive a portion of return, while broker-dealers and securities lending agents may obtain most of the gains earned on cash collateral reinvestment.[31] Participants also only receive a return when the reinvested cash collateral earns more than the amounts owed to (1) the cash collateral pool manager as a fee for managing the cash collateral pool, if any, and (2) the broker-dealer as a "rebate." The plan sponsor agrees to a split of the remaining return between the securities lending agent and the plan participants in various proportions, such as 80 percent to the participants, and 20 percent to the securities lending agent. The amount that the plan receives can serve to offset custody fees and administrative expenses or to simply enhance participants' portfolio returns.

[30]The lending agent typically absorbs the operational expenses associated with providing the service.

[31]According to individuals we interviewed, broker-dealers may negotiate to receive a rebate from the securities lending agent of some of the return earned on the reinvestment of cash collateral because they would have earned a short-term rate of return on the cash they provided as collateral if they had kept it in their possession. However, since they are providing the cash as collateral, they are not able to earn interest on it.

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More Transparency and Disclosure May Help Plan Participants and Plan Sponsors Face Challenges with Securities Lending with Cash Collateral Reinvestment

Participants Are Unaware of Securities Lending with Cash Collateral Reinvestment Arrangements and the Risks Such Arrangements Pose to Them

Participants may be unaware that their 401(k) plan's investments are utilizing securities lending with cash collateral reinvestment. Information regarding securities lending with cash collateral reinvestment is generally buried deeply within the pages of investment option documents that participants receive. For example, we found, in one mutual fund's annual report, the fact that the investment option engages in securities lending was disclosed on page 68 of a 90-page document. Moreover, as shown in figure 3, documents from an index fund registered with SEC, disclosed pertinent information about securities lending on page 14 of a 52-page document of a supplementary document to a mutual fund's prospectus, which 401(k) plan participants do not receive automatically.[12] Therefore, participants may never see information on securities lending, and the disclosed information on securities lending may be embedded in massive documents of varying degrees in which they would have to know what to look for and also understand what the documents are disclosing about securities lending. Furthermore, as written, information regarding securities lending with cash collateral reinvestment may give the impression that any financial risk to plan assets is low when this may not be the case.

[12]The 52-page document is the "Statement of Additional Information" (SAI), which is a supplementary document to a mutual fund's prospectus, that contains additional information about the mutual fund and includes further disclosure regarding its operations. In general, 401(k) plan participants do not receive the SAI or the prospectus automatically, although plan sponsors do receive a prospectus, as do retail investors. There was also a 37-page annual report, as well as a 40-page prospectus for the index fund.

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Figure 3: Example of a Securities Lending Disclosure in Registered Investment Option's Required Disclosures

Excerpt from page B-14 of one 52-page "Statement of Additional Information" (text shown actual size)

Securities Lending. A fund may lend its investment securities to qualified institutional investors (typically brokers, dealers, banks, or other financial institutions) who may need to borrow securities in order to complete certain transactions, such as covering short sales, avoiding failures to deliver securities, or completing arbitrage operations. By lending its investment securities, a fund attempts to increase its net investment income through the receipt of interest on the securities lent. Any gain or loss in the market price of the securities lent that might occur during the term of the loan would be for the account of the fund. If the borrower defaults on its obligation to return the securities lent because of insolvency or other reasons, a fund could experience delays and costs in recovering the securities lent or in gaining access to the collateral. These delays and costs could be greater for foreign securities. If a fund is not able to recover the securities lent, a fund may sell the collateral and purchase a replacement investment in the market. The value of the collateral could decrease below the value of the replacement investment by the time the replacement investment is purchased. Cash received as collateral through loan transactions may be invested in other eligible securities. this cash subjects that investment to market appreciation or depreciation.

The terms and the structure of the loan arrangements, as well as the aggregate amount of securities loans, must be consistent with the 1940 Act, and the rules or interpretations of the SEC thereunder. These provisions limit the amount of securities a fund may lend to 33 1/3% of the fund's total assets, and require that (1) the borrower pledge and maintain with the fund collateral consisting of cash, an irrevocable letter of credit, or securities issued or guaranteed by the U.S. government having at all times not less than 100% of the value of the securities lent; (2) the borrower add to such collateral whenever the price of the securities lent rises (i.e., the borrower "marks-to-market" on a daily basis); (3) the loan be made subject to termination by the fund at any time; and (4) the fund receive reasonable interest on the loan (which may include the fund's investing any cash collateral in interest bearing short-term investments), any distribution on the lent securities, and any increase in their market value. Loan arrangements made by each fund will comply with all other applicable regulatory requirements, including the rules of the New York Stock Exchange, which presently require the borrower, after notice, to redeliver the securities within the normal settlement time of three business days. The advisor will consider the creditworthiness of the borrower, among other things, in making decisions with respect to the lending of securities, subject to oversight by the board of trustees. At the present time, the SEC does not object if an investment company pays reasonable negotiated fees in connection with lent securities, so long as such fees are set forth in a written contract and approved by the investment company's trustees. In addition, voting rights pass with the lent securities, but if a fund has knowledge that a material event will occur affecting securities on loan, and in respect of which the holder of the securities will be entitled to vote or consent, the lender must be entitled to call the loaned securities in time to vote or consent.

Source: GAO presentation of a private investment company's Statement of Additional Information for an index fund.

Labor's recently issued participant disclosure regulations will undoubtedly affect the disclosures participants receive. Participants will receive core information about investments available under the plan, including

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performance and fee information, in a chart or similar format designed to facilitate investment comparisons.[33] However, since these regulations require only disclosure of investment options, and not all practices utilized by those investment options—of which securities lending is one practice—it is unclear how much or to what extent securities lending fees and risks will be discussed in these disclosures. There is nothing in these regulations that explicitly requires plan sponsors to disclose information on the risks of securities lending with cash collateral reinvestment or withdrawal restrictions that can result from securities lending.[34] Without better disclosures about securities lending with cash collateral reinvestment, participants may continue to be unaware of the practice of cash collateral reinvestment and the risk it poses to their 401(k) balances, such as ultimately being responsible for the risk of loss of the cash collateral pool investments.

One way industry experts have suggested to help protect participants' 401(k) retirement savings when placed in investments that utilize securities lending with cash collateral reinvestment is by limiting the percentage of 401(k) plan assets that could potentially be loaned out at any one time. Industry experts we talked to stressed the importance of limiting the amount of 401(k) assets that can be subject to securities lending, similar to SEC staff's limits on lending by mutual funds. SEC staff no-action letters effectively limit the amount of assets that can be lent from a mutual fund at one time to one-third of the fund's total asset value. Furthermore, SEC limits the amount of total mutual fund assets and money market fund assets that can be invested in illiquid securities, such as some asset-backed securities that do not trade on exchanges and do not have an accessible market for buyers and sellers, to 15 percent and 5 percent, respectively.[35] However, there are no comparable regulations that limit the total amount of 401(k) plan assets that can be lent or invested in illiquid securities.

[33]29 C.F.R. § 2550.404c-1.

[34]Between 2007 and 2010, some plan sponsors and participants were restricted from withdrawing their plan assets from certain 401(k) investment options, for various reasons. Withdrawal restrictions, in general, may have prevented some realized losses during the period of the restrictions.

[35]The term "illiquid security" generally includes any security that cannot be sold or disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within 7 days.

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Plan Sponsors May Not be Aware That Investment Options Utilize Securities Lending Arrangements or of the Risks Such Arrangements Pose

Plan sponsors may not know whether their investment options offered to plan participants engage in securities lending with cash collateral reinvestment. For example, 17 of the 74 plan sponsors who responded to our brief poll[36] responded "no" to our question about whether their investments that engage in securities lending had disclosed to them that this investment practice was a possibility. An additional 20 plan sponsors responded that they were not sure whether this information had been disclosed. Other industry officials have expressed similar concerns. One large investment consulting firm stated that many of its plan sponsor clients may not be aware that their investment options utilize securities lending programs. An industry expert we spoke to, who is also a 401(k) plan sponsor, admitted that he did not know whether the investment options offered through his plan engaged in securities lending. Another industry expert told us that there were poor communications between investment option managers and lending agents (e.g., custodial banks)—investment option managers did not ask the right questions about how the cash collateral was being invested, and custodian banks who acted on behalf of investment options' managers thought their customers were educated enough to understand that the cash collateral posted by borrowers was invested in collective investment pools.

Industry experts told us that many plan sponsors are also unaware of the risks involved with the cash collateral reinvestment portion of their service providers' securities lending programs, or may not fully understand the risks. Recent litigation involving banks that engage plan assets in their securities lending programs illustrates instances where plan sponsors may not have understood the practice of securities lending, and where parties involved, under minimal scrutiny, may have taken additional risks with plans' assets. Over the past few years, plan sponsors and others filed lawsuits against Northern Trust, State Street, JP Morgan, Bank of New York Mellon, Wells Fargo, U.S. Bank, and Wachovia for allegedly violating their fiduciary, contractual, and other legal responsibilities in losing millions of dollars for the investment funds in their securities lending contracts. Most of the lawsuits involve the loss of cash collateral

[36]GAO conducted a poll in coordination with *Plansponsor Magazine (Plansponsor)* and asked plan sponsors about withdrawal restrictions in their plans. The poll respondents were members of *Plansponsor's* subscription list, and their responses cannot be considered representative of the overall population of 401(k) plan sponsors. Our main use of this information was to better inform our understanding of these issues from a plan sponsor perspective and to design our subsequent audit work. Because of the methodological limitations and low response rate of this poll, this information is anecdotal and represents only the views of 74 members who responded to our poll.

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invested by the custodian banks in their securities lending programs. Plan sponsors allege that they were intentionally misled by their custodian banks as to where their cash collateral was being invested. Critics of these plaintiff's lawsuits say that the plan sponsors are simply disgruntled customers seeking to recoup unavoidable investment losses from banks that have profited from their plans' assets.[37]

SEC and Private Sector Entities Are Seeking to Make Securities Lending Arrangements More Transparent

SEC and others in industry are already taking steps to address certain issues related to securities lending. SEC and the Financial Industry Regulatory Authority (FINRA)[38] are working on proposals for additional disclosure on securities lending. The Dodd-Frank Act calls for the SEC to promulgate rules no later than July 21, 2012, that are designed to increase the transparency of information available to brokers, dealers, and investors with respect to the loan or borrowing of securities.[39] Such rules would result in improved disclosure in connection with securities lending. FINRA is also looking at promulgating rules that will ensure that broker-dealers allow customers to fully understand all the risks involved and that will focus on disclosing things from potential conflicts to restrictions firms may have on liquidating securities.[40]

Some securities lending agents have already begun to implement various changes to their securities lending programs and the way they manage cash collateral. These changes have come as a result of securities lending agents, who have recently reported that some plan sponsors that they service have not only requested more disclosure about securities lending and cash collateral pools but have also requested that their securities lending programs take on less risk. For example, one securities lending agent is calling for a "back to basics approach" with the focus on

[37]We have not verified the status of any of these cases.

[38]FINRA is the largest independent regulator for all securities firms doing business in the United States. It oversees nearly 4,600 brokerage firms, 163,000 branch offices, and 631,000 registered securities representatives. Its chief role is to protect investors by maintaining the fairness of the U.S. capital markets.

[39]Pub. L. No. 111-203, § 984(b), 124 Stat. 1376, 1933 (2010), codified at 15 U.S.C. § 78j note. The new act does not limit the authority of the federal banking agencies to also prescribe rules regarding the loan or borrowing of securities.

[40]FINRA has also asked for input on how to create an ADV-like form for broker-dealers, which is the key disclosure document used by investment advisers that requires detailed disclosures of services, conflicts, and fees.

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protecting principal and maintaining liquidity while generating incremental returns for participants. Securities lending agents stated that going forward, cash collateral pools would likely be of shorter duration and have more standardized guidelines of what they could invest in. They also said that these guidelines could possibly be structured along the lines of SEC's liquidity requirements for money market funds, under which, among other things, money market funds must maintain minimum daily and weekly asset positions.[41] With these changes, they believe that 401(k) plan participants could receive some protection from the losses and withdrawal restrictions that they recently experienced.

Despite these efforts, it is unclear whether the improved disclosures will provide information about the gains and losses from securities lending to investors and other stakeholders, including plan participants and plan sponsors. Currently, banking regulators do not require banks, who are often securities lending agents, to report gains or losses from their securities lending programs. Although the Financial Accounting Standards Board requires banks to make publicly available this information in their financial statements, the information is not reported to any federal regulator and is also not broken out by type of plan. The Federal Financial Institutions Examination Council[42] supervisory policy on securities lending stipulates that information on securities borrowing and lending transactions should be made publicly available by commercial banks in their financial statements. However, banks do not break out this information by type of plan and may only provide the information as a summary total that includes other revenue streams, such as investment advisory and administration fees, making it difficult to determine, as we found, revenue specific to securities lending.

[41]SEC's rule 2a-7, which governs money market funds, requires that these funds maintain at least 10 percent of their assets in cash, U.S. Treasury securities, or securities that mature or can be converted to cash within 1 business day, and at least 30 percent of their assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that mature or can be converted to cash within a week.

[42]The council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by FRB, FDIC, the National Credit Union Administration, OCC, and the Office of Thrift Supervision, and to make recommendations to promote uniformity in the supervision of financial institutions.

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GAO Has Recommended Changes Labor Can Make to Help Plan Sponsors and Participants Better Understand Securities Lending with Cash Collateral Reinvestment

In our recently issued report on withdrawal restrictions, GAO made several recommendations to Labor about actions the Department could take to help improve transparency on the practice of securities lending arrangements and assist plan sponsors and participants in understanding the role, risk, and benefits associated with securities lending with cash collateral reinvestment. Specifically, we recommended that Labor:

1. Amend its regulations on plan sponsor disclosure to participants to include provisions specific to the practice of cash collateral reinvestment utilized by fund providers' securities lending programs and provide plan sponsors with guidance alerting them to the risks of engaging in securities lending with cash collateral reinvestment and the type of information they should seek from their service providers about these investments.

2. Review the practice of securities lending with cash collateral reinvestment, to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) plan assets are utilized in this practice. ERISA already requires that the fees paid to plan service providers be reasonable with respect to the services performed and Labor, in its implementation of PTE 2006-16, its prohibited transaction class exemption for securities lending, specifically requires that compensation received by the parties involved in the securities lending transaction should be reasonable.

3. Revise its PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements utilizing cash collateral reinvestment on behalf of 401(k) plan participants not do so unless they ensure the reasonableness of the distributions of expected returns associated with this arrangement. Labor's PTE 2006-16, authorizes securities lending transactions that might otherwise constitute "prohibited transactions" under ERISA, but the exemption currently lacks specifics on the utilization of 401(k) plan assets in the practice of securities lending. In addition, according to Labor, the exemption does not address or provide any relief for the reinvestment of cash collateral.[43] Without such information, plan sponsors do not have the information

[43]Labor's PTE 2006-16 does state, however, that, in return for lending securities, the plan may receive a reasonable fee (in connection with the securities lending transaction) and/or have the opportunity to earn additional compensation through the investment of cash collateral. It further states that all fees and other consideration received by the plan in connection with the loan of securities should be reasonable.

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they need to assess the potential gains and losses from cash collateral reinvestments, since other regulators that oversee the financial entities involved in securities lending also do not require that such information be explicitly disclosed to plan sponsors. By revising the existing exemption, Labor can ensure that plan sponsors who enter into securities lending arrangements with cash collateral reinvestment are not prevented from meeting their fiduciary obligations when doing so.

Labor has agreed to consider amending its PTE 2006-16 to require the securities lending agreement to provide enhanced disclosures to plan fiduciaries and to consider providing plan sponsors with guidance alerting them to the risks of engaging in securities lending and the types of information they should seek from their service providers about these investments.

Concluding Observations

Securities lending with cash collateral reinvestment is a complex arrangement, made all the more so because of the lack of transparency of how it is done. What at a surface level seems like an easy way to make money utilizing securities in 401(k) plan assets turns out to be profitable to plan participants only after there is a positive return on the cash collateral pool investments and everyone engaged in the transaction is paid. Not only is the risk of loss unclear to plan participants, but plan sponsors may also not understand the risks of these types of arrangements for plan participants. This can be the case particularly with indirect securities lending arrangements, such as through a mutual fund, as plan sponsors never see the gains or losses of such arrangements because they are passed along to participants through the net asset value of the mutual funds shares. Currently, plan sponsors and participants are minor participants in securities lending arrangements, yet ultimately bear the risk of loss from the cash collateral reinvestment.

It is clear that plan sponsors and participants need more transparent information about how securities lending arrangements work and a better understanding of the gains and losses from cash collateral pool investments that affect plan assets, and ultimately plan participants. Financial regulators and industry participants are beginning to make changes that can help plan sponsors fulfill their obligations. Labor can also takes steps to assist plan sponsors. Without more transparency and better understanding, securities lending arrangements with cash collateral reinvestment will continue as is, whereas plan sponsors and participants will remain, in some cases, unaware of these arrangements and the risk of loss they pose.

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Mr. Chairman and Members of the Committee, this concludes my prepared statement. I would be happy to respond to any questions.

GAO Contact and Staff Acknowledgments

For further information about this testimony, please contact Charles A. Jeszeck at (202) 512-7215 or jeszeckc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Tamara Cross, Assistant Director; Monika Gomez; Jessica Gray; James Bennett; Susannah Compton; Sheila McCoy; Roger Thomas; and Walter Vance were key contributors to this testimony.

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Good afternoon,

My name is Anthony Nazzaro, I am the Principal and Owner of A.A. Nazzaro Associates. We are a Securities Lending Manager and Consulting Group in operation since 1987. I would first like to thank the Committee for the opportunity to appear before you today. It is a wonderful honor and a privilege for me to do so.

I believe I was invited to appear and give testimony because of my experience and the longevity of my career in the securities lending industry. My participation in this industry spans some 35 years, in roles ranging from an in-house lender at Yale University to a custodian agent lender for the pension funds of the Commonwealth of Pennsylvania, to our present status as an independent manager for university and foundation endowments. We currently manage the securities lending programs for Princeton University and The Robert Wood Johnson Foundation.

It is my hope that I can offer some perspective, insight and constructive counsel for pension funds which represent a large segment of the beneficial owners participating as lenders of securities.

Many large pension funds that participate in securities lending choose to do so through an agent lender such as their Custodian Bank. It is my sense that when a fund enters into an agreement with its agent lender, the fund may not fully appreciate or understand that it has also hired an investment manager. Many times the fund may be focused upon the lending of securities side of the equation and less upon the reinvestment of cash collateral. As a result, the focus or scrutiny is more heavily weighted toward the counterparty risk of the Borrower and overshadows or obscures the reinvestment risk. This may result in less scrutiny of the cash collateral investment guidelines proffered by the agent lender. In addition, given the wide ranging authority of the agent lender over all lendable assets and the reinvestment of cash collateral, the size of the assets held in the cash collateral portfolio may grow to become the largest portfolio in the fund's universe and the agent lender may become its largest investment manager.

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The omission or failure to perceive the agent lender as an investment manager may result in a lack of sufficient reporting and oversight of the cash collateral portfolio and an assumption that the reinvestment of cash is part of the agent's custodial function in its management of the securities lending program. The danger and risk in this perception was brought to light and exposed during the recent financial crisis and brings us here today.
The reason I am highlighting this issue is because I believe there are some basic steps that can be taken to protect pension funds and limit their risk.

Step One: Documentation

In addition to the execution of a securities lending agency agreement which is standard documentation, pension funds should execute an investment manager agreement. This elevates the duty and standard of care by the agent lender/investment manager. The investment reports would receive a heightened degree of visibility and are more likely to come within the purview of those persons or committees with oversight at the pension fund.

Step Two: Investment Guidelines for Cash Collateral

Implementation of stringent guidelines for the reinvestment of cash collateral. An example would be guidelines that resemble those of a Rule 2a7 money market fund. This would limit holdings in the portfolio to only securities of high credit quality, high in liquidity and short in duration or weighted average maturity.

Step Three: Reporting and Valuation

Receipt of daily reports as to valuation of the cash collateral corresponding to the securities lending loan balances. The value of the cash collateral portfolio report should be equal to or close to the 102% collateralization required for loans and received from counterparty borrowers.

Step Four: Limits upon Program Participation

Implementation of a limit upon the amount or value of securities which may be loaned in order to reduce exposure of a portfolio. This can be done in a number of ways.

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A. Set a certain dollar amount which acts as a ceiling or cap on the program. For example, a one billion dollar fund may set a limit of 150 million as the maximum value of its securities that may be on loan.

B. The limit may be expressed as a percentage of total assets. Using the above example, loan balances may not exceed 15% of the total value of the lendable portfolio.

C. A restriction may also be set as to the portfolios that may be eligible to participate in the lending program and made available for lending. In our example of the billion dollar fund, there may be ten different types of asset classes in separate portfolios whereby four are eligible and allowed to participate in the lending program and six are excluded or restricted from being loaned.

The above recommendations are four steps that pension funds can implement that I believe would be both constructive and prudent. It is my opinion that implementation of some or all of these steps could have mitigated the problems that funds experienced during the financial crisis.

Respectfully submitted by:
Anthony A. Nazzaro
March 16, 2011

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Testimony to the United States Senate
Special Committee on Aging
Chairman Herb Kohl (D-WI) and Ranking Member Bob Corker (R-TN)
Wednesday, March 16, 2011

"Risks and Responsibilities in Securities Lending"
By Ed Blount
Executive Director
Center for the Study of Financial Market Evolution

Chairman Kohl, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to share a few thoughts with you today. I commend you highly for holding this hearing and hope that we will continue to share ideas well into the future. My oral and written remarks are my responsibility alone. They do not necessarily reflect the views of my employer, the Center, any of its staff or members.

I approach this issue with the perspective gained from 35 years of varied roles in the securities lending community and the experience gained from having built, and then sold a profitable business that pioneered the analysis of performance measurement for securities lending programs. Prior to that, I was an executive on Wall Street at Citibank and Bank of New York with responsibility for managing securities lending service lines, among other securities services. Before my Wall Street experience, I was a Captain in the United States Marine Corps, with graduate degrees from New York University and Pepperdine University, and an undergraduate degree from Fordham University.

Introductory Comments

On the surface, the problem cited by the GAO Report appears to be a lender-side issue, i.e., the cash collateral lockups that froze the assets of 401(k) Defined Contribution accountholders and others during, and for up to a year after the crisis. However, this is really a problem for the entire investment community. The effect of restrictions on the supply of lendable securities could quickly degrade the liquidity and efficiency of the U.S. capital markets by raising the risks of settlement failures and increasing the capital charges for brokers with customer segregation deficits. All this would erode the global competitiveness of U.S. domestic capital markets and, ultimately, American business.

This is not an overstatement of the risks of punitive legislation and regulation. Restrictive actions of regulators affecting lendable securities could well impair the ability of pension plan sponsors to offer passive index funds and to hedge actively managed portfolios. (Index fund managers use securities lending income to offset trade commissions and custody fees, thereby reducing the tracking error against the fund's benchmark index. Active managers hedge with derivatives such as options and futures, which are created by dealers who then hedge their own exposures using short positions in the securities markets, that are, in turn, settled with

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borrowed securities.) The reduced availability of index funds and hedges would increase portfolio risks and threaten the investment returns that pension beneficiaries need and expect.

At a very fundamental level, securities lenders help to make the markets more efficient. A 1999 report by the international bank and brokerage regulators (CPSS and IOSCO) concluded that, "Securities lending markets are a vital component of domestic and international financial markets, providing liquidity and greater flexibility to securities, cash and derivatives markets."

The supply of lendable securities is highly sensitive to the actions of federal regulators. The Department of Labor's 1981 amendment of its Prohibited Transactions Exemption to ease its rules for securities lending greatly increased the level of securities available to borrowers, as well as the income to pensioners. Indeed, it has been estimated that the earnings from securities lending programs *alone* can enhance the portfolio's yield to a level that can take as much as a year off the viable retirement age of new workers entering the labor market.

Let me pause here for a moment. If I say that securities lending is important, I do not mean to say that problems do not exist in the lending community. Nor do I intend my comments to be taken as a defense of the status quo, such that pensioners might once again be deprived of access to their own funds in the uncertain days of financial crisis. We should not, as a people, subject our elders to added fears of loss of their retirement funds. Life is uncertain enough in our advancing years without adding risk to our 401(k) accounts. Yet it will serve as no benefit if the unintended consequences of new regulations are to undermine the ability of the capital markets to contribute to the welfare of today's workers, senior citizens and other beneficiaries of Defined Contribution plans.

The cause of the lockups was the illiquidity of certain asset-backed securities, which were included in the cash collateral pools of those funds that lent out their securities. In that regard, the problems of securities lenders and their investor/beneficiaries are the same as those of many other commingled funds in the United States during the recent market crisis. This is not the first time that securities lending has been incorrectly linked with nefarious activities.

- For many years, institutional investors refused to lend securities in the belief that by so doing they would be feeding the short sellers, who would then act to reduce the value of their portfolios. A major study that I led, for which I presented the findings at a World Bank / IMF conference in Moscow, demonstrated that the short sellers actually preserved portfolio values, especially during times of greatest market stress.
- More recently, hedge funds were seen by academics as manipulators voting proxies to subvert the corporate governance process through with borrowed shares, to the disadvantage of the long-term investors who had lent them the shares. In fact, a study that I led and presented to the Securities and

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> Exchange Commission, demonstrated that sound alternatives existed to explain the vast majority of suspicious loans. The activity spikes seen as evidence of manipulation were actually caused by lenders recalling shares to vote, thereby triggering substitutions among the borrowing firms.

Securities lending, by its nature, creates a complex network of interrelationships whose intentions and processes may be misunderstood and wrongfully accused. It may be said that the workings of the US Congress attract similarly-misinformed disbelievers. In both cases, the true cause of the problem often lies outside the boundaries of the accused institution.

During the crisis, the suddenly-illiquid, individual beneficiaries of Defined Contribution accounts absorbed the effects of investment choices made by others, i.e., their plan sponsors and cash managers. By contrast, the sponsors of Defined Benefit plans have to absorb the losses from their own decisions, since they are the employers whose contributions are increased by the investment shortcomings of their retirement plans.

In that context, DC plan sponsors, unlike Defined Benefit plan sponsors, have no financial incentive to increase investment revenue, such as securities lending income, for their beneficiaries. To the extent that DC plan sponsors have fiduciary responsibility for investment decisions, they bear risks which create contra-incentives to engage in securities lending and make other risk/reward decisions that could ultimately increase their exposure to the trial bar. All in all, DC beneficiaries gain the income from securities lending while their administrators merely gain more work and more risk. As a result, it is easier for DC plan sponsors to simply reject as investment options those mutual funds which lend, rather than learn how to evaluate the ways in which risks in securities lending evolve as market conditions change, so as to help beneficiaries fine-tune their exposures.

Such a decision appears to have been made by many plan sponsors, whose management mandates now routinely reject the possibility of income from securities lending services. Not surprisingly, perhaps, the investment performance of DB plans is exceeding that of DC plans, even when offered by the same corporate plan sponsor. In effect, we're creating a yield deviation between DC and DB plans where there isn't a good reason for it.

Recommendations

Going forward, it will be necessary to construct a framework with more closely aligns the interests and responsibilities of all those in the DC plan securities lending community, without unnecessarily impairing the ability of the market system to contribute to the welfare of both DC and DB plan beneficiaries.

- Among the changes that I believe are necessary are an improvement and extension of the disclosure regime for securities lending cash managers.

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However, I believe that such disclosures must be incentives-based and tempered by competitive sensitivities, not imposed by regulatory fiat.

- Furthermore, I believe that an expert council should be established to define the limits of prudence for collateral cash managers, one that is based on close monitoring of changing market conditions. That council might either be modeled on, or incorporated within the existing ERISA Advisory Council.
- Moreover, I believe that educational programs should be funded by the securities lending community, not the government, through incentives such as capital charge credits, and then provided to DC plan sponsors and beneficiaries as a way of improving their awareness of their own responsibilities and those of their service providers.
- Finally, I do not believe that the Prohibited Transaction Exemption should be modified, nor do I believe that the definition of a plan fiduciary should be expanded to include lending service providers. Any assumption of either real or potential liability (via fiduciary broadening) will have real yield erosion since provider service pricing, naturally, will be reflective of these risks. Again, every regulatory action influences the decision to either engage in securities lending or not, thus denying workers higher yields and fewer work-months until retirement.

In summary, if all members of the service provider community fulfill their responsibilities, no new legislation or regulatory enforcement will be necessary. The cash lockups of the financial crisis were not attributable to a failure of securities lending.

The importance of these lending programs to pension beneficiaries and their financial intermediaries makes the interrelated set of responsibilities for managing lending risks very important. I will discuss those responsibilities further in the appendix to my testimony.

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Appendix

PLAN SPONSOR - LENDER / BOARD RESPONSIBILITIES

All beneficial owners initiate their securities lending programs with contract negotiations. If a lending agent is to be retained, the contract terms will usually be based upon the commitments expressed in the winning agent's response to a formal Request For Proposal. Although some contracts may be "evergreen," i.e., without a termination date, it is more likely that the term will run from four to six years. During that time, the contract should specify that the program must be subjected to periodic reviews of risk-adjusted returns and risk management controls. These reviews should be defined within the contract, as Performance Reviews based on Reinvestment Guidelines and Risk Control Monitoring.

Contractual / Performance Review: Until the imposition of international bank capital rules, the indemnification provided by a bank lending agent was a key criteria in the selection process. Sometimes, indemnities were the only issue considered along with the relative split of income between agent and principal. In part, that's because conservative income projections and the assurance of equal treatment (queues) made it look as if there was no performance difference among lending agents. In such a market, default indemnifications combined with attractive revenue splits usually won contracts. But administrators became aware of the potential for higher returns when some lending programs generated higher yields on cash reinvestments, enabling those to pay higher rebates and attract more borrowers, thus generating more volume and greater earnings for their beneficiaries. Performance and the controls on reinvestment behavior have become important considerations in present negotiations.

Ultimately, much of the securities lending agent's role involves money management because market decisions are made with every reinvestment of cash collateral. At the same time, lending agents make credit decisions when they accept the risk that a borrower will default. Securities lending contracts try to control both market and credit risks.

Revenues and fees result from negotiations between funds and agents involving the totality of a relationship. These values alone are insufficient to permit an accurate analysis of program performance unless considered in the context of market conditions, industry practices and peer results. Similarly, the composition and limitations on portfolio management must also be considered in any program review.

Since borrowers and agents form a large set of commitments to others in the marketplace, every lending principal's goal should be to insure that its commitment from agents and borrowers is as near to the nucleus of their set of commitments as

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possible. That way, as commitments are peeled away like the layers of an onion during a crisis, the fund can be assured that its counterparties will remain among the preferred circle.

Reinvestment Guidelines: Investments in cash pools are determined by guidelines negotiated with a bank's clients. It is the customer's responsibility to review those guidelines as market conditions change.

Lenders and banks to negotiate appropriate guidelines to manage the cash pools, then closely monitor the ongoing execution of their pool investment strategies for compliance. The board should require staff to monitor the results of stress tests and value-at-risk analyses, using an ongoing assessment of the relative risk-tolerance encoded in the guidelines and the testing assumptions, then report the results to stakeholders.

STAFF / CONSULTANT OVERSIGHT

Securities lending programs require regular oversight by beneficial owners and/or their consultants. No matter how detailed the controlling documents may be, lending programs often require decisions about special transactions and discretionary actions that must be reviewed with agents on a timely basis. In particular, any changes to the risk tolerances of the oversight board must be incorporated within the contracts, guidelines and practices of the lending program. For programs operating under guidelines granting discretionary authority to lending agents, special care should be taken to ensure pool investments are reviewed and approved by staff and/or consultants.

Lending contracts usually describe the agent's responsibilities in a functional, not transactional manner, so it may not be apparent that existing practices could well be inadequate for special transactions, as well as for new securities or trades which result from financial innovation. A detailed flowchart of duties, known as a fault-tree analysis, is helpful for isolating exposures and anticipating the potential for breakdowns. Peer-based reviews of program performance can also provide clues as to the degree of prudence used in managing the program's assets. Using tools such as these, the staff should perform regular reviews to ensure compliance with existing policies and suggest any needed improvements to current practices.

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LENDING AGENT RESPONSIBILITIES

Lending agents manage lending programs in a fashion very similar to the ways that banks manage their depository and credit operations. The recommended best practices for lending agents have been defined by the securities lending division of the Risk Management Association (RMA), which is the professional association for commercial bank loan officers. The division's executive committee, consisting of senior officers from several of the largest and most experienced lending agents, are responsible for updating the guidelines as appropriate.

Liabilities are created when broker-borrowers deposit cash with the lending agent as collateral for their borrowed securities. Assets are purchased with the cash by the lending agent's cash management division, so as to earn a profit for the lenders. Generally, these reinvested pool assets have a longer maturity than the deposit liabilities. The longer maturities create an asset-liability gap, or a "duration mismatch." The pool assets may also have a lower credit quality than the loaned assets, which creates a "credit mismatch." These mismatches allow the lending program to earn a profit over the rebates on cash deposits that are paid to the securities-borrower-depositors. Securities lending cash pools have different liquidity risks from other cash management and money market funds. When retail money funds are gaining deposits from shareholders, the cash pools of securities lenders are often shrinking. As a result, the mismatches create complex risks that are the responsibility of the lending agent to manage, as described below:

Interest rate monitoring: It is the cash manager's duty to monitor the volatility of the deposits. If deposits fluctuate rapidly, then the duration mismatch must be shortened to allow an extra liquidity buffer. Credit mismatches can create heightened exposures for the pool during times of economic stress. The cash manager must monitor the direction of interest rates, default rates and the spread between short- and long-term rates. The spread among many maturities in the fixed income market is called the "yield curve" when shown on a graph. The shape of the curve can change very rapidly and in unexpected ways, especially when interest rates are moving up or down rapidly. Those changes can have a huge influence on the level of risks and on the potential for losses in the cash pool, because they strongly influence the volatility of deposit liabilities.

Desk monitoring: The agent's trading desk is in the best position to anticipate significant changes in the volatility of deposit liabilities, for one borrower or for all approved borrowers. If a borrower fails to return a securities loan when it is recalled, the trading desk is well positioned to understand whether an "event of default" should be declared, thus triggering a wholesale termination of all loans and a return of cash collateral to the defaulting borrower. However, the cash manager must also be consulted in the event that a duration mismatch in the pool may have created a situation where the lender might be exposed to liquidation losses from depressed asset values.

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Loan inventory buffering: When a lender sells portfolio securities, or a lender wishes to vote the loaned securities, the agent will try to reallocate the loan to other lenders in its program, in order to avoid recalling the securities from the borrower. The reallocations are taken against "buffers," which are created by the lending agent in the form of lendable securities held in reserve against unexpected recalls. These buffers are an important protection for lenders and borrowers alike.

Returns and rebates: Borrowers will return securities when they discover that higher rebates are available from another lender. This can create volatility if agents do not adjust their rebates to match changing market conditions. The lending agent is responsible for monitoring rebate levels and trends in market conditions.

Ratio lending: In order to generate cash balances, lending agents will sometimes require that a larger volume of "easy-to-borrow" securities be taken along with the more desirable "hard-to-borrow" securities. It is the agent's responsibility to insure that those lenders who supply a larger share of hard-to-borrow securities benefit commensurately from the higher proportion of attractive value that they add to the agent's program. If the agent finds that its overall program benefits disproportionately from a certain lender's participation, then that lender should receive a higher share of lending income than other lenders with less attractive portfolios.

SECURITIES BORROWER RESPONSIBILITIES

Securities can only be borrowed in the United States for purposes permitted by and codified in Regulation T of Federal Reserve. To preserve systemic market stability and reduce overall counterparty exposures, leading industry participants have defined "best practices" through their professional associations, such as the Securities Industry Financial Markets Association (SIFMA), the International Securities Lenders Association (ISLA) and the Risk Management Association (RMA).

Contract Comparison: A primary consideration for all securities borrowers is the accuracy of the records controlling their positions. To that end, ISLA has issued guidelines for best practices in comparing the loan contracts of counterparties.[1] For example, counterparties must compare open loans each day, using data elements from an approved ISLA matrix. Discrepancies in the comparisons, called "breaks," must be resolved on the same day that they are identified. ("Breaks should not be outstanding more than one day.") Pending loans must be compared from the day

[1] International Securities Lending Association, "Statement on Best Practice Guidelines for Using Contract Compare," July 7, 2006, London, England; www.isla.co.uk/.../Best_Practices/ISLA-Contract-Compare-Best-Practices-ppt.pdf

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they're negotiated. Finally, the counterparty that created the discrepancy must be held responsible for its resolution.

Lender Protection: The process by which loans are recalled from borrowers is described extensively by RMA publications.[2] Generally, recalls allow for settlement using the normal clearing cycle, to permit the borrower to purchase the securities in the open market. Failed recalls trigger a resolution process that may eventually result in a "buy-in" which protects the lender's assets and may expose the borrower to market pricing risk. However, the cost and risk of the buy-in are controlled by the lending agreement.

Rule 15c3-3 is the SEC's investor protection rule, created under authority of the Securities Exchange Act of 1934. Among its provisions, the rule limits the degree to which customer assets can be rehypothecated and mandates that brokers maintain segregated positions between their customer and proprietary (firm) assets. Recent amendments to the rule also require that brokers maintain possession and control records for three years, subject to regulatory examination.[3]

Diversification of sources: All participants in the market community have an obligation to protect the counterparty network, starting with their own relationships. Therefore, borrowers should follow basic investment management disciplines such as diversification of suppliers and monitoring of on-lending counterparties.

REGULATORY RESPONSIBILITIES

Regulators should not impair the ability of markets to self-correct. Regulations to require banks to absorb risks of illiquidity or underperformance in the lender's cash pool would effectively shift those liabilities to the balance sheets of bank agents. In that case, federal banking regulations would increase capital requirements on banks so as to protect the FDIC against contingent exposures. The capital charges would create a cost to the banks that would necessarily be passed along to the lending programs. Even if no losses occurred, the increased costs to plans would either discourage the use of lending programs or decrease the returns to beneficiaries. In either case, capital market stability would be enhanced more efficiently if oversight boards vigilantly monitored the degree to which their staffs, agents and counterparties satisfied their own responsibilities, as defined above, as well as

[2] RMA Committee on Securities Lending, "Statement on Best Practices Guidelines for Loan Termination," 2001, Philadelphia, PA; www.rmahq.org/NR/rdonlyres/...7056.../TerminationofLoan.pdf
[3] http://www.sec.gov/rules/final/34-50295.htm

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monitored the risk tolerances implied by the reinvestment guidelines and other program specifications.

Excessive regulation *per se* can have also negative consequences. The negative taint of restrictive legislation/regulation can create a global backlash within the securities lending community by casting the shadow of distrust across all institutional lenders' reviews of their agency lending contracts for the next few years. If a large number of institutions moved to end their securities lending programs, the results would be disastrous for capital market efficiency and liquidity. Therefore, regulators should create positive incentives, not negative hurdles, for participants that are designed to strengthen the best practices that underpin the lending markets. This may be possible through capital waivers and credits to the capital requirements imposed on banks and brokers, as well as to the guarantee funds of their clearing corporations and central counterparties (CCPs).[4]

In August, 2009, the International Monetary Fund described the adverse impact on global market liquidity that resulted from decreased collateral flows and heightened counterparty risks in the securities lending markets. The IMF's study found that the $1.5 trillion contraction in the securities lending markets after the Lehman default had greatly reduced global market liquidity. This illustrates the sensitivity of the market system to changes in capital exposure of lending market participants. Among the issues raised by the IMF were the degree to which reforms encouraging the formation or use of CCPS consider whether risk is merely being transferred, but not eliminated in the formation of CCPs; the complexity of formulas for computing the level of adequate capital for CCPs; and the exposures associated with CCP interoperability and pooling of collateral. Recommendations to implement CCPs within the securities lending community should consider the fact that no institutional investor was penalized through a counterparty's failure to return securities to an institutional lending program.

Market infrastructure revisions, such as CCPs and inter-market agreements, can change the risk dynamics for securities lenders in subtle but important ways. For instance, certain clearing corporations have cross-margining agreements to permit members of multiple clearing houses to use excess Treasuries at one to collateralize stock index futures at another.[5] Yet, that creates the potential for competing claims

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[4] As regulators know, markets do not guarantee transactions, and neither do their regulating governments or self-regulating agencies. It is the clearing corporation associated with a market that guarantees the settlement of its transactions — but only for those firms who are members of the clearing corporation. Even those guarantees are limited by agreement of the members. Of course, even if there were no limits on the guarantee, the capital resources of clearing networks are limited in practice to the contributions of members, reinforced by government backing. Some clearing corporations may also have contingency claims on members' capital, but that claim is constrained, as a practical matter, by the fact that those members are, in turn, subsidiaries of holding companies. These subsidiaries, by definition, have limitations on access to parent capital, so the practical reserves available to non-member transactors may be insufficient to satisfy all claims in a crisis.

[5] Some clearing systems accept partial position guarantees from other systems in order to reduce the capital obligations of members who participate in both. This creates a transfer and acceptance of risk

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by clearing houses that may, during liquidation, override the claims of the institution that loaned those bonds to a failed dealer. Moreover, the ability to pledge assets from one market against liabilities in another can create a cross-margin into the government securities markets for both options and stock houses. Since pensions and their lending agents may not be members of either clearing (or central counterparty) system, much less both, settlement priorities of borrowers may be changed in ways that are difficult to factor into a pension fund's investment policy statement.

When the linkages are international, even experts may be challenged by the implications for member transactors, again not even considering non-members. Indeed, some regulators are becoming deeply concerned that a worldwide recession could trigger a market cataclysm since financial systems have become so closely meshed. Although growing in strength, this apprehension is not a new phenomenon. Alexander Lamalfussy, speaking as head of the Bank for International Settlements, the central bankers' central banker, expressed this fear as far back as March, 1992. Mr. Lamalfussy warned that national regulators might not have adequately considered this linkage risk in approving new trading activities and derivative instruments. Central counterparty systems can themselves increase the systemic risks to the market if, as the IMF warns, the risks are merely transferred and not diminished.[6]

Doubtless, as central bankers, regulators and other oversight officials weigh the recent recommendations by the Basle Committee on Banking Supervision to change the risk capital rules -- a development started by the impact of 1997's Asian crisis and accelerated by the 2008 global credit crisis -- there will be revisions made to the market infrastructure. These will have important implications for securities lenders and their agents that must be taken into account by market regulators, as well as by legislators. If the result is the creation of positive capital incentives for the market system to self-correct, then the exercise will have been well worth its investment.

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that may not be immediately apparent to non-members. For instance, claims for settlement of clearing-system-based securities loans may take precedence in liquidation schemes over non-system loans.

[6] Similar concerns were expressed by Charles Bowsher, Comptroller General, in his May, 1994, testimony before U.S. Congress. After describing the ties among 15 major U.S. derivatives dealers, Mr. Bowsher said that, "This combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole." http://www.gao.gov/products/GGD-94-133

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Honeywell

TESTIMONY OF ALLISON R. KLAUSNER

ON BEHALF OF

HONEYWELL INTERNATIONAL INC.

BEFORE THE

UNITED STATES SENATE
SPECIAL COMMITTEE ON AGING

FOR THE HEARING

ON THE

PRACTICE OF SECURITIES LENDING

BY EMPLOYER RETIREMENT PLANS

WEDNESDAY, MARCH 16, 2011

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Introduction

My name is Allison Klausner and I am the Assistant General Counsel – Benefits for Honeywell International Inc. ("Honeywell"). Honeywell is a Fortune 50 company, with approximately 140,000 employees worldwide, of which 70,000 are located in the United States.

On behalf of Honeywell, I want to express Honeywell's appreciation of Senator Kohl's and Senator Corker's desire to understand the practice of securities lending in the context of employer sponsored defined contribution plans. I understand that my testimony today has been requested to provide the Senate Special Committee on Aging with insight into how one plan sponsor's fiduciary committee has addressed securities lending issues which will in turn provide the Senate Committee with insight into how fiduciaries on a broad scale may do the same.

Over the years, securities lending has provided tremendous value to participants and beneficiaries of employer sponsored defined contribution plans, including those with employee deferrals and contributions. I encourage the Senate Special Committee on Aging to recognize that, if actions are taken to prohibit fiduciaries from offering securities lending funds in defined contribution plans, plan participants and retirees may lose valuable opportunities, now and in the future, as they strive to achieve retirement security.

Honeywell Plan Background

Honeywell's primary defined contribution plan is a fairly typical 401(k) plan whereby participants are permitted to direct the investments of their deferrals and contributions, as well as vested employer matching contributions. The plan provides participants with the opportunity to select from a robust range of asset classes with varying potential risks and rewards. These funds include a short term fixed income fund, a bond fund, equity based funds, specialty funds, target date funds and the Honeywell common stock fund.

Selecting and Evaluating Funds

The Honeywell Savings Plan Investment Committee is a fiduciary committee consisting of five professionals at Honeywell. Two of the current committee members dedicate significantly all of their time addressing issues relating to the investment of ERISA plan assets, one of whom does so exclusively for the company's defined contribution plans. Of the remaining three current committee members, two hold positions at Honeywell in the corporate human resources group and one holds a position in the tax department. All five Committee members have received fiduciary education and are counseled on an ongoing basis with regard to their fiduciary responsibilities, duties and obligations, including those relating to the selection of investment managers and/or funds.

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The Honeywell Committee members understand that satisfaction of their fiduciary duties is critical to supporting the long-term retirement security of the plan's participants and the company's retirees. The Committee members recognize that they must engage in a prudent process, which considers many factors when selecting and evaluating investment funds. Specifically, the process should be designed to identify whether a particular fund, with all its features, including, but not limited to, whether it has a securities lending component, is an appropriate fund for defined contribution plan assets to be invested, either by an affirmative election or, alternatively, by default. And, just as the procedure for selecting a particular fund is where the fiduciaries' focus should be, I encourage the Senate Special Committee on Aging to consider that the matter of whether defined contribution plan assets are invested in securities lending funds or non-securities lending funds is one that should be evaluated in the context of the fiduciary process.

A fiduciary's process in selecting a fund will be based on consideration of many diverse factors. In addition to giving consideration to the unique constitution of the relevant plan participant body, these factors may include (1) the amount of fees to be charged by the investment manager, (2) the type of fund (for example, active vs. passive), (3) the asset class, (4) the past performance of the fund and its current leadership, and (5) the plan's complete fund line-up. All these factors, and others, are important when evaluating whether plan fiduciaries have provided a diverse and robust array of investment choices which in turn may help defined contribution plan participants achieve their personal, unique investment and retirement goals.

Indeed, securities lending funds in Honeywell's defined contribution plan's fund line up has supported many participants' retirement goals as those investment funds (1) typically charged lower fees than comparable non-securities lending funds and (2) historically had investment gains that contributed to the investment returns for the assets invested in such funds. The take-away is that, depending upon facts and circumstances, offering defined contribution plan participants the opportunity to invest in securities lending funds can indeed be a prudent decision.

Notwithstanding the potential benefits and prudence of offering defined contribution plan participants the opportunity to invest in securities lending funds, Honeywell's savings investment committee determined, starting in October 2008, to transition from securities lending funds to non-securities lending funds. Among other things, the Committee's then current thinking was that, on a go-forward basis, this change was prudent. The Committee recognized that (1) the then economic climate and that which was anticipated in the then near future and (2) the gate-keeping measures which were being implemented, weighed against continuing to offer securities lending funds for investment of defined contribution plan assets. Although the plan's fiduciaries understood that the gate-keeping measures were purportedly designed to stem the possibility that there would be a "run on the bank" within the securities lending programs, and that the gate-keeping measures did achieve such goal, the gate-keeping measures did handcuff plan fiduciaries and restricted fiduciaries'

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ability to make decisions which could have impacted plan participants' opportunity to achieve retirement security.

I note that, although participant level activity wasn't directly restricted, plan fiduciaries were restricted from making wholesale plan level changes that potentially could have benefitted or been in the best interest of the plan's participants. For example, the gate-keeping measures changed the rules that would apply in the event the plan fiduciaries chose to implement a new, competing, non-securities lending fund.

Flexibility to Offer Securities Lending Funds

Today's legislative and regulatory framework permits fiduciaries to offer defined contribution plan participants with access to investment funds with a securities lending feature. As I mentioned at the start of my testimony, I encourage the Senate Special Committee on Aging to recognize the importance of maintaining the flexibility currently available. Fiduciaries should not be required to operate in a rigid environment which prohibits them from providing plan participants and retirees with valuable opportunities to achieve retirement security.

* * * * *

In closing, although the matter of securities lending funds in employer sponsored defined contribution plans is a topic that is worthy of your attention, I suggest that we take care not to study the issue in a vacuum or elevate the matter of securities lending over other issues of equal or greater importance to defined contribution plan participants. In addition, since plan administrators and fiduciaries, as well as third party providers, are in the process of implementing new legislation and regulation designed to protect participants -- with regard to plan fees and expenses, specifically, and encourage and protect their retirement security, generally -- and since there does not appear to be an urgent need to address the issue of employer sponsored defined contribution plans and securities lending funds, perhaps this is a time to rest and allow the new rules to take hold before we consider any new rules or requirements.

* * * * * *

Thank you for asking me to be a witness at today's hearing. If you have any questions, I would be happy to address them.

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Testimony of Steven R. Meier
Chief Investment Officer, Global Cash Management
State Street Global Advisors
United States Senate Special Committee on Aging
March 16, 2011

Chairman Kohl, Ranking Member Corker and Members of the Special Committee: Thank you for the opportunity to appear before you today. My name is Steven Meier and I am the Chief Investment Officer, Global Cash Management, for State Street Global Advisors ("SSgA"), the investment management business of State Street Corporation ("State Street"). The Committee has asked me to address the practice of securities lending by employee retirement plans such as 401(k) plans and I hope my testimony will assist you with your important work. Our interests at State Street are aligned with those of our securities lending clients, who are generally long-standing clients for whom securities lending is one of many services State Street provides. We have managed the cash collateral pools and the lending program in a prudent manner, consistent with our fiduciary duties.

At State Street, we believe that securities lending can play a role in the development of a balanced investment program for professionally managed retirement plans. As you know, employee retirement plans typically earn dividends and interest from the plan's investment portfolio. However, if participants choose to invest in a plan option that engages in securities lending, the investment portfolio can earn additional incremental income. While the amount of this incremental income varies by portfolio and depends upon a number of factors such as prevailing interest rates and spreads between Federal funds and other credits, this incremental income can be significant. The plan can use this income either to offset ongoing expenses that would otherwise have been paid by the plan participants, such as custodial or administration fees, or to supplement the plan's investment return for participants. Whatever the use, the incremental

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income derived from securities lending activity directly benefits the millions of American workers that rely on their employee retirement plans.

BACKGROUND AND EXPERIENCE

Let me begin with a brief description of my background and experience. I have more than twenty-seven years' experience in financial services, with a focus on traditional money markets, fixed income, global cash, and financing. I began my career working as a securities lending management trainee at the Irving Trust Company in 1984. I worked there for approximately two years before leaving for graduate school. During my time at Irving, I was able to learn the securities lending and cash collateral investment business in its early years. Today I am an Executive Vice President, and my primary responsibility as Chief Investment Officer of the cash asset class is to manage global cash activities, including money market funds and other cash management products such as the collateral investment vehicles for SSgA-managed funds that participate in securities lending. I am a member of SSgA's Executive Management Group, as well as its Senior Management Group and Investment Committee.

State Street is one of the world's leading providers of financial services to institutional investors, with nearly $22 trillion in assets under custody and administration, and almost $2 trillion under management. SSgA is the investment management business of State Street and manages traditional cash, money market funds, and other investment programs, including separate accounts and commingled cash collateral vehicles used by participants in State Street's securities lending program. In 2009 and 2010, SSgA was named the "World's Best Bank" in the Asset Management category by *Global Finance Magazine*.

THE SECURITIES LENDING INDUSTRY

Securities lending is a means by which institutional clients who hold and plan to retain long securities positions can earn incremental income. The asset owner, generally with the

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assistance of a securities lending agent, lends a security it holds as a long position to a borrower who needs the security to facilitate settlement of a securities transaction, often in connection with a short sale. The borrower has an obligation to return the borrowed security and provides collateral to secure that obligation. This collateral is typically worth between 102 – 105% of the market value of the borrowed security, and can be either cash, which is most common, or securities. During the course of the loan, as the market value of the security on loan varies, the lender either collects more collateral from the borrower (if the value of the security has gone up) or returns some collateral to the borrower (if the value of the security has gone down).

If the lender has received cash collateral, it reinvests the collateral and when the loan terminates, it pays the broker-dealer a negotiated "rebate rate" on the cash pledged to secure the loan, and shares the remaining reinvestment income with the securities lending agent. The lending agent's "split" of the proceeds is its compensation for its services administering the program, such as matching lenders to borrowers, re-assigning loans when a lender divests an asset, marking to market the value of securities on loan daily, and either collecting additional collateral from borrowers, or returning a portion of collateral to them, depending on the loan. These administrative services play an important role in maximizing the return that a plan can achieve from participating in a lending program. The lending agent's split is also compensation for the risks it takes by indemnifying lenders against the failure of a borrower, such as Lehman, to return a security. This indemnity substantially reduces the risk to a plan of participating in a lending program by shifting the risk of the failure of a borrower to return securities if the borrower enters bankruptcy or otherwise defaults on its obligations; such indemnity correspondingly exposes the lending agent to increased risks.

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STATE STREET'S SECURITIES LENDING PROGRAM

Institutional clients can choose to participate in securities lending at State Street in two ways. A client can appoint State Street as its "lending agent" and directly lend its securities to borrowers. Plans that choose to directly lend their securities in this way negotiate how much they will compensate State Street for its services as lending agent and choose whether to accept cash collateral and which investment vehicle to use for cash collateral reinvestment (e.g., a separately managed account or a choice of several commingled collateral pools).

Second, an institutional investor such as a 401(k) plan may participate in securities lending by investing in State Street's bank-maintained collective and common trust funds that, in turn, lend securities and invest cash collateral in collateral vehicles managed by SSgA. I will refer to those bank-maintained collective and common trust funds as "Lending Funds." In general, the plan sponsors that choose to offer Lending Funds also have the option of offering a non-lending version of the same fund, and the Lending Fund version includes the phrase "Lending Fund" in its name for the sake of clarity. When a Lending Fund loans securities and receives cash collateral, it agrees to pay a rebate to the borrower in an amount that reflects current market rates and is intended to compensate the borrower for the interest it could have otherwise received on that cash. The remaining income from reinvestment of the cash collateral is split between the Lending Fund investor and State Street as lending agent.

State Street's split is its sole compensation for its work as lending agent, which is done by State Street's Securities Finance division, not SSgA. The split is not tied to any compensation SSgA receives for its management of the collateral pools. For unrelated services, such as custody and administration, State Street will also receive compensation from the client.

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IMPACT OF THE FINANCIAL CRISIS ON CASH COLLATERAL REINVESTMENT

As this Committee is aware, the events of the recent global financial crisis that began in 2007 and worsened in 2008 were unprecedented. Our nation experienced a liquidity crisis in the fixed income sector as the secondary market for such securities essentially ceased functioning. Within the span of a few days in September 2008, we witnessed the failure of long-standing financial institutions and a large SEC-registered money market fund. The value of equity and non-Treasury debt securities plunged along with investor confidence.

These events impacted lenders of securities in several ways, including a significant drain of liquidity from their cash collateral investment pools. Specifically, as the market value of certain securities declined, lenders marked down the value of their securities on loan and had to return large amounts of cash collateral to borrowers. At the same time, borrowers de-leveraged their businesses, returning many of the securities they had borrowed without borrowing new securities. Again, this resulted in the return of significant amounts of cash collateral. Finally, lenders themselves reacted to the market by making changes to their portfolios, selling securities to raise cash or alter their asset allocation. When lenders sold securities that had been out on loan and the loans could not be re-assigned, the loans of those securities terminated and the lenders returned the cash collateral to the borrowers. In fact, during the period from June 2008 to December 2008, State Street managed a nearly 50% decline in outstanding loan balances without any 401(k) plan investor invested in a Lending Fund realizing a loss due to a lack of cash collateral pool liquidity.

However, this series of events caused significant impacts on cash collateral vehicles. Depending on their risk profiles and return objectives, collateral vehicles own assets of varying levels of liquidity, ranging from short-term cash and cash equivalents to high quality medium-

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and long-term assets such as asset-backed securities and unsecured debt. If redemptions from a cash collateral vehicle (due to ongoing legal obligations to borrowers under the securities lending arrangement) exceed the vehicle's cash and cash equivalents and additional liquidity is required to meet its participants' obligations, the manager of the cash collateral vehicle will be forced to sell medium- and long-term assets to raise liquidity. In the market environment of 2008, such an imbalance made it virtually impossible to sell these assets, and if sales were possible, would have caused managers to sell assets at a substantial loss that did not reflect the intrinsic value of those securities, but rather reflected short-term illiquidity and unprecedented spread volatility in the markets.

State Street acted cautiously and thoughtfully to protect the interests of all of our securities lending clients. As a result, our Lending Fund investors did not incur any realized losses in connection with cash collateral reinvestment, unless they chose to take an in-kind distribution of securities and sell them at a loss. We are particularly proud of the way State Street has managed its securities lending program during the financial crisis over the last several years:

- We maintained 401(k) plan participants' full, unrestricted rights to make withdrawals from their retirement savings invested in Lending Funds.
- Due to our prudent management, none of the cash collateral pools realized material credit losses. As Chief Investment Officer, Global Cash management, I am particularly proud of this fact. We avoided the sale of strong credits into a distressed market and reinvested cash flow in highly liquid, short-term securities for a period of approximately one year before Lehman's default, building up the short-term liquidity in our cash collateral vehicles and managing the vehicles in an increasingly conservative manner.

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- State Street restricted certain withdrawals from the Lending Funds at the plan sponsor level for a period of time after the Lehman bankruptcy, to ensure consistent access among retirement plans to the available liquidity in our common and collective trust funds. We lifted those restrictions in August 2010 after we voluntarily contributed $330 million to the collateral pools, in light of the market's continued discounting of certain asset-backed securities held by the collateral pools – a discount that resulted from continued liquidity challenges and wider credit spreads, not the credit quality of the assets.
- Retirement plans, including 401(k) plans, that appointed State Street as securities lending agent and directly lend the securities in their portfolio and reinvest the cash collateral in SSgA-managed cash collateral pools have remained able to access the liquidity they needed to support normal investment activity.
- We, like many securities lending agents, indemnified our clients when Lehman Brothers defaulted upon its obligations as a borrower. Because we agree to hold retirement plans harmless in the event that the financial institutions to which they have lent securities default on their obligations, when Lehman Brothers declared bankruptcy, the risks of that default rested with State Street and not our lending clients.

We believe State Street's actions exhibited its commitment to maintaining safety of principal, adequate liquidity and strong consistent returns for all Lending Fund investors while managing the impact and risks inherent in this difficult market cycle. State Street believed, and continues to believe, that it acted in the best interests of all investors in the common and collective trust funds managed by SSgA that engaged in securities lending.

DISCLOSURES REGARDING SECURITIES LENDING

We understand that the Committee is also interested in how much plan sponsors and plan participants knew about and understood the risks of cash collateral reinvestment. State Street has

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followed the model established by federal banking regulations, which primarily required us to make information available to our institutional investors. Throughout the financial crisis, State Street also undertook to distribute additional securities lending disclosures through a number of channels to institutions invested in Lending Funds. State Street has always adhered to industry best practices regarding disclosure, and we continue to be fully committed to appropriate levels of transparency.

As proud as we are of these steps, we are challenged by an issue that we believe affects many providers of lending services to direct contribution plans: State Street, acting in a capacity of investment manager to a plan sponsor (or a service provider of the plan sponsor, such as a recordkeeper) often does not have sufficient information about the individual 401(k) participants in its Lending Funds to communicate with them directly. We welcome discussion and collaboration with the Committee and other stakeholders about how else the industry can improve its disclosures to retirement investors given the limited ability of asset managers and lending agents like State Street to convey information directly to individual participants in retirement plans.

Thank you again for the opportunity to be here today to speak on this subject. I would be pleased to answer the Committee's questions.

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United States Government Accountability Office

GAO

Report to the Chairman, Special Committee on Aging, U.S. Senate

March 2011

401(K) PLANS

Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood

This Report Is Temporarily Restricted Pending Official Public Release.

GAO-11-291

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GAO
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Highlights

Highlights of GAO-11-291, a report to the Chairman, Special Committee on Aging, U.S. Senate

March 2011

401(K) PLANS

Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood

Why GAO Did This Study

401(k) plan sponsors are responsible for offering an array of appropriate investment options, and participants are responsible for directing their investments among those options. While participants expect to be able to switch investment options or withdraw money from their accounts, during the recent economic downturn, some 401(k) plan sponsors and participants found that they were restricted from doing so.

GAO was asked to (1) identify some of the specific investments and practices that prevented plan sponsors and participants from accessing their 401(k) plan assets and (2) determine any changes the Department of Labor (Labor) could make to assist sponsors in understanding the challenges posed by the investments and practices that restricted withdrawals. To do this, GAO reviewed relevant federal laws and regulations and consulted with experts, federal officials, service providers, and plan sponsors.

What GAO Recommends

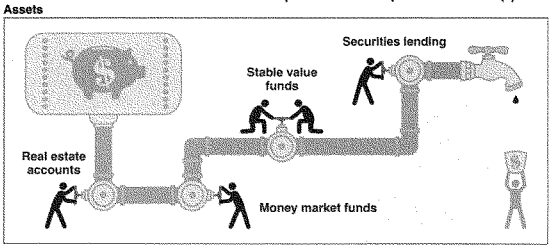
GAO recommends Labor study stable value funds and the practice of securities lending with cash collateral reinvestment by 401(k) plans to identify situations or conditions where plan sponsors could be prevented from meeting their fiduciary obligations, revise one of its prohibited transaction exemptions, and provide better disclosures and guidance to plan sponsors and participants. Labor disagreed with three of GAO's recommendations and stated that it will consider the remaining four. GAO continues to believe in its recommendations.

View GAO-11-291 or key components.
For more information, contact Charles Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

What GAO Found

Between 2007 and 2010, some 401(k) plan sponsors and participants were restricted from withdrawing their plan assets from certain 401(k) investment options, see figure, including real estate, money market, and stable value investment options, as well as other investment options that lent securities (the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests). In most cases, the withdrawal restrictions were caused by losses and illiquidity in the investment options' underlying portfolios and sometimes contract constraints placed on plan sponsors by the investment options. For stable value funds, and also for those investment options that lent securities, the withdrawal restrictions and their causes highlight the risks that participants face when allocating their 401(k) plan assets to these investment options—and, that losses are borne by plan participants. In addition, participants often do not understand or may receive insufficient disclosures of the risks posed by these investments. Further, plan sponsors may be unaware or receive insufficient disclosures of the risks and challenges involved with those investment options and practices.

Investments and Practices that Restricted Plan Sponsor and Participant Access to 401(k) Plan Assets



Source: GAO.

Labor can take a variety of steps to help plan sponsors who offer stable value funds and investment options that lend securities. Many of these steps can draw upon the changes that the Securities and Exchange Commission and others have already made, or will make, regarding these investment options and recent suggestions from plan sponsors, industry service providers, and other key stakeholders. Specifically, Labor could identify and take action to address those stable value contract constraints that may hinder plan sponsors from performing their fiduciary responsibilities and provide better disclosures to plan sponsors about certain investment options to help sponsors make decisions on behalf of participants. Similarly, revising Labor's prohibited transaction exemption for securities lending to restrict those securities lending arrangements that may pose unreasonable financial terms upon plans and providing more guidance, in general, about such transactions can also help plan sponsors and participants understand the risks that cash collateral reinvestment can pose to plan assets in investment options that lend securities and how to mitigate them.

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Abbreviations

CFTC	Commodity Futures Trading Commission
CIF	collective investment fund
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Industry Regulatory Authority
FRB	Federal Reserve Board
GIC	guaranteed investment contract
OCC	Office of the Comptroller of the Currency
PTE	prohibited transaction exemption
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission

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United States Government Accountability Office
Washington, DC 20548

March 10, 2011

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate

Dear Mr. Chairman:

The recent problems in the U.S. mortgage market and subsequent financial crisis revealed underlying weaknesses in the U.S. financial system and illustrated the importance of due diligence in financial matters. Investors, including 401(k) plan participants, experienced large losses from their investments in 2008.[1] There were reports that some 401(k) participants experienced losses and were restricted from accessing their plan assets in certain situations, and that employers that sponsored 401(k) plans (plan sponsors) were also restricted from withdrawing plan assets. Nearly 90 percent of all 401(k) plans are participant-directed, meaning they generally allow participants to choose how much to invest, within federal limits, and to select from a menu of diversified investment options chosen by the plan sponsor. As such, most 401(k) plan participants expect to be able to switch investment options or withdraw money from their accounts.[2] Similarly, plan sponsors also expect to be able to change the investment options offered to their 401(k) plan participants without significant restrictions and, in fact, have a duty under the Employee Retirement Income Security Act of 1974 (ERISA) to act prudently when selecting investment options for plan participants and to act solely in the interest of the participants. The financial crisis illustrated that withdrawal restrictions can be a condition of certain investments, but they can also be

[1]Industry researchers have estimated that the average 401(k) retirement account balance declined 27.8 percent in 2008, before rising 31.9 percent in 2009. Thus, over this 2-year period, the average retirement account balance lost 4.8 percent. For example, if the average 401(k) retirement account balance was $100, a decline of 27.8 percent would bring the balance to $72.20 at the end of 2008. Then, an increase of 31.9 percent would bring the balance to $95.20 at the end of 2009. According to an industry association, the average 401(k) retirement account balance outperformed the S&P 500 Index in both 2008 and 2009.

[2]Other 401(k) plans are trustee-directed, wherein an employer appoints trustees who decide how the plan's assets will be invested. For the purposes of this report, we are discussing participant-directed 401(k) plans.

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a limitation of which some plan participants and plan sponsors may not be aware.

Since it was unclear from the reports why certain types of investment options restricted withdrawals and how and when withdrawal restrictions were placed, we were asked to determine what happened during the financial crisis to participant accounts and to plan sponsors' control over the investment options offered to 401(k) plan participants. To better understand the type of investments that were offered to plan participants and whether plan participants and plan sponsors were adequately informed about the potential for withdrawal restrictions, we answered the following questions:

1. What are some of the specific investments and practices that prevented plan sponsors and participants from accessing 401(k) plan assets?

2. What changes, if any, could Labor make to assist plan sponsors in understanding the challenges posed by certain investments and practices?

To determine the specific practices that may have affected plan sponsors' and participants' access to 401(k) plan assets during the recent market downturn, we reviewed articles published by industry experts, related documents from the Department of Labor (Labor), such as published materials available to plan fiduciaries regarding plan investment practices or suggested disclosures, and a report by Labor's ERISA Advisory Council. We also conducted a short poll of plan sponsors. The poll was conducted in coordination with *Plansponsor Magazine (Plansponsor)* and asked plan sponsors about withdrawal restrictions in their plans. The poll respondents were members of *Plansponsor's* subscription list, and their responses cannot be considered representative of the overall population of 401(k) plan sponsors. Our main use of this information was to better inform our understanding of these issues from a plan sponsor perspective and to design our subsequent audit work. Because of the methodological limitations and low response rate of this poll, this information is anecdotal and represents only the views of the 74 members who responded to our poll.

To demonstrate the scope of the potential effects of withdrawal restrictions and risks to participants' earnings, we gathered data from industry associations and private researchers; however, because there was no comprehensive data source available, it was difficult to determine how

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widespread the incidences of withdrawal restrictions were and to quantify any losses to 401(k) participant accounts. We also interviewed plan sponsors, plan service providers, representatives from industry associations, researchers, and Labor officials to determine the circumstances that led to withdrawal restrictions during the recent market downturn, to get an understanding of the advantages and disadvantages of investing in certain investment options and engaging in certain investment practices, and to determine the various relationships between 401(k) plans and parties involved in these investment options and practices.

To examine how the oversight and regulatory requirements governing withdrawal restrictions ensure that 401(k) plan sponsors and participants are aware of the potential for restricted access to plan investment options, we reviewed ERISA and Labor's related regulations, guidance, and frequently asked questions to determine their specific disclosure requirements and fiduciary responsibility standards. We reviewed the relevant federal laws and regulations, including those pertaining to disclosure requirements, of the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC), and interviewed officials at each of the federal entities about how they govern withdrawal restrictions and other investment practices. We reviewed Labor's, SEC's, and banking regulators', requirements to see if changes to those requirements could better inform plan sponsors and participants of the risks associated with certain investments and investment practices. We also collected and reviewed examples of disclosures from various investment options offered by 401(k) plans to see if the disclosures were clear and understandable and if they complied with current requirements. In addition, we interviewed Labor officials about how they oversee withdrawal restrictions and monitor disclosures to plan sponsors and participants, and interviewed service providers, other industry and participant organizations, and pension professionals to obtain their views on current oversight, disclosure and fiduciary requirements.

We conducted this performance audit from November 2009 to March 2011, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Background

Under Title I of ERISA, plan sponsors are permitted to offer their employees two broad types of retirement plans, defined benefit and defined contribution. Plan sponsors that offer defined benefit plans typically invest their own money in the plan and, regardless of how the plans' investments perform, promise to provide eligible employees guaranteed retirement benefits, which are generally fixed levels of monthly retirement income based on years of service, age at retirement, and, frequently, earnings. In contrast, plan sponsors that offer defined contribution plans do not promise employees a specific benefit amount at retirement—instead, the employee and/or their plan sponsor contribute money to an individual account held in trust for the employee. The employee's retirement income from the defined contribution plan is based on the value of their individual account at retirement, which reflects the contributions to, performance of the investments in, and any fees charged against their account. Over the past three decades, there has been a general shift by plan sponsors away from defined benefit plans to defined contribution plans.

The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pretax compensation to the plan under section 401(k) of the Internal Revenue Code.[3] The use of 401(k) plans accelerated in the 1980s after the U.S. Department of the Treasury (Treasury) issued a ruling clarifying a new section of the tax code that allowed employers and employees to make pretax contributions, up to certain limits, to employees' individual accounts. According to estimates by industry researchers, 49 million Americans were active 401(k) plan participants in 2009 and, by year end, 401(k) plan assets amounted to $2.8 trillion.[4] In most 401(k) plans, participants bear the risk of their investments' performance and the responsibility for ensuring they have adequate savings in retirement. Participants may, under certain circumstances, withdraw their retirement savings early but may have to pay tax penalties for doing so. Current law limits participant access to retirement savings in employer-sponsored retirement plans although, in certain circumstances, 401(k) plan sponsors

[3]In 2010, the federal limit for pretax contributions to 401(k) accounts was $16,500. Participants aged 50 and over were eligible for an additional $5,500 in "catch-up" contributions.

[4]Employee Benefit Research Institute. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009*, Issue Brief No. 350 (Washington D.C.: November 2010).

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may provide participants with access to their tax-deferred retirement savings before retirement.[5]

Plan sponsors that offer 401(k) plans have responsibilities under ERISA. The law establishes that a plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets.[6] Typically, the plan sponsor is a fiduciary under this definition. ERISA requires that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries. In accordance with ERISA and related Labor regulations and guidance, plan sponsors and other fiduciaries must exercise an appropriate level of care and diligence given the scope of the plan and act for the exclusive benefit of plan participants and beneficiaries, rather than for their own or another party's gain. Responsibilities of a fiduciary may include, but are not limited to

- selecting and monitoring any service providers to the plan;
- reporting plan information to the federal government and to participants;
- adhering to the plan documents, including any investment policy statement;
- identifying parties-in-interest to the plan and taking steps to monitor transactions with them;
- selecting and monitoring investment options the plan will offer and diversifying plan investments; and
- ensuring that the services provided to the plan are necessary and that the cost of those services is reasonable.

[5]Plan sponsors may provide participants access to their retirement savings in the form of a participant loan, a hardship withdrawal, or a lump-sum distribution when the participant separates from the plan sponsor. Participants who take an early distribution generally pay a 10 percent early withdrawal penalty and income taxes on the distribution amount and may face other restrictions and fees, such as loan origination fees.

[6]Labor's proposed regulations of October 2010, would amend the definition of an ERISA fiduciary, reducing the number of conditions that need to be met to be deemed an ERISA fiduciary. As such, the proposed regulation, if finalized, would encompass a greater number of entities assisting plan sponsors with selecting investment options. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

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Because 401(k) plans place the responsibility for ensuring adequate retirement savings on participants and limit a fiduciary's liability for investment decisions made by participants, Labor has placed additional responsibilities on plan sponsors and their fiduciaries who offer these plans. For participants to have control, they must be given the opportunity to choose from a broad range of investment alternatives. They must be allowed to give investment instructions at least once a quarter and perhaps more often if the investment option is volatile. In addition, participants must be given sufficient information to make informed decisions about the investment options offered under the plan.[7]

ERISA allows plan sponsors to hire companies that will provide the services necessary to operate their 401(k) plans. Service providers are various outside entities, such as investment companies, banks, or insurance companies that a plan sponsor hires to provide the services necessary to operate the plan such as

- investment management (e.g., selecting and managing the securities included in a mutual fund);
- consulting and providing financial advice (e.g., selecting vendors for investment options or other services);
- record keeping (e.g., tracking individual account contributions);
- custodial or trustee services for plan assets (e.g., holding the plan assets in a bank); and
- telephone or Web-based customer services for participants.

Labor's Employee Benefits Security Administration (EBSA) oversees 401(k) plans,[8] educates and assists plan sponsors and participants,

[7]Our recent reports on target date funds and conflicted investment advice illustrate that managing the risks faced in saving for retirement through 401(k) plans today can be complicated and pose significant challenges for participants and sponsors alike. See GAO, *Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*, GAO-11-118 (Washington, D.C.: Jan. 31, 2011); and GAO, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, GAO-11-119 (Washington, D.C.: Jan. 28, 2011).

[8]IRS also oversees various aspects of 401(k) contributions under the Internal Revenue Code.

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investigates alleged violations of ERISA, responds to requests for interpretations of ERISA through advisory opinions and rulings, and makes determinations to exempt transactions that would otherwise be prohibited under ERISA.[9] However, the specific investment products commonly offered in 401(k) plans fall under the authority of the applicable securities, banking, or insurance regulators. These regulators include SEC, federal and state banking agencies, and state insurance commissioners as follows:

- SEC, among other responsibilities, regulates securities markets and issuers, including mutual funds under various securities laws.
- Federal agencies charged with oversight of banks—primarily FRB, OCC, FDIC, and state banking agencies—oversee bank investment products, such as collective investment funds (CIF),[10] which are trusts that pool the investments of retirement plans or other institutional investors.[11]
- State insurance agencies generally regulate insurance products. Some investment products may also include one or more insurance elements, which are not present in other investment options. Generally, these elements include an annuity feature and interest and expense guarantees.[12]

[9]Labor regulations specify that participants must be offered at least three different investment options so that they can diversify investments within an investment category, such as through a mutual fund, and diversify among the investment alternatives offered.

[10]The operation of CIFs by national banks is subject to regulation under OCC regulations. While certain CIFs offered by state banks must comply with OCC regulations in order to qualify for tax-exempt treatment (*See* 26 U.S.C. § 584) these CIFs generally are not limited to employee benefit assets. CIFs offered by state banks that consist solely of employee benefit assets such as retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income tax must only comply with applicable state law requirements (which may include a cross-reference to OCC regulations) and are not required under the tax code to comply with OCC regulations. 12 C.F.R. § 9.18(a)(2).

[11]An institutional investor is an organization that pools large sums of money and invests those sums in securities, real property and other investment assets. Institutional investors include banks, insurance companies, retirement or pension funds, hedge funds, foundations and mutual funds.

[12]In the United States, an annuity contract is created when an insured party, usually an individual, gives an insurance company money that will later be distributed back to the insured party over time. Annuity contracts traditionally provide a guaranteed distribution of income over time, until the death of the person or persons named in the contract or until a final date, whichever comes first.

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401(k) Investment Options

ERISA does not prohibit a plan from offering any type of investment to its participants, but gives plan sponsors flexibility to choose the investments to be offered through their 401(k) plans.[13] There are many types of 401(k) investment options, including those listed in table 1.

Table 1: Investment Options Typically Offered through a 401(k) Plan

Type of investment option	Description
Real estate accounts	Real estate accounts are open-ended, commingled accounts that invest directly in real estate, such as funds that buy and manage commercial properties. Real estate accounts are equity accounts consisting primarily of high quality, well-leased real estate properties in the industrial, office, retail, and hotel sectors. If real estate accounts are offered by insurance companies as separate accounts, they are regulated by the State Insurance Commissioner in the state they are created.
Mutual funds	A mutual fund, legally known as an open-end investment company, is a company that pools money from many investors and invests the money in stocks, bonds, short-term money market instruments, other securities or assets, or some combination of these investments. These investments comprise the fund's portfolio. Mutual funds are registered and regulated under the Investment Company Act of 1940, and are supervised by the SEC. Mutual funds sell shares to public investors. Each share represents an investor's proportionate ownership in the fund's holdings and the income those holdings generate. Mutual fund shares are "redeemable," which means that when mutual fund investors want to sell their shares, the investors sell them back to the fund, or to a broker acting for the fund, at their current net asset value per share, minus any fees the fund may charge.
Money market funds	Money market funds are open-end management investment companies that are registered under the Investment Company Act of 1940, and regulated under rule 2a-7 under that act. Money market funds invest in high-quality, short-term debt instruments such as commercial paper, treasury bills and repurchase agreements. Generally, these funds, unlike other investment companies, seek to maintain a stable net asset value per share (market value of assets minus liabilities divided by number of shares outstanding), typically $1 per share.
Collective Investment Funds (CIFs)	A CIF is a bank-administered trust that holds commingled assets that meet specific criteria. Each CIF is established under a "plan" that details the terms under which the bank manages and administers the fund's assets. The bank acts as a fiduciary for the CIF and holds legal title to the fund's assets. Participants in a CIF are the beneficial owners of the fund's assets. While each participant owns an undivided interest in the aggregate assets of a CIF, a participant does not directly own any specific asset held by a CIF. CIFs are designed to enhance investment management by combining assets from different accounts into a single fund with a specific investment strategy. Many banks establish CIFs as an investment vehicle for employee benefit accounts, including 401(k) plans.

[13]Title I of ERISA does not proscribe or prohibit particular types of investment products or options, but plan sponsors must conduct due diligence and prudently select the investment options they want to offer to their participants.

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Type of investment option	Description
Balanced funds	Balanced funds are pooled accounts invested in stocks, bonds, and often additional asset classes. They are classified into two subcategories: target-date funds and nontarget-date balanced funds. Target date funds are often registered mutual funds and hold a mix of stocks, bonds, and other investments. Over time, the investment allocation gradually shifts according to the fund's investment strategy. Target date funds are designed to be investments for individuals with particular retirement dates in mind. The name of the fund often refers to its target date. For example, a fund with the name "Target 2030" is designed for individuals who intend to retire in or near the year 2030. Nontarget-date balanced funds include asset allocation or hybrid funds.
Stable value funds	Stable value funds are a fixed income investment option, designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns set in the contract. See below for more information.

Source GAO

Note: See GAO-11-118 for more information on target date funds

Labor reports that, in recent years, there has been a dramatic increase in the number of investment options typically offered under 401(k) plans. Many investments offered under 401(k) plans today pool the money of a large number of individual investors into funds called commingled or pooled accounts.[14] However, larger plans are more likely to structure their investments in separate accounts.[15] Both types of accounts may be invested in stocks, bonds, or real estate, but the type and number of options plan sponsors offer to participants in any given 401(k) plan vary based on a number of factors, including the size of the plan and the chosen plan service providers.

Results from a 2009 survey conducted by an industry consulting firm show that the most commonly offered 401(k) investment options in 2009 were equity, bond, and stable value funds.[16] Results from the survey also indicated that the percentage of plans offering money market funds significantly increased between 2007 and 2009. As shown in figure 1, equity funds accounted for over 40 percent of the 401(k) plan assets at the close of 2009. Other plan assets were invested in company stock; stable value funds, including guaranteed investment contracts; balanced funds; bond funds; and money funds.

[14]Commingled or collective funds are designed to combine the assets of unrelated retirement plans, enabling participants to diversify and gain the economies of scale, i.e., the advantages that being part of a larger fund affords, such as greater profits and less cost. Participants own a share in a pool of assets.

[15]For plans that offer separate accounts, participants own the assets in the pool.

[16]Hewitt Associates, *Trends and Experience in 401(k) Plans* (Lincolnshire, IL: 2009).

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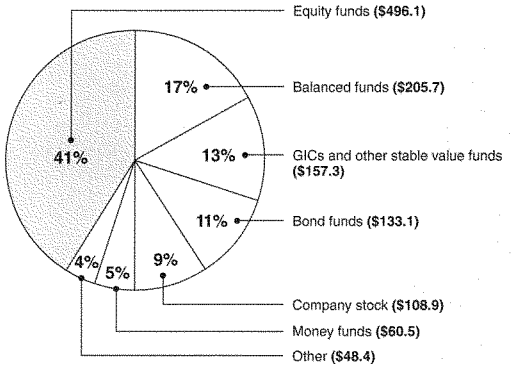
Figure 1: Estimated Aggregate Asset Allocation of 401(k) Plan Assets, 2009

Dollars in billions



Sources: Employee Benefit Research Institute and Investment Company Institute.

Note: GAO analyzed data provided in the November 2010 EBRI Issue Brief No. 350, in which EBRI and ICI summarize data from their 2009 EBRI/ICI 401(k) database. According to EBRI and ICI, at year end 2009, all 401(k) plans held a total of $2.8 trillion in assets, and that the database is a representative sample of the estimated universe of 401(k) plans. EBRI and ICI state the database contains information on over 51,000 401(k) plans (about 10 percent of plans) with $1.21 trillion in assets (about 44 percent of 401(k) plan assets) and about 20 million participants (about 42 percent of the universe of active 401(k) plan participants). The percentages presented in this figure are estimates of 401(k) plan assets included in each investment type based on the population covered in the database, or $1.21 trillion in 401(k) plan assets. The "Equity funds" and "Bond funds" categories consist of pooled investments—including mutual funds and CIFs—that are primarily invested in stocks and bonds, respectively. The "Other" category is the residual for other investments, such as real estate funds, and the "Money funds" category includes money market funds and other funds that are designed to maintain a stable share price, other than GICs and stable value funds. For definitions of key terms used in the report, please see the glossary.

Stable Value Funds

A key type of investment commonly offered through 401(k) plans is the stable value fund, which is a capital preservation investment option. These funds are primarily offered to defined contribution plan participants,

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including 401(k) plan participants.[17] Stable value funds are marketed as being invested in high-quality, diversified fixed income investments that are protected against interest rate volatility. According to the Stable Value Investment Association, about 50 percent of 401(k) plans offer stable value funds and when a stable value fund is offered, participants put about 15 to 20 percent of their plan assets, on average, into the investment option. Stable value funds are designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns.

While these funds attempt to maintain a stable return, actual return could vary over time because of changes in the market value of the underlying stable value portfolio assets, among other things.[18] To protect the fund from interest rate volatility, an important component of a stable value fund is the contract that plan sponsors or stable value fund managers purchase from plan service providers, including banks and insurers. The contract is a guarantee by a service provider, in the event of participant withdrawals, to pay participants at book value should the market value of the stable value portfolio be worth less than the amount needed to pay that book value.[19] As part of the price of providing this guarantee, contract providers

[17]The stable value fund industry used to offer "stable value mutual funds" to investors who invested in Individual Retirement Accounts; however, after SEC staff raised concerns about the funds' accounting methods, stable value mutual funds were terminated.

[18]The market value of a stable value fund is the collective prices at which the underlying assets of the fund are trading in the market at a given time.

[19]The book value of a stable value fund is the principal contributed to the investment option, plus accrued interest, minus withdrawals and fees. Accrued interest, minus withdrawals and fees, is calculated based on a methodology specified in the stable value fund contract and is reset on a periodic basis, which is usually quarterly or semiannually.

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typically require certain restrictions on plan sponsor and participant withdrawals or transfers of plan assets from stable value funds.[20]

While the market value of a stable value fund fluctuates as market prices of the underlying assets rise and fall, its book value fluctuates much less often, if at all—the rate of return may be fixed, indexed, or reset periodically based on certain factors, including the actual performance of the underlying assets—depending on the type of stable value fund contract obtained by the plan. Table 2 describes the three types of stable value fund contracts. Stable value funds may hold one contract type or a combination of contracts.

Table 2: Descriptions of the Three Types of Stable Value Fund Contracts

Type of stable value fund	Description
Traditional guaranteed investment contracts (GIC)	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return regardless of the performance of the underlying assets, which the insurance company owns and holds within their general account.
Separate account GICs	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return, which may be fixed, indexed, or reset periodically based on the actual performance of the underlying assets. The insurance company owns and holds the underlying assets in a separate, customized account for the exclusive benefit of a single plan.
Synthetic GICs	Plan sponsors contract with a bank or insurance company to guarantee participants principal protection and a rate of return relative to a portfolio of assets held in an external trust owned by the plan. The rate of return, which is based on the actual performance of the underlying assets, is reset periodically.

Source: GAO

Note: For the purpose of this report, stable value funds described are those typically categorized as synthetic guaranteed investment contracts.

[20]In fact, according to a stable value fund provider, plan sponsor restrictions are necessary to provide the fund manager with a tool to protect the remaining investors in the fund and to protect the issuers of wrap contracts used by the funds. Similarly, in a 2006 *Akron Law Review* publication, an industry expert notes that, in order for a wrap contract to be a financially sound product, wrap contract providers nearly universally insist that plan participants not be allowed to make direct transfers from a stable value fund into a money market fund. The author argues that these participant restrictions are not only necessary to maintain favorable returns above those of other low-risk investments, but also to ensure that less financially sophisticated plan participants are not disadvantaged by financially sophisticated, market-timing plan participants. Paul J. Donahue, "Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market," *Akron Law Review* 39, No. 1 (2005-2006).

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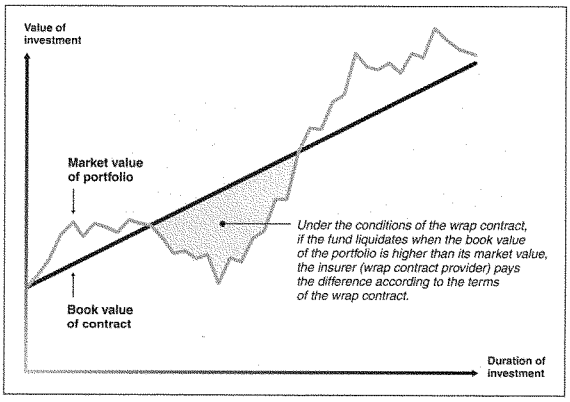
For synthetic GICs, contracts are called "wrap contracts." These stable value funds may obtain multiple wrap contracts from wrap contract providers to cover the underlying assets held in the stable value portfolio. As shown in figure 2, if participants want to withdraw funds when the value of a stable value portfolio falls below the book value the wrap contract provider may make up the difference for participants. In this situation, the wrap contract provider must only cover the difference between market value and book value if the total amount of participants' withdrawals exceeded the market value of the underlying stable value portfolio.

Figure 2: Stable Value Fund Wrap Contract



Source: GAO presentation of Stable Value Investment Association information.

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401(k) Investment Practice: Securities Lending with Cash Collateral Reinvestment

Many of the investment options offered by plan sponsors, including money market funds, stable value funds, and equity funds, engage in a practice called securities lending, where some of the assets held in these investment options on behalf of plan participants are lent out for a period of time to a third party, usually a broker-dealer.[21] In return, the broker-dealer provides collateral to the securities lending agent to hold until the broker-dealer returns the borrowed securities.[22] For example, an S&P 500 index fund will hold the same stocks in approximately the same ratio as they comprise the S&P 500, in an attempt to approximate the return of the S&P 500. There will always be a gap between the S&P 500 and an index fund that tries to approximate the returns of the S&P 500, by buying and selling stocks to maintain the same values as are held in the S&P 500. This gap, also known as "tracking error," is caused by, among other things, fund expenses, such as investment advisory fees, and brokerage expenses, that the index itself would not have. These index funds may try to decrease the gap by earning greater return on the stocks they hold by temporarily lending out the securities and then investing the cash collateral they receive.[23] Table 3 defines the various parties involved in a typical securities lending transaction.

[21]Some of the $2.8 trillion in assets held in 401(k) plans at the end of 2009 were utilized in securities lending programs, but the specific percentage is unknown. The percentage of assets lent out at any given time varies by type of 401(k) investment option. While SEC staff, by no-action letters, limit the percentage of assets in mutual funds and money market funds that can be utilized in securities lending programs, other 401(k) investment options that are not registered with SEC, such as some equity, bond, and stable value funds, are generally not limited in the percentage of assets that can be utilized by securities lending programs.

[22]The securities lending agent takes collateral for the loan that can be either cash or securities, such as bonds or stocks. However, in the United States, cash is the primary form of collateral taken in securities lending transactions and, thus, for the purpose of this report, investment options that lend securities are those investment options that participate in the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests, or securities lending with cash collateral reinvestment.

[23]If the investment option takes cash as collateral, the lender has the right to reinvest that cash to earn an additional return. The borrower does not pay an additional fee to borrow the securities, called a "negative rebate," unless the security is in extremely high borrowing demand. If the investment option takes securities as collateral, the borrower will pay the lender a fee.

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Table 3: Various Parties Involved in a Typical Securities Lending Transaction with Cash Collateral Reinvestment

Entity	Role
Plan participants	Plan participants contribute to their 401(k) and direct that contribution to certain investment options. In 401(k) plans, the assets are held in trust for participants.
Plan sponsor	A plan sponsor chooses which investment options to offer to its participants and, when making that choice, may decide whether to offer investment options that engage in securities lending.
Plan service provider	A plan service provider purchases securities on behalf of 401(k) plan participants. May act as securities lending agent.[a]
Securities lending agent	The securities lending agent may coordinate loans of securities, hire a manager to invest cash collateral, and often takes on counterparty risk—or the risk that the borrower will fail to return the securities—on behalf of the plan. May be an affiliate of the custodian, i.e., an entity, usually a bank, that has legal responsibility for safekeeping a plan's securities.
Borrower	The borrower contracts with a broker-dealer to acquire the securities it needs to cover its obligations. The broker-dealer can also be the borrower. There are many reasons why an entity might seek to borrow securities, including for "short" sales, i.e., borrowing a security from a broker and selling it, with the understanding that it must be bought back and returned to the broker. Short selling is a technique used by investors who try to profit from the falling price of a stock.
Broker-dealer	The broker-dealer borrows securities on behalf of its customers, providing cash as collateral to the securities lending agent.[b] A broker-dealer is a company or other organization that trades securities for its own account or on behalf of its customers. Although many broker-dealers are "independent" firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer.
Cash collateral pool manager	The cash collateral pool manager invests the cash provided as collateral for the borrowed securities in order to earn additional return for the securities lending agent during the period of time that the securities are borrowed. The securities lending agent can be the cash collateral pool manager, but usually it is an affiliate of the securities lending agent.

Source: GAO

[a]Custodial banks commonly provide securities lending services to defined benefit and defined contribution plans. If the plan invests plan assets in separate accounts, plan sponsors can choose whether or not to participate directly in a securities lending program. If the plan invests plan assets in commingled accounts—including mutual funds and collective investment funds—it may also participate indirectly in securities lending if those commingled accounts participate in securities lending.

[b]The amount of collateral provided by the broker-dealer may depend on the type of security being lent. For U.S. securities a typical collateral rate is 102 percent, for international securities it is 105 percent, of the value of the securities being lent out.

Figure 3 shows how a simple securities lending transaction would work.

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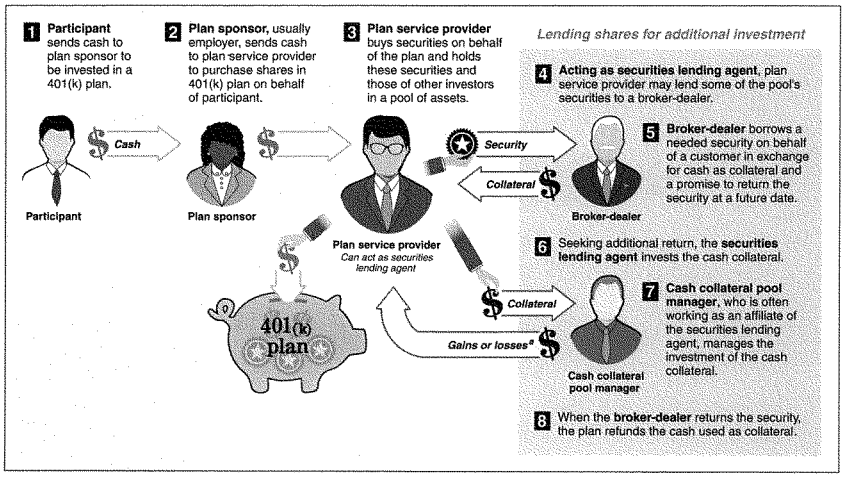
Figure 3: Example of a Simple Securities Lending with Cash Collateral Reinvestment Transaction



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

Note: When securities are on loan, the lenders, or plan participants, retain all the benefits of ownership including rights to dividends, interest payments, corporate actions (excluding proxy voting), and market exposure to unrealized capital gains or losses.

*Participants earn additional return in this transaction when the reinvested cash collateral earns more than the amounts owed to (1) the cash collateral pool manager as a fee for managing the cash collateral pool and (2) the broker-dealer as a "rebate." Generally the return left over after these two entities are paid is split between the securities lending agent and plan participants in varying percentages. The proceeds from securities lending that plan participants receive typically serves to offset custody fees and administrative expenses or to simply enhance participants' portfolio returns.

Institutions engaged in securities lending for a 401(k) plan subject to ERISA are supposed to take all steps necessary to design and maintain their programs to conform to an ERISA exemption that authorizes securities lending transactions that might otherwise constitute "prohibited

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transactions" under ERISA.[24] In general, ERISA prohibits parties-in-interest—such as service providers, plan fiduciaries, the employer, the union, owners, officers, and relatives of parties-in-interest—from doing business with the plan[25] but provides various exemptions to these prohibited transactions.[26] Some of the exemptions provide for dealings with banks, insurance companies, and other financial institutions essential to the ongoing operations of the plan. Labor issued Prohibited Transaction Exemption (PTE) 2006-16 to allow the lending of securities by employee benefit plans to certain banks and broker-dealers and to permit the payment of compensation to a lending fiduciary for services rendered in connection with loans of plan assets that are securities.[27]

Certain Investment Options Placed Withdrawal Restrictions on 401(k) Plan Sponsors and Participants

Between 2007 and 2010, some plan sponsors and participants were restricted from withdrawing their plan assets from certain 401(k) investment options, such as real estate, money market, and stable value

[24]Prohibited Transaction Exemption (PTE) 2006-16; Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006).

[25]29 U.S.C. § 1106. Prohibited transactions under ERISA include a sale, exchange, or lease between the plan and party-in-interest; lending money or other extension of credit between the plan and party-in-interest; and furnishing goods, services, or facilities between the plan and party-in-interest, among other prohibited transactions. Labor may grant administrative exemptions from the prohibited transaction provisions of ERISA.

[26]ERISA provides a number of detailed exemptions to its prohibited transaction provisions and permits Labor to establish additional ones. 29 U.S.C. §1108.

[27]Prohibited Transaction Exemption (PTE) 2006-16. This exemption permits the lending of securities owned by an employee benefit plan to persons who would otherwise constitute a "party in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities and permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities.

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investment options.[28] As shown in figure 4, beyond elevated levels of withdrawal requests, there were various reasons why certain investment options restricted withdrawals.[29]

[28]There are a number of reasons why plan sponsors and participants may want to withdraw their assets. For example, plan sponsors can switch investment options because they want to offer different investment options or because fees are too high at their current service provider. Participants often transfer their plan assets into riskier or safer investment options or may withdraw their 401(k) assets because they are experiencing a personal hardship. Participants are also allowed to withdraw their assets when they retire. Between 2007 and 2010, while some investment options placed restrictions on participants and sponsors who wanted to withdraw to move their plan assets into other investments, investment options generally did not restrict certain withdrawals that were defined by plan sponsors. This included hardship withdrawals and withdrawals at retirement, if applicable.

[29]Withdrawal restrictions, in general, may have prevented some realized losses during the period of the restrictions.

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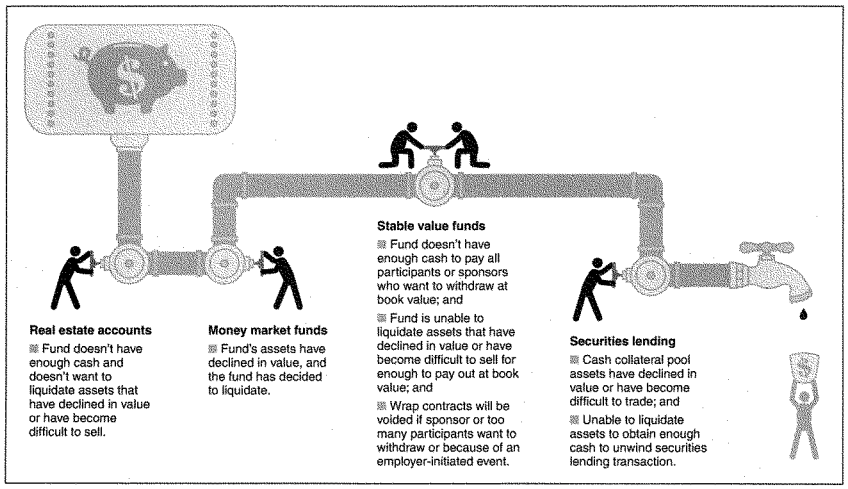
Figure 4: Reasons Withdrawal Restrictions May Have Occurred Regarding 401(k) Plan Assets



Source: GAO.

Real Estate Accounts Restricted Withdrawals Because of Illiquid Assets

Multiple real estate accounts placed restrictions on participant and sponsor withdrawals in 2007 and 2008—some of which lasted into 2011.[30] Since these accounts buy and manage real estate, such as commercial properties, which is inherently more illiquid than some assets in other 401(k) investment options, industry experts we spoke to told us that few plan sponsors tend to offer these investment options in 401(k) plans. Nevertheless, some 401(k) plan participants had invested some of their 401(k) plan assets with these types of investment options and found those

[30]Generally, defined benefit plans are more likely to invest in real estate than defined contribution plans. As such, public reports of redemption restrictions noted that numerous defined benefit plans also experienced withdrawal restrictions from these investment options.

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assets frozen during the last few years because some of the investments in the real estate accounts—for example, an investment by the real estate fund in a high-rise building or other commercial property—had lost significant value and became difficult to sell. As a result, participants' and plan sponsors' withdrawals of their assets from the investment options were postponed by managers of the accounts, sometimes for multiple years.[31] While the number of 401(k) plan sponsors or participants whose withdrawals were affected or who lost money as a result of withdrawal restrictions is unknown, at least one lawsuit was filed on behalf of ERISA plans, including 401(k) plan participants, alleging that a service provider breached its fiduciary duties by managing a real estate account that restricted withdrawals inconsistently with its stated objective to maintain adequate liquidity to provide for daily withdrawals.[32] As of December 2010, some of the restrictions that were placed on these real estate accounts had been lifted, and some plan participants and sponsors had received their requested plan assets.

Industry experts told us that withdrawal restrictions on real estate accounts are not unusual—in fact such accounts have implemented withdrawal restrictions in the past—and that, for this reason, these investment options disclose to plan sponsors and participants in account documentation that the real estate account manager may temporarily freeze withdrawals. We found that plan sponsors generally receive information about real estate accounts, including the maximum number of days allowed to defer withdrawals from the account, in the contract that they sign with their service provider. In addition, we reviewed disclosures to participants that stated that the investment option was subject to investment and liquidity risk and other risks inherent in real estate such as those associated with general and local economic conditions, and that payment of principal and earnings may be delayed. However, some of the industry officials we spoke to noted that, regardless of these disclosures, participants may not have known that their plan assets could be frozen because they failed to read or understand the disclosures.

[31]While restrictions were placed on participants and sponsors who wanted to withdraw to move their plan assets into other investments, a representative of the real estate accounts that we spoke to told us that, despite the restrictions, it continued to pay benefits for certain withdrawals that were defined by plan sponsors, including hardship withdrawals and withdrawals at retirement at normal age, if applicable.

[32]*Mullaney v. Principal Global Investors, LLC et al.* No.4:10-cv-00199-RP-TJS (U.S. Dist. Ct., So. Dist. Of Iowa)(April 30, 2010).

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One Money Market Fund Restricted Withdrawals Because of Losses and Illiquid Assets, While Others Required Support to Prevent Potential Restrictions

While money market funds account for only a small portion of 401(k) plan assets, during 2007 and 2008, many money market funds experienced severe financial difficulties from exposure to losses from debt securities issued by structured investment vehicles and Lehman Brothers Holdings Inc. (Lehman), and one of them placed restrictions on all withdrawals from the investment option. The once-more than $60 billion money market fund, the Reserve Primary Fund, "broke the buck" on September 16, 2008, because its $785 million holdings of Lehman debt securities had defaulted, causing a 3 percent loss to investors, including 401(k) plan participants.[33] As a result of investor concern over Lehman's default, the Primary Fund faced a very large number of withdrawal requests over a short period of time—or a run on the fund—which the other Reserve funds also experienced.[34] The Primary Fund stopped satisfying redemption requests and formally instituted withdrawal restrictions on all investors on September 22, 2008, when it obtained an SEC order permitting the suspension of redemptions in certain Reserve Funds, including the Primary Fund, to permit their orderly liquidation.[35]

[33]Money market funds must operate in accordance with rule 2a-7 under the Investment Company Act of 1940. Under rule 2a-7, as in effect in 2008, money market funds were permitted to maintain a stable net asset value, usually $1.00, by using the "amortized cost" valuation method. Under this valuation method, securities are valued at acquisition cost, with certain adjustments, instead of fair market value. If there is a difference of more than one-half of 1 percent ($.005 per share) between amortized cost and net asset value, the fund is deemed to have "broken the buck," and must reprice its shares. The Primary Fund's Lehman holdings were valued at zero in September 2008 which led to a repriced net asset value of $0.97 per share. However, these Lehman holdings were subsequently sold for around 22 cents on the dollar and thus, as of approximately July 16, 2010, Primary Fund investors had been paid 99 cents on the dollar.

[34]According to the "Report of the President's Working Group on Financial Markets: Money Market Reform Options," October 2010, money market funds are vulnerable to runs because shareholders have an incentive to redeem their shares before others do when there is a perception the fund might suffer a loss. Even when the fund suffers a small loss, shareholders who choose to redeem may do so at the expense of the remaining shareholders.

[35]Subject to certain exceptions, Section 22(e) of the Investment Company Act of 1940 prohibits mutual funds, including money market funds, from (i) suspending the right of redemption, or (ii) postponing payment upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of the security to the fund or its agent. One of the exceptions is by order of the SEC for the protection of the fund's security holders. SEC issued an order covering the Reserve Primary Fund and the U.S. Government Fund on September 22, 2008, and an order covering additional Reserve money market funds on October 24, 2008.

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With the exception of the Reserve Primary Fund, the money market funds that were exposed to losses in 2007 and 2008 obtained support in some form from their advisers or other affiliated service providers that may have helped to avoid potential restrictions. This support either absorbed the losses or provided a guarantee covering a sufficient amount of losses to prevent the money market fund from breaking the buck. In addition, these funds received support from federal regulators to help them remain liquid and preserve their value. Shortly after the Reserve Primary Fund began to experience difficulties, on September 19, 2008, the Treasury announced the Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain investments in money market funds that decided to participate in the program.[36] On the same day, the FRB announced the creation of its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, through which it extended credit to U.S. banks and bank holding companies to finance their purchases of high-quality asset-backed commercial paper from money market funds.[37] As a result of the service provider and federal support that provided additional liquidity to money market funds, additional redemption suspensions and liquidations may have been prevented.

Because of the severity of the problems experienced by money market funds during 2007 and 2008, SEC reformed its regulations governing money market funds. The new regulations are designed to make money market funds more resilient, more liquid, and to reduce the chance of runs on money market funds in the future.[38] Among other things, the new regulations now permit a money market fund that has broken the buck, or that is at imminent risk of doing so, and that has irrevocably decided to

[36]Treasury's Temporary Guarantee Program for Money Market Funds expired on September 18, 2009. Treasury guaranteed that upon liquidation of a participating money market fund, the fund's shareholders would receive the fund's stable share price of $1.00 for each fund share owned as of September 19, 2008. Participating funds were required to agree to liquidate and to suspend shareholder redemptions if they broke the buck. Most money market funds elected to participate in the program. On November 20, 2008, SEC adopted an interim final temporary rule under section 22(e) of the Investment Company Act that permitted investment companies that commenced liquidation under the Guarantee Program to suspend redemptions of outstanding shares and postpone payment of redemption proceeds. 17 C.F.R. § 270.22e-3T. According to SEC staff, none did.

[37]FRB's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility expired on February 1, 2010.

[38]Money Market Reform, 75 Fed. Reg. 10,060 (Mar. 4, 2010) (codified at 17 C.F.R. pt. 270 and 274). The new rules were effective May 5, 2010.

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liquidate, to suspend redemptions without obtaining an SEC order.[39] These changes could permit additional participant and sponsor withdrawal restrictions in the future, if additional money market funds liquidate.

Some Stable Value Fund Assets Were Restricted Because of Losses, Illiquid Assets, and Contract Constraints, Which Also Pose Risks to Participants

Some Stable Value Funds Restricted Plan Sponsor and Participant Withdrawals, but the Extent Is Unknown

Industry experts have noted that most stable value funds avoided withdrawal restrictions in 2008 and 2009, but we found that the total number of plan sponsors and participants affected by withdrawal restrictions from stable value funds was unknown. Stable value funds can place restrictions on plan sponsor and participant withdrawals in some circumstances when the market value of the fund's underlying assets is below the book value, and more participants want to cash out than the fund's cash holdings can handle. According to the Stable Value Investment Association and industry consultants, many stable value funds were operating with market values below book values in 2008 and 2009 because of losses and illiquidity in their underlying assets, but plan participants allocated increasing amounts of their 401(k) assets to stable value funds. An industry association indicated that this increase in participants' contributions to stable value funds likely allowed stable value funds to avoid liquidity problems that could have caused withdrawal restrictions or losses for participants.

However, when many stable value funds experienced market values below book values during 2008 and 2009, some participants and plan sponsors were restricted from withdrawing their plan assets from some stable value

[39]Specifically, the new rule (rule 22e-3) permits a money market fund to suspend redemptions and postpone payment of redemption proceeds to facilitate an orderly liquidation of the fund if: (1) the fund's board, including a majority of the disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results to investors, (2) the board, including a majority of the disinterested directors, irrevocably has approved liquidation of the fund, and (3) the fund has notified SEC prior to suspending redemptions.

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portfolios because of stipulations in their wrap contracts. For example, after their company's bankruptcy, participants in Mervyns LLC's 401(k) plan were restricted from withdrawing their assets invested in the stable value option. In this situation, the protections that would have been afforded to the Mervyns participants by the stable value fund's wrap contract were voided by the plan sponsor's bankruptcy, since it was considered an "employer-initiated event" in the contract. Similarly, some plan sponsors were restricted from withdrawing plan assets from stable value funds because of constraining language in the wrap contract that provided for withdrawal restrictions in the case of employer-initiated events. Specifically, wrap contracts typically stipulate that stable value managers have the right to restrict plan sponsor withdrawals for employer-initiated events for up to 12 months in order to unwind investments and ensure that participants can be paid out at book value, but during this time participants are generally able to make withdrawals from the investment option at any time.[40] Employer-initiated events could include layoffs, bankruptcies, and changing stable value fund providers and might include anything that may cause withdrawals of a large plan asset amount from the investment option in a short time frame. For example, one plan sponsor who recently acquired another company noted that the acquisition took only 4.5 months, but it was restricted from withdrawing from the companies' two stable value funds for nearly 2 years because the acquisition, as an employer-initiated event, required a merger of the two existing stable value funds, but existing contract providers refused to accommodate the stable value fund merger without loss to participants. Another plan sponsor we spoke to noted that its 401(k) plan switched plan service providers and had to wait until the stable value fund provider had come up with enough cash to implement the change. As of the date of the switch, new contributions to the stable value option were attributed directly to the new stable value fund at the new provider, but the plan had to keep the past contributions on the plan's records until the restriction was lifted.

[40]Restrictions may vary depending on the way the stable value fund is structured. 12-month restrictions, such as the restrictions described above, are generally stipulated in contracts where the stable value fund is structured as a commingled investment option. For plan sponsors who offer stable value funds as separate account investment options, there is generally no exit option, per se. Instead, for stable value funds that are operated as separate account investment options, plan sponsors generally cannot exit at book value until market values recover to that amount.

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Losses and Illiquidity in Stable Value Portfolios and Contract Constraints Increase Participants' Risks for Restrictions and Losses

The losses and illiquidity of the underlying assets of stable value funds and contract constraints that led to the withdrawal restrictions raised some concerns about the risks that these investment options pose to participants. Specifically, the industry has documented that, between 2005 and 2007, many stable value funds began including riskier assets than had been traditionally included in stable value portfolios—including highly rated corporate bonds, mortgage-backed securities,[41] and asset-backed securities,[42] at the expense of treasuries—in an effort to increase participants' return and to attract more investors. However, many of these securities suffered price declines, which contributed to the stable value funds' market values falling below their book values and has resulted in lower returns for participants. When the market value of the stable value portfolio is above book value, participants who want to withdraw their plan assets from the stable value fund receive book value, and stable value fund providers retain the extra as profit and as reimbursement for their costs to run the stable value fund.[43] However, as shown in table 4, when the market value of the stable value portfolio's assets is below book value, and the contract is voided by an employer-initiated event, plan participants can face withdrawal restrictions until the stable value fund generates enough cash from new contributions or by selling existing portfolio assets.[44]

[41]Mortgage-backed securities are securities whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying mortgage loans, most commonly on residential property. For example, a bank or other entity lends a borrower the money to buy a house and collects monthly payments on the loan. This loan and a number of others, perhaps hundreds, are sold to a larger bank that packages the loans together into a mortgage-backed security. The larger bank then issues shares of this security to investors who buy them and ultimately collect the dividends in the form of the monthly mortgage payments.

[42]An asset-backed security is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets. The pools of underlying assets can include common payments from credit cards, auto loans, and mortgage loans, to esoteric cash flows from aircraft leases, royalty payments and movie revenues.

[43]Some of the amount that the provider retains may be paid back to existing or new participants through small increases in their future book value.

[44]Such restrictions are likely to occur in this situation if the stable value fund was structured as a commingled investment option.

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Table 4: Potential Effects on Participants if Market Value Is Below Book Value

Wrap contract is:	What happens if many participants want to withdraw?
Valid—withdrawals do not result from employer-initiated events.	Stable value fund pays participants with cash holdings and proceeds from selling other stable value holdings. Since the stable value holdings are not enough to pay participants at book value, the wrap provider pays the difference between market value and book value.[a]
Void—withdrawals result from employer-initiated events that void the contract.	Stable value fund pays participants the market value of their investment in the fund with cash holdings and proceeds from selling other stable value holdings.
	or
	Stable value fund restricts withdrawals until the stable value fund can provide participants with cash holdings and proceeds from selling other stable value holdings.

Source GAO

[a]Wrap providers cover the difference between market value and book value; not the full amount necessary to pay participants who request withdrawals. For example, if the book value of a participant's plan assets in the stable value fund is $100, but the market value of their plan assets is only $97, then the wrap provider would pay $3, and the stable value fund would pay $97 if the participant wanted to withdraw their assets.

In addition to withdrawal restrictions, when the market value of the stable value portfolio's assets is below book value, participants are at risk for losses from the investment option. As noted above, in the case of an employer-initiated event, the wrap contract protections that would provide participants with book value could be voided, thereby placing plan participants at risk for any losses of the underlying assets.[45] For example, when Lehman filed for bankruptcy in September 2008, wrap contracts that covered portions of the stable value fund in the Lehman 401(k) plan became void, which resulted in losses for some plan participants who withdrew their plan assets from the investment option. Furthermore, even if the wrap contract remains valid, if more participants request transfers out of the investment option when the market value of the fund is less than book value than the fund's liquidity reserves can handle, new participants and participants who remain in the fund could be at risk for the losses from the investment option because the rate of return earned on the stable value fund, going forward, will be adjusted downward by the wrap contract provider to reflect the market losses that were temporarily

[45]Depending on the specific situation, some plan sponsors may be able to negotiate with the stable value fund provider to continue to provide book value to participants, even though an employer-initiated event has occurred. However, if the plan sponsor is able to negotiate with the wrap provider or find a new wrap provider who will accept the losses on the original contract, participants who are covered under the renegotiated or new contract will likely be charged a higher fee to make up for the losses.

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covered by the wrap provider.[40] In fact, industry experts note that wrap providers had never made a payment in fulfillment of a wrap contract that they did not recoup. As a result of the adjusted rate of return, future assets contributed to the stable value fund, whether by current or new participants, will earn less than the original assets that incurred the losses because the wrap provider will guarantee a lower return for those future contributions in order to make up for the market losses. Although one of the reasons why stable value fund providers place restrictions on plan sponsor and participant withdrawals is to limit these situations, even unrestricted participant withdrawals could trigger an inequitable distribution of risk and losses. This is of particular concern when interest rates have risen sharply, and investors leave the stable value fund in search of higher yields.

Stable Value Wrap Contracts Also Expose Participants to Other Risks

In addition to causing potential losses for participants, wrap contracts can also expose participants to other risks. Figure 5 illustrates some of the potential risks associated with stable value fund wrap contracts.

[40]If participants request transfers out when the market value of the fund is less than book value, the cash held by the stable value fund has been exhausted, and the withdrawal requests are not related to an employer-initiated event, the wrap contract will partially cover the difference between the market value and book value of the withdrawals. The wrap provider pays participants only if there is a deficit between book value and market value after all participants have left the plan.

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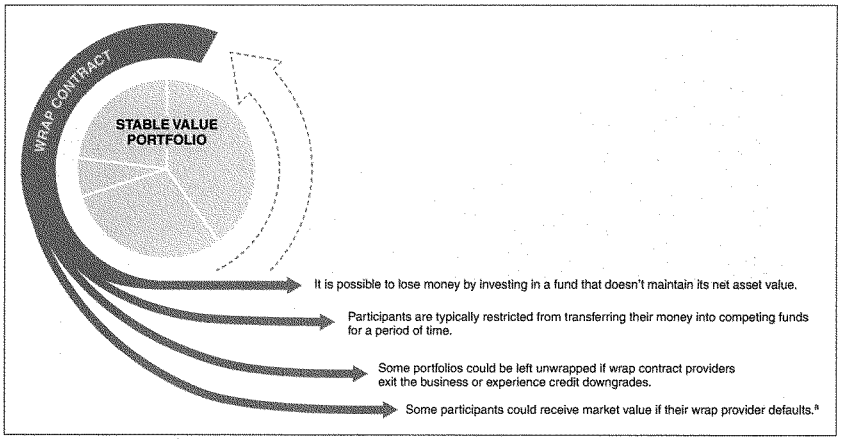
Figure 5: Potential Risks Associated with Stable Value Fund Wrap Contracts



Source: GAO interviews and analysis of stable value fund issues.

[a]One of the major wrap contract providers almost went bankrupt, requiring a federal bailout.

- "Competing" fund restrictions—If participants wish to withdraw their assets from a stable value fund, the terms of the wrap contract may prohibit them from transferring their assets into "competing" investment options offered by the plan sponsor, as defined in the wrap contract. Participants may instead be required to put their assets into a noncompeting investment option for 90 days.[47] Because these funds are intended to be longer term investments, these restrictions are typically included in the wrap contract to prevent participants from taking of

[47]These wrap contract restrictions are sometimes called "equity wash provisions" because once the participant transfers their plan assets out of the stable value fund, they are precluded by the contract from investing their plan assets directly into "competing" investment options, which could include money market funds or other short-term fixed income funds, and instead are required to put their money in a non-competing investment option, such as an equity fund.

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advantage of interest rate fluctuations; however, they still represent a risk to participants since they are prevented from directing their assets.

- Rising fees for wrap contracts—Industry experts note that wrap contracts have gotten more expensive in recent years as wrap providers also became aware of the significant risks taken in stable value fund portfolios. For example, one stable value fund provider stated that, as of March 2010, virtually all wrap providers had ceased accepting new stable value portfolios unless the contracts stipulated new contract terms—including tougher investment parameters and higher fees—which were more favorable for wrap providers but could create unwelcome inflexibility for plan sponsors.[48] Such higher fees for wrap providers, everything else equal, could also result in lower returns for participants. Wrap capacity has also recently been constrained because some wrap providers left the market, and others saw decreases in their credit ratings. Because of this, some stable value funds have had difficulty obtaining wrap contracts on portions of their underlying stable value portfolios, which has increased the likelihood that participants could bear potential losses from the underlying investments in stable value funds. For example, AIG, one of the major wrap providers, no longer provides wrap contracts.[49] Similarly, according to industry reports, a few other firms, including UBS and Rabobank, decided to stop providing wrap coverage. These developments would also tend to place upward pressure on fees.[50] While some providers have entered the market, and other stable value fund providers have agreed to provide this coverage for their plan sponsors until they can obtain a wrap contract, wrap capacity is not yet back to previous levels.

[48]Some plan sponsors have also called for less risk to be taken in the stable value portfolio.

[49]According to a Congressional Oversight Panel June 10, 2010 report, *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy*, on the day that AIG was poised to fail, it had $38 billion in stable value wrap contracts.

[50]The combined effects of wrap providers exiting the business, credit downgrades in the insurance industry, and reevaluations of risk in the historically "low-risk" wrap contract business caused the majority of remaining wrap providers to significantly reduce their risk exposure, triggering much tighter investment restrictions on the underlying stable value portfolio and increasing fees.

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Certain Investment Options That Lent Securities Placed Restrictions on Plan Sponsor Withdrawals Because of Losses and Illiquid Assets in the Cash Collateral Pool, Which Also Posed Risks to Participants

We also found that some restrictions were placed on investment options that lent securities. Any number of 401(k) investment options can lend securities, including index funds, money market funds, and stable value funds. Some service providers that offered the investment options that lent securities did not allow plan sponsors to withdraw or transfer all of the 401(k) plans' investments in those investment options because of collateral pool losses.[51] These losses occurred because the cash collateral pools had been invested in risky assets that subsequently lost value and became difficult to trade.[52] As a result of the losses, the pools were not worth the amount that the investment option needed to return the cash collateral and pay rebates to borrowers.[53] During the period of withdrawal restrictions, some plan sponsors were allowed to withdraw only a certain percentage of their plan's assets in the investment option over a given time period—in many cases 2 to 4 percent—or they were required to take their share of the cash collateral pool's illiquid and devalued assets.[54]

Similar to stable value funds, the losses and illiquid assets in the cash collateral pools that led to these restrictions on plan sponsor withdrawals raised concerns about the risks this practice poses to participants' account balances, given the returns they receive. In the case of securities lending

[51]Some investment options that were registered with SEC, such as mutual funds, also experienced realized and unrealized cash collateral pool losses but did not place restrictions on plan sponsors' withdrawals because of the losses. Instead, realized cash collateral pool losses were included in the net asset value of the registered investment option.

[52]These assets may not have been perceived as risky when they were acquired and, in fact, may have complied with the plans' or the investment options managers' investment guidelines covering cash collateral reinvestment. Some investment guidelines were very broad and therefore provided some discretion to the lending agent. As a result, some lenders may have chosen more aggressive reinvestment strategies when more conservative approaches were available.

[53]This is known as a "collateral deficiency" and, as used here, occurs when the securities lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption.

[54]Securities lending agents had differing experiences in their respective cash collateral pools, and managed their clients' realized and unrealized losses differently—some placed restrictions on plan sponsor withdrawals. In addition, the restrictions varied by the type of investment options that plan sponsors offered. On one hand, investment options that were separate accounts required that a minimum percentage of the account's securities had to be lent out. However, investment options that were commingled accounts virtually eliminated plan sponsors' abilities to withdraw from the commingled accounts, limiting withdrawals to between 2 and 4 percent of their assets per month.

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with cash collateral, participants bear the ultimate risk of loss from the cash collateral pool investments.[55] While securities lending agents may bear counterparty risk from securities lending activities with cash collateral—i.e., reimburse plan participants for losses caused by borrower default—they generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer, which is the risk that remains with plan participants. However, in the event that there were gains from the investments of the cash collateral pool, participants only receive a portion of return, while securities lending service providers, including broker-dealers and securities lending agents, may obtain most of the gains earned on cash collateral reinvestment.[56] In addition, some securities lending agents reported large portions of their annual revenues from the returns earned by cash collateral reinvestment activities for their institutional investors, including 401(k) plans.[57] In 2008, one of the largest securities lending agents reported that its revenues from such lending were over $1 billion. See figure 6 for a breakdown on the return that participants can receive.

[55]Participants ultimately bore the risk of loss from market risks of the cash collateral portfolio—the potential for portfolio losses resulting from the change in value of stock prices of the portfolio's assets, interest rates, foreign exchange rates, and commodity prices—but were only provided with a portion of the return generated as a result of the risks taken on their behalf.

[56]According to individuals we interviewed, broker-dealers may negotiate to receive a rebate from the securities lending agent of some of the return earned on the reinvestment of cash collateral because they would have earned a short-term rate of return on the cash they provided as collateral if they had kept it in their possession. However, since they are providing the cash as collateral, they are not able to earn interest on it.

[57]The lending agent typically absorbs the operational expenses associated with providing the service.

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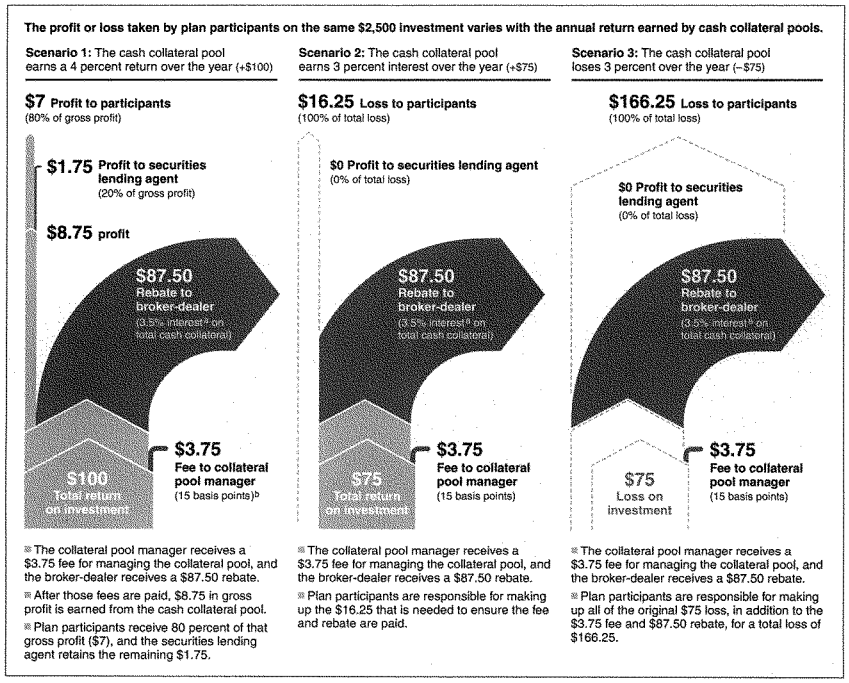
Figure 6: Gain or Loss Earned on Reinvestment of Cash Collateral from Securities Lending in Differing Market Scenarios



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

Note: All of these scenarios are based on certain assumptions. The rates were chosen to depict a situation that may have been in effect in the years/months prior to and at the beginning of the crisis. While today's rates may vary from the rates depicted here, the distribution of gains/losses will not likely differ materially for the same type of securities loan. Thus, in this example,

- The securities lending agent contracts with (1) the plan sponsor to allow the plan's assets to be lent and (2) with the broker-dealer to lend the assets,

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- The security lent is not a "special" security—or a security that is sought after in the market by borrowers,
- The total amount of cash collateral as a result of the securities lending transaction, $2,500, is provided by the broker-dealer at the beginning of the year and the securities lending transaction remains in effect throughout the year,
- The securities lending agent reinvests all of the cash collateral provided by the broker-dealer in a cash collateral pool managed by the collateral pool manager, who charges 15 basis points of the total amount of cash collateral to manage the pool ($3.75),
- The broker-dealer is promised a rebate—an annualized return of 3.5 percent interest on the total amount of cash collateral they provide over the year ($87.50), and
- The plan sponsor agrees to an 80/20 revenue sharing split between plan participants and the securities lending agent, which means that participants get 80 percent, and the lending agent gets 20 percent of the revenue earned from the cash collateral pool after fees are paid.

[a]Typically, the rate promised to the broker-dealer as a rebate is based on a benchmark rate, such as the federal funds rate or LIBOR and is not typically provided in a one-time payment as shown in the graphic, but more likely paid on a daily or monthly basis. The greater the demand for the security being lent, the lower the rebate paid to the broker-dealer. "Special" securities that have an extremely high borrowing demand, or that are in short supply and therefore hard to borrow, can obtain "negative" rebates, requiring the borrower to not only pledge cash, but also pay a fee to plan participants.

[b]15 basis points is the same as 0.15 percent.

Because securities lending agents typically do not bear the risk of loss of the collateral pool, yet gain when the collateral pool makes money, they may be encouraged to take more risks with the underlying assets of the investment options—both by investing in riskier assets and by delaying the sale of those assets. Some cash collateral pool managers invested in certain assets that increased the risk of the pool. These assets were of questionable credit quality or required a longer duration of investment than the typical plan assumed were in the cash collateral pool. For example, prior to September 2008, some pools had invested in Lehman Brothers Holdings, Inc., securities that became almost worthless in 2008, making them too illiquid to pay all withdrawal requests.[58] Furthermore, we found that plan sponsors may have also had the incentive to offer investment options that lent securities more aggressively because those investment options offered higher returns, yet were still marketed as

[58]While Lehman may have had a high credit rating immediately prior to its bankruptcy, that rating may have been based on materially misleading periodic reports. In fact, the report of the Examiner in Lehman's bankruptcy proceedings stated that "unbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse-engineered the firm's net leverage ratio for public consumption."

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relatively "risk free." Thus, in trying to offer participants investment options that provided competitive returns, plan sponsors may have searched out investment options that may have, as a result of securities lending with cash collateral, increased participant risks in the process of seeking higher returns.[59]

In addition to withdrawal restrictions, these risky assets in securities lending cash collateral pools caused realized losses for participants in the last few years.[60] A recent industry publication estimated that unrealized losses in securities lending cash collateral pools affected most pension plans and many defined contribution plans, but some 401(k) plans also experienced realized cash collateral pool losses in 2008. In addition, some retirement plans, including 401(k) plans, have recently filed lawsuits against some of the larger securities lending agents as a result of these losses.[61] The litigation claims included allegations of violations of the lending agents' fiduciary, contractual, and other legal responsibilities in losing millions of dollars for the investment funds in their securities lending contracts. In addition, several securities lending agents have requested and received individual prohibited transaction exemptions from Labor that have allowed them to reduce some of the cash collateral pool

[59]Many investment options, by design, invest in securities with some risk. If the securities are lent out and the cash collateral is then invested in risky securities, it creates a leveraged situation where $1 invested in the fund is exposed to more than $1 of risk. To the extent that returns on the two sets of risky assets are correlated, a market downturn could result in both the lent securities, and the collateral investments suffering losses at the same time.

[60]Losses may have been realized or unrealized. Realized losses caused the value of the investment option to decline and were less likely to cause withdrawal restrictions, whereas unrealized losses did not cause the value of the investment option to decline and were more likely to cause withdrawal restrictions.

[61]For example, BP Corporation pension plan committee filed suit in October 2008 against Northern Trust Company, asserting multiple causes of action grounded in the fiduciary obligations prescribed by §§ 404, 409, and 502 of ERISA. This case is still pending, and no rulings have been made. *BP Corporation North America, Inc. Savings Plan Investment Oversight Committee v. Northern Trust Investments N.A.*, No. 1: 08-cv-6029 (N.D. Ill.)(October 21, 2008). Other cases include: *Public School Teachers' Pension & Retirement Fund of Chicago et.al. and City of Atlanta Firefighters' Pension Plan, v. Northern Trust Investments*, No. 1:10-cv-00619 (N.D. Ill.)(January 29, 2010); *Board of Trustees of the AFTRA Retirement Fund et.al. v. J.P. Morgan Chase Bank N.A.*, No. 1:09-cv-00686-SAS-DCF (S.D. N.Y.)(January 23, 2009); and *Diebold v. Northern Trust Investments N.A. et.al.*, No. 1:09-cv-01934 (N.D. Ill..)(March 30, 2009). We did not verify the status of these cases.

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losses.[62] Specifically, these exemptions allowed securities lending agents either to buy the problematic securities from a number of cash collateral pools that held pension plan and 401(k) plans assets or to shore up those pools with cash in an attempt to create liquidity in the otherwise cash-strapped collateral pools.[63]

Disclosures about Stable Value Funds and Securities Lending Are Limited and Difficult for Participants to Understand

Given the risk and limitations that participants are exposed to when investing in stable value funds, information provided to participants may be difficult for them to understand and may not fully explain the risks taken on their behalf by stable value funds, including the variety of events that could affect participants' withdrawals or that could cause losses. See figure 7. While participants receive some disclosures about stable value funds and some of the risks associated with investing in them, industry experts found in 2009 that participants often are not able to understand those disclosures.[64] For example, a defined contribution consulting firm recently expressed concern over participants' perception that these investment options are risk-free and recommended that stable value funds should be required to make a statement explaining how such a fund is managed and identifying the risks associated with the fund, such as the underlying assets, the wrap providers, and the wrap contract.

[62]Individual exemptions relating to actions taken by service providers to ensure liquidity of cash collateral pools were granted by Labor in 2009 and 2010, including PTE 2009–11, JP Morgan Chase Bank, National Association; PTE 2009-27, Bank of New York Mellon Corporation; and PTE 2010-25, State Street Bank and Trust Company.

[63]For example, one securities lending agent contributed cash to one of their cash collateral pools that experienced losses as a result of the Lehman default—in accordance with their portion of the split on gross profit—but sponsors that withdraw from the cash collateral pool within three years will forfeit this loss sharing. Another securities lending agent contributed cash representing 20 percent—or the loss from a Lehman security—of the unrealized and realized losses in one of their collateral pools.

[64]ERISA Advisory Council. *Report on Stable Value Funds and Retirement Security in the Current Economic Conditions* (2009).

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Figure 7: Example of a Stable Value Fund Disclosure Provided to 401(k) Participants

Excerpts from a two-page stable value fund fact sheet (text shown actual size)

Risk Management

- Issuer exposure is constrained to minimize issuer credit risk and increase diversification.
- Duration target is managed at portfolio and product levels to provide consistent income from interest and principal repayments while minimizing convexity risk.
- A tiered liquidity protocol and laddered portfolio maturity structure are utilized to minimize liquidity risk.

[illegible] actual investment advisory fees incurred by clients may vary depending on account size and other account-specific factors. The [illegible] investment advisor's [illegible]

[illegible] ngs. It should not be assumed that any of the securities transactions or holdings listed or discussed were or will be profitable, or that the investment recommendations or decisions we will make in the future will be profitable or will equal the investment performance of the securities listed or discussed herein.

Source: GAO presentation of a private investment company's fact sheet for a stable value fund.

Furthermore, it is unclear to what extent stable value fund disclosures include a discussion of all of the risks that participants could be exposed to and all of the information participants need to evaluate the benefits and risks of the investment option. Labor published final participant disclosure regulations in October 2010 that will affect the disclosures participants receive about investment options, including stable value funds.[65] One industry expert we spoke to said that while the newly required disclosures clearly include participant restrictions defined in the stable value contracts, such as restrictions on transferring plan assets into competing

[65]Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule, 75 Fed. Reg. 64,910 (Oct. 20, 2010)(codified at 29 C.F.R. pt. 2550). As a result of these regulations, which became effective on December 20, 2010, participants will receive core information about investments available under the plan, including performance and fee information, prior to investing and on an annual basis, in a chart or similar format designed to facilitate investment comparisons. Participants will also receive quarterly statements on plan fees and expenses deducted from their accounts along with a description of the services for which the charge or deduction was made. 29 C.F.R. § 2550.404a-5 and § 2550.404c-1.

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funds, the expert did not believe that the potential for restrictions of stable value withdrawals based on employer-initiated events would be included in these new disclosures to participants. In addition, industry experts we talked to said that participants were frequently not given an important piece of information—the market to book value of the stable value portfolio—unless they asked for it. In fact, some experts said that plan sponsors may not be inclined to provide this information to participants for fear that it would cause what would be deemed an employer-initiated event.[66] While one expert believed that participants would continue to receive disclosures from stable value funds about the stable value funds' book values, the expert did not believe that the market value of the stable value portfolio would be required by Labor's recently published participant disclosure regulations. One industry expert stated that the ratio of market to book value of the stable value portfolio was the summary statistic that would help plan participants understand whether their investments are at risk if the other participants in their plan withdraw from the fund. While Labor's recent regulations may address some of these risks in a requirement that the participant disclosures include an Internet Web site address that provides participants access to the investment option's principal strategies and principal risks, it is unclear whether participants will find this method of disclosure useful in understanding the specific risks associated with stable value funds and comparing those risks with the risks posed by other investments.

Participants may also be unaware of the risks taken on their behalf by investment options that lend securities, including the complex compensation structures and variety of events that could affect participants' withdrawals or that could cause losses. As with stable value fund disclosures, disclosures regarding the risks associated with engaging in securities lending with cash collateral reinvestment are generally also buried deeply within the pages of investment option documents and, as written, may give the incorrect impression that any financial risk to plan assets is low. In one mutual fund's annual report, the fact that the investment option engages in securities lending is disclosed on page 68 of

[66]Wrap contracts may stipulate plan sponsor communications with participants that induce transfers from the funds as employer-initiated events.

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the 90 page document.[67] Figure 8 shows pertinent information about securities lending that would be provided to a plan participant from another investment option, an index fund, registered with the SEC. The figure shows page 14 of a 52-page document. The 52-page document is the "Statement of Additional Information" (SAI) which is a supplementary document to a mutual fund's prospectus that contains additional information about the mutual fund and includes further disclosure regarding its operations. There is also a 37-page annual report, as well as a 40-page prospectus for the index fund.

[67]The placement of this information in disclosure documents depends on the investment option's approach to securities lending. If, for example, the investment option only lends on an intrinsic value basis, and only reinvests cash to preserve principal, their risk may in fact be low. Since the economic crisis, securities lenders are calling for a move towards an intrinsic value lending approach, rather than a focus on cash collateral reinvestment to generate additional returns.

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Figure 8: Example of a Securities Lending Disclosure in Registered Investment Option's Required Disclosures

Excerpt from page B-14 of one 52-page "Statement of Additional Information" (text shown actual size)

Securities Lending. A fund may lend its investment securities to qualified institutional investors (typically brokers, dealers, banks, or other financial institutions) who may need to borrow securities in order to complete certain transactions, such as covering short sales, avoiding failures to deliver securities, or completing arbitrage operations. By lending its investment securities, a fund attempts to increase its net investment income through the receipt of interest on the securities lent. Any gain or loss in the market price of the securities lent that might occur during the term of the loan would be for the account of the fund. If the borrower defaults on its obligation to return the securities lent because of insolvency or other reasons, a fund could experience delays and costs in recovering the securities lent or in gaining access to the collateral. These delays and costs could be greater for foreign securities. If a fund is not able to recover the securities lent, a fund may sell the collateral and purchase a replacement investment in the market. The value of the collateral could decrease below the value of the replacement investment by the time the replacement investment is purchased. Cash received as collateral through loan transactions may be invested in other eligible securities. this cash subjects that investment to market appreciation or depreciation.

The terms and the structure of the loan arrangements, as well as the aggregate amount of securities loans, must be consistent with the 1940 Act, and the rules or interpretations of the SEC thereunder. These provisions limit the amount of securities a fund may lend to 33 1/3% of the fund's total assets, and require that (1) the borrower pledge and maintain with the fund collateral consisting of cash, an irrevocable letter of credit, or securities issued or guaranteed by the U.S. government having at all times not less than 100% of the value of the securities lent; (2) the borrower add to such collateral whenever the price of the securities lent rises (i.e., the borrower "marks-to-market" on a daily basis); (3) the loan be made subject to termination by the fund at any time; and (4) the fund receive reasonable interest on the loan (which may include the fund's investing any cash collateral in interest bearing short-term investments), any distribution on the lent securities, and any increase in their market value. Loan arrangements made by each fund will comply with all other applicable regulatory requirements, including the rules of the New York Stock Exchange, which presently require the borrower, after notice, to redeliver the securities within the normal settlement time of three business days. The advisor will consider the creditworthiness of the borrower, among other things, in making decisions with respect to the lending of securities, subject to oversight by the board of trustees. At the present time, the SEC does not object if an investment company pays reasonable negotiated fees in connection with lent securities, so long as such fees are set forth in a written contract and approved by the investment company's trustees. In addition, voting rights pass with the lent securities, but if a fund has knowledge that a material event will occur affecting securities on loan, and in respect of which the holder of the securities will be entitled to vote or consent, the lender must be entitled to call the loaned securities in time to vote or consent.

Source: GAO presentation of a private investment company's Statement of Additional Information for an index fund.

In general, 401(k) participants do not receive the SAI or the prospectus automatically, although plan sponsors do receive a prospectus, and so do retail investors. Therefore, participants may never see this disclosure on

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securities lending. One plan sponsor we spoke to, described the SAI as an attachment to the prospectus. The sponsor told us that it is necessary to know where to find this information and then work through the details. All disclosure information is embedded in massive documents of varying degrees of importance. Labor's recently issued participant disclosure regulations will undoubtedly affect the disclosures participants receive. Participants will receive core information about investments available under the plan, including performance and fee information, in a chart or similar format designed to facilitate investment comparisons. However, since these regulations require only disclosure of investment options, and not all practices utilized by those investment options—of which securities lending is one practice—it is unclear how much or to what extent securities lending fees and risks will be discussed in these disclosures.[68] There is nothing in the regulations that explicitly requires plan sponsors to disclose information on the risks of securities lending with cash collateral reinvestment or withdrawal restrictions that can result from securities lending. Without better disclosures on securities lending with cash collateral, participants may continue to be unaware of the practice of cash collateral reinvestment and the risk it poses to plan participants, as well as the potential for withdrawal restrictions resulting from such practices.

[68] 29 C.F.R. § 2550.404c-1.

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Labor Can Take Steps to Help Plan Sponsors Understand the Risks and Challenges Posed By Certain Investments and Practices

Eliminating Stable Value Fund Restrictions That Can Compromise Sponsors' Fulfillment of Their Fiduciary Obligations and Providing Better Information Can Help Plan Sponsors

Stable value funds are typically subject to restrictions and wrap contracts that may prevent plan sponsors or fiduciaries from meeting their fiduciary obligations when choosing to offer a stable value fund.[60] A stable value fund contract can constrain a plan sponsor's ability to add investment options or communicate information about the basic health of the investment option to participants. In addition, stable value fund contractual arrangements can discourage plan sponsors from communicating with their plan participants about the levels of risk the particular investment options were assuming. These types of arrangements that limit sponsor behavior and that may void the stable value contract, however, are not prohibited by current regulation, and experts told us that they are commonly accepted industry practices.

The wrap contracts associated with stable value funds may cause problems for plan sponsors because they typically limit the type of information that can be shared with participants. Wrap contracts typically prohibit sponsors from making any communication that may result in fund redemptions. This can complicate the plan sponsor's role in administering the plan. For example, in a situation where a sponsor becomes aware that the market value of the stable value fund's underlying assets has fallen below book value, which could put participant assets at risk, the sponsor is in a unique position—if the sponsor communicates this information to

[60]Section 404(a)(1) of Title I of ERISA provides a "prudent man standard of care" that a fiduciary must observe in meeting his or her duties with respect to the plan. As such, the fiduciary must act solely in the interests of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Among other requirements, the fiduciary must discharge his responsibilities with the appropriate care, skill, prudence, and diligence that similarly situated fiduciaries acting in a like capacity and familiar with such matters would use in a similarly situated enterprise of a like character and with like aims. 29 U.S.C. § 1104(a)(1).

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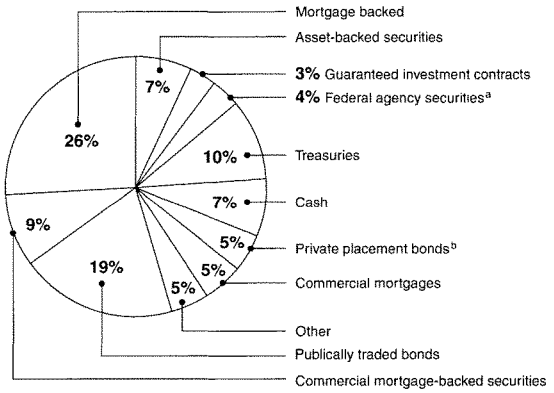
participants, it would likely void an insurance contract that could be valuable to the plan's participants. However, failing to communicate this information to participants may compromise the plan sponsor's role as a fiduciary with respect to the plan.

During our review, industry experts told us that sponsors of varying plan sizes often lacked an understanding of the underlying investments and the features of stable value funds. Stable value funds are marketed to plan sponsors as low-risk investments that provide consistent stable returns, protection of the invested principal, and immediate liquidity, characteristics that have attracted many sponsors and participants to stable value funds. Stable value funds are also considered to be invested in high-credit quality, fixed income securities, such as low-risk, government and corporate bonds with short- to medium-term maturities. Yet, as shown in figure 9, as of the end of 2008, nearly 50 percent of the underlying assets in stable value funds were asset-backed or mortgage-backed securities.

Figure 9: Underlying Assets in Stable Value Funds (year end 2008)



Source: Stable Value Investment Association's 13th Annual Stable Value Investment and Policy Survey

[a]Federal agency securities are debt instruments issued by federal credit agencies.

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[69]A private placement is a direct offering of securities directly to an institutional investor, such as a bank, mutual fund, insurance company, pension fund, or foundation

Given their mix of underlying assets, many stable value funds' credit rates dropped sharply in 2008 and 2009 because of lower returns on their underlying bond holdings and market conditions that prompted stable value managers to put more money into cash during the financial crisis. Despite the problems that stable value funds experienced during 2008 and 2009, investors continued to put money into stable value funds as they sought a less risky investment which helped to shore up stable value returns.

Labor's ERISA Advisory Council reported in 2009 that plan sponsors need, among other things, a better understanding of a stable value fund's portfolio composition, the current financial condition of fund issuers and wrap providers, and the safeguards they each have in place in the event of default.[70] The council reported that only with this critical information can plan sponsors adequately determine the appropriateness of selecting a particular stable value fund or whether such an investment meets the needs of the plan. The council heard testimony that such information may either not be readily available from wrap providers or stable value fund managers or that plans sponsors do not know to ask for, or do not understand, the information that might be made available. Without this information, plan sponsors may continue to offer stable value funds to plan participants, the associated risks of which they and plan participants may not clearly understand.

[70]An asset in a stable value fund can potentially default, for example, if the loan underlying an interest-only bond defaults or prepays. A wrap provider can potentially default on its "guarantee" or its obligation to cover any gap between market value and book value of a stable value fund's assets.

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Example of an Employer-Initiated Event That Could Void the Stable Value Wrap Contract

A common sponsor response to an underperforming fund is to replace it with another fund. However, in the case of a stable value fund that has a market value below book value, replacing the stable value fund could invalidate the wrap protection, or at least trigger clauses in the contract that might delay the liquidation of the fund. Some funds allow the option of a "12-month put," in other words, a 1-year advance notice required to terminate a fund, while others may not allow termination of the fund until market value and book value converge. A sponsor may be faced with the difficult choice of either maintaining an underperforming stable value fund or voiding an insurance contract that may be potentially valuable to their plan participants.

Labor's ERISA Advisory Council also reported that plan sponsors need more information with regard to a stable value fund's underlying assets, including how those funds are valued, its wrap provider, and a fund's costs and fees.[71] In addition, understanding the events that could void a wrap contract could help plan sponsors make strategic decisions. The stress of the market volatility in 2008 and 2009 (which led to lower market values for many stable value funds) has placed increased scrutiny on sponsor behavior that might be considered an employer-initiated event according to the terms of wrap contracts and highlighted the need for plan sponsors to have a better understanding of all the implications of their decisions regarding the wrap provisions of their stable value funds.

According to industry reports, some plan sponsors are now asking for more flexibility in their wrap contract provisions and, as a result, some stable value fund providers are starting to offer options that might provide that flexibility. One stable value fund provider stated that one of the concerns about stable value funds that came to light as a result of the 2008 financial crisis was that wrap contracts may have been too inflexible to provide plan sponsors with the ability to make necessary business decisions, such as closing a plant or layoffs, without affecting their stable value fund options in their 401(k) plans. The stable value fund provider stated that plan sponsors may view the embedded protections in wrap contracts that would preclude them from making these decisions as too constraining and has thus begun to offer some plan sponsors with choices that provide greater flexibility. For example, the stable value fund provider is offering its plan sponsors two stable value fund choices that seek to provide them with flexibility for employer-initiated events or participant communications and a greater likelihood that they will not void the contract if they make changes to their plans. While these flexibilities in the terms of wrap contracts may be offered to some plan sponsors, not all plan

[71] According to the ERISA Advisory Council, plan sponsors need (1) issuer specific information regarding the underlying assets of a stable value fund for insight into the risk/reward characteristics that will result in any variance between the fair market value and the book value; (2) issuer specific information regarding the wrap contract provider, since the financial stability of the wrap contract provider(s) may be a factor in the ability of the fund to be able to continue to make payments at book value when book value is greater than the fair market value of the underlying assets; (3) information on the administrative cost and other fees related to the fund, to aid in determining the efficiency and prudence of the investment; and (4) information concerning the periodic fair market valuation of the fund as compared with book value that would allow them to evaluate any risk of a market value adjustment.

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sponsors are able to negotiate special terms to protect their plan participants or themselves.[72]

Recently enacted legislation requires Labor and other regulators to review various aspects of stable value fund contracts, providing Labor an opportunity to aid plan sponsors and participants in better understanding stable value funds. Specifically, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[73] prescribes that the SEC and the Commodity Futures Trading Commission (CFTC) jointly conduct a study to determine whether stable value contracts fall within the definition of a swap.[74] Given that Labor will be required to inform the study, the agency is in a unique position to focus on ways to help plan sponsors better understand stable value funds.

[72]Industry experts who testified before the ERISA Advisory Council stated that the level of due diligence for stable value fund selection is qualitatively different from the due diligence in selecting a mutual fund. Unlike mutual funds, where there are a variety of sources regarding their current and historic value, the only source of stable value fund information is the stable value fund provider. Thus, some plan sponsors are in a position where they not only do not understand the composition and diversification of the underlying portfolio of stable value funds, but they also do not understand how the market to book value of their plan's stable value fund compares to other stable value funds.

[73]Pub. L. No. 111-203, §719, 124 Stat. 1377, 1656 (2010). The Dodd-Frank Act was signed into law on July 21, 2010. The stated intent of the new law is to promote the financial stability of the United States by improving the accountability and transparency in the financial system and protecting consumers from abusive financial services practices.

[74]Swaps are one of the financial transactions addressed by the Dodd-Frank Act. Normally, the vast majority of retirement plans do not directly employ swaps. However, the Dodd-Frank Act's definition of swap could include components of stable value fund products because the Dodd-Frank Act defines "swap" broadly to include certain agreements where the value is determined by reference to an underlying asset (subject to certain exclusions). The investments underlying a stable value fund are protected by the issuer's guarantee to pay the book value of the investments if the market value is depleted. It is this protective wrap contract that could be considered a swap under the Dodd-Frank Act. SEC and CFTC are to consult with Labor, Treasury, and state regulators who regulate the issuers of stable value contracts and issue a report by October 11, 2011. If they determine that stable value contracts fall within the definition of a swap, they are to determine if an exemption is in the public interest. Until such time, the requirements of the act are not to apply to stable value contracts and stable value contracts in effect prior to the adoption of any regulations are not to be considered swaps. Section 719(d) of Dodd-Frank 15 U.S.C. § 8307.

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Changes to Labor's Disclosure Regulations Can Also Help Plan Sponsors Become Aware of the Risks Associated with Investment Options That Lend Securities

Industry experts told us that many plan sponsors are unaware of the risks involved with the cash collateral reinvestment portion of their service providers' securities lending programs, or may not fully understand the risks. Other plan sponsors may not know whether their investment options engage in such lending at all. For example, 17 of the 74 plan sponsors who responded to our brief poll responded "no" to our question about whether their investments that engage in securities lending had disclosed to them that this investment practice was a possibility. An additional 20 plan sponsors responded that they were not sure whether this information had been disclosed.[73]

Other industry officials have expressed similar concerns. One large investment consulting firm has stated that many of its plan sponsor clients may not be aware that their investment options utilize securities lending programs. An industry expert we spoke to, who is also a 401(k) plan sponsor, admitted that he did not know whether the investment options offered through his plan engaged in securities lending. Another industry expert told us that there were poor communications between investment option managers and lending agents (e.g., custodial banks)—investment option managers did not ask the right questions about how the cash collateral was being invested, and custodian banks who acted on behalf of investment options' managers thought their customers were educated enough to understand that the cash collateral posted by borrowers was invested in collective investment pools.

Recent litigation involving banks that engage plan assets in their securities lending programs illustrates instances where plan sponsors may not have understood the practice of securities lending, and where parties involved, under minimal scrutiny, may have taken additional risks with plans' assets. Over the past few years, plan sponsors and others filed lawsuits against Northern Trust, State Street, JP Morgan, Bank of New York Mellon, Wells Fargo, U.S. Bank, and Wachovia for allegedly violating their fiduciary, contractual, and other legal responsibilities in losing millions of dollars for the investment funds in their securities lending contracts. Most of the lawsuits involve the loss of cash collateral invested by the custodian banks in their securities lending programs. Plan sponsors allege that they were

[73]Our poll respondents' responses cannot be considered representative of the overall population of 401(k) plan sponsors. Because of the methodological limitations of this poll, this information is anecdotal and represents only the views of the 74 members who responded to our poll.

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intentionally misled by their custodian banks as to where their cash collateral was being invested. Critics of these plaintiff's lawsuits say that the plan sponsors are simply disgruntled customers seeking to recoup unavoidable investment losses from banks that have profited from their plans' assets.[76]

One way industry experts have suggested to help protect participants' 401(k) retirement savings when placed in investments that utilize securities lending with cash collateral reinvestment is by limiting the percentage of 401(k) plan assets that could potentially be loaned out at any one time. Industry experts we talked to stressed the importance of limiting the amount of 401(k) assets that can be subject to securities lending, similar to SEC staff's limits on lending by mutual funds. SEC staff no-action letters effectively limit the amount of assets that can be lent from a mutual fund at one time to one-third of the fund's total asset value. Furthermore, SEC limits the amount of total mutual fund assets and money market fund assets to 15 percent and 5 percent, respectively, that can be invested in illiquid securities, such as some asset-backed securities that do not trade on exchanges and do not have an accessible market for buyers and sellers.[77] However, there are no comparable limitations on the total amount of 401(k) plan assets that can be lent or invested in illiquid securities.

[76]We have not verified the status of any of these cases.

[77]The term "illiquid security" generally includes any security that cannot be sold or disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within 7 days.

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SEC and Others Are Taking Steps to Improve Transparency and Disclosures on Securities Lending, and Labor Can Also Require Better Disclosures for Plan Sponsors

SEC and others in industry are already taking steps to address certain issues related to securities lending. SEC and the Financial Industry Regulatory Authority (FINRA)[78] are working on proposals for additional disclosure on securities lending. The Dodd-Frank Act calls for the SEC to promulgate rules no later than July 21, 2012, that are designed to increase the transparency of information available to brokers, dealers, and investors with respect to the loan or borrowing of securities.[79] FINRA is also looking at promulgating rules that will ensure that broker-dealers allow customers to fully understand all the risks involved and that will focus on disclosing things from potential conflicts to restrictions firms may have on liquidating securities.[80]

It is unclear whether the improved disclosures will provide information about the gains and losses from securities lending to investors and other stakeholders. Currently, banking regulators do not require banks to report gains or losses from their securities lending programs. Although the Financial Accounting Standards Board requires banks to make publicly available this information in their financial statements, the information is not reported to any federal regulator and is also not broken out by type of plan. The Federal Financial Institutions Examination Council[81] supervisory policy on securities lending stipulates that information on securities borrowing and lending transactions should be made publicly available by commercial banks in their financial statements. However, banks do not break out this information by type of plan and may only provide the information as a summary total that includes other revenue streams, such

[78]FINRA is the largest independent regulator for all securities firms doing business in the United States. It oversees nearly 4,600 brokerage firms, 163,000 branch offices, and 631,000 registered securities representatives. Its chief role is to protect investors by maintaining the fairness of the U.S. capital markets.

[79]Section 984(b) of Dodd-Frank, 15 U.S.C. § 78j. The new act does not limit the authority of the federal banking agencies to also prescribe rules regarding the loan or borrowing of securities.

[80]FINRA has also asked for input on how to create an ADV-like form for broker-dealers, which is the key disclosure document used by investment advisers that requires detailed disclosures of services, conflicts, and fees.

[81]The council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by FRB, FDIC, the National Credit Union Administration, OCC, and the Office of Thrift Supervision, and to make recommendations to promote uniformity in the supervision of financial institutions.

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as investment advisory and administration fees, making it difficult to determine revenue specific to securities lending.

Some securities lending agents have already begun to implement various changes to their securities lending programs and the way they manage cash collateral. These changes have come as a result of securities lending agents, who have recently reported that some plan sponsors that they service have not only requested more disclosure about securities lending and cash collateral pools but have also requested that their securities lending programs take on less risk. For example, one securities lending agent is calling for a "back to basics approach" with the focus on protecting principal and maintaining liquidity while generating incremental returns for participants. Securities lending agents stated that going forward, cash collateral pools would likely be of shorter duration and have more standardized guidelines of what they could invest in. They also said that these guidelines could possibly be structured along the lines of SEC's liquidity requirements for money market funds, under which, among other things, money market funds must maintain minimum daily and weekly asset positions.[82] With these changes, they believe that 401(k) plan participants could receive some protection from the losses and withdrawal restrictions that they recently experienced.

Labor could also take steps to improve transparency on the practice of securities lending by amending its prohibited transaction exemption regarding the practice of securities lending. Labor's PTE 2006-16, authorizes securities lending transactions that might otherwise constitute "prohibited transactions" under ERISA, but the exemption currently lacks specifics on the utilization of 401(k) plan assets in the practice of securities lending. In addition, according to Labor, the exemption does not address or provide any relief for the reinvestment of cash collateral.[83]

[82]SEC's rule 2a-7, which governs money market funds, requires that all taxable money market funds maintain at least 10 percent of their assets in cash, U.S. Treasury securities, or securities that mature or can be converted to cash within one business day, and that all money market funds hold at least 30 percent of their assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that mature or can be converted to cash within a week.

[83]Labor's PTE 2006-16 does state, however, that, in return for lending securities, the plan may receive a reasonable fee (in connection with the securities lending transaction) and/or have the opportunity to earn additional compensation through the investment of cash collateral. It further states that all fees and other consideration received by the plan in connection with the loan of securities should be reasonable.

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Without such information, plan sponsors do not have the information they need to assess the potential gains and losses from cash collateral reinvestments, since other regulators that oversee the financial entities involved in securities lending also do not require that such information be explicitly disclosed to plan sponsors. By revising the existing exemption, Labor can ensure that plan sponsors who enter into securities lending arrangements with cash collateral reinvestment are not prevented from meeting their fiduciary obligations when doing so.

Labor can also help to ensure that plan sponsors clearly understand the gains and losses associated with securities lending by amending its two recently issued rules, one regarding service provider disclosure to plan sponsors,[84] and one regarding plan sponsor disclosure to participants, to include information specific to securities lending. The recent amendment to the interim final rule, which affects the "up-front" or "point of sale" disclosure, i.e., when a service provider and a plan sponsor enter into a service agreement or contract, enhances disclosure to fiduciaries of 401(k) and other retirement plans. It requires service providers to disclose, among other things, a description of the services to be provided; a statement that the covered service provider will provide its services as a fiduciary to the covered plan;[85] a description of all "direct compensation" (i.e., compensation received directly from the covered plan) and "indirect compensation" (i.e., compensation that is received from any source other than the covered plan, plan sponsor, covered service provider, an affiliate, or a subcontractor) that the covered service provider reasonably expects to receive in connection with the disclosed services. The regulation is meant to assist fiduciaries in determining both the reasonableness of compensation paid to plan service providers and any conflicts of interest that may impact a service provider's performance under a service contract or arrangement.

[84]Reasonable Contract or Arrangement Under Section 408(b)(2)–Fee Disclosure; Interim Final Rule, 75 Fed. Reg. 41,600 (July 16, 2010)(to be codified at 29 C.F.R. § 2550.408b-2).

[85]A statement is also required when the covered service provider provides their services as a registered investment advisor. A "covered service provider" is a provider that enters into a contract or arrangement with the retirement plan and expects to receive $1,000 or more in direct or indirect compensation for services to the plan, regardless of whether the services are performed by the covered service provider, an affiliate, or a subcontractor, or as a registered investment advisor registered under the Advisors Act or under state law providing services directly to the plan.

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With regard to the practice of securities lending, the regulation would presumably require a custodian to disclose the fact that it receives compensation from its role in the investment strategy of securities lending. However, it is unclear how much assistance it would provide to plan sponsors in understanding securities lending with cash collateral reinvestment or the gains and losses associated with that practice. For example, as currently written, it is unclear whether it would be obvious to the plan sponsor how much of a profit the custodian would take compared with the profit the plan would receive. It is also unclear whether the custodian would have to reveal exactly how it used the plan's profit, such as to reduce plan fees, or whether the custodian would disclose that the other service providers involved in the transaction received their compensation, in the form of fees and rebates, regardless of the performance of the cash collateral reinvestment pool. Labor's regulations, as currently written, will not assist plan sponsors in understanding the mechanics of a securities lending transaction and how the entities involved in the transaction, specifically those involved in the cash collateral reinvestment activity, are paid. Plan sponsors need to know that the profit they make is a net return after everyone else is paid for their role and that any loss from the cash collateral pool comes out of their plans' assets. The current regulations also do not contain specific provisions requiring disclosure of the potential for withdrawal restrictions, which could assist plan sponsors in their decision-making process when selecting investment options to offer through their 401(k) plans.

Conclusions

For a growing number of American workers, their prospects for a secure retirement increasingly rest on the retirement savings they accumulate in their 401(k) plans. One of the touted benefits of 401(k) plans was their transparency to and control by participants. Participants could see their accounts grow and control how much to contribute and where to invest those contributions. Yet, it is becoming increasingly obvious that saving for retirement is not as simple as it appeared 30 years ago when 401(k) plans were first created. As this report shows, and as our past report on undisclosed fees and more recent reports on target date funds and conflicted investment advice illustrate, managing the risks faced in savings for retirement through 401(k) plans today can be complicated and pose significant challenges for participants and sponsors alike.

At a minimum, greater transparency and disclosure are necessary to help plan sponsors and participants understand the restrictions and limitations they could face with certain 401(k) investment options and the risk of loss to plan participants' investments in 401(k) plans. The recent financial

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crisis vividly illustrated the importance of transparency when dealing with complex financial instruments. What seems like an optimal way to make money off of 401(k) plan assets, such as through securities lending with cash collateral reinvestment, can appear to be straightforward until the scope of the risks and complexities of the cash collateral reinvestment transaction have to be explained to investors, plans sponsors, and plan participants. Expecting plan sponsors and plan participants to understand the intricacies of today's many investment options without sufficient guidance and information is unrealistic.

Without more explicit and accessible information on stable value funds and securities lending with cash collateral reinvestment, participants are unknowingly bearing a greater risk of loss than they are currently aware of and, more importantly, have no control over. Labor has already provided much needed disclosure requirements for plan sponsors to give to plan participants. Amending those regulations to include disclosure explicitly targeted to the risks of investing in stable value funds and provisions on securities lending will help to ensure that plan participants, like plan sponsors, are informed about stable value funds and securities lending with cash collateral reinvestment and are able to make the best decisions to save for their retirement.

The maturation of the 401(k) system, coupled with the increased complexity of the financial markets, is posing new challenges for Labor, financial regulators, plan sponsors, and participants. Changes called for in the Dodd-Frank Act are likely to clarify stable value contracts and provide more disclosure on securities lending. Because of the statutory requirements in the Dodd-Frank Act, Labor has an opportunity to assist plan sponsors and participants with two complex areas, stable value fund contracts and securities lending with cash collateral reinvestment. Such careful, thoughtful action to facilitate prudent decision making on the part of sponsors and participants can bolster retirement security and avoid the long-term loss of participant confidence in the 401(k) system.

Recommendations For Executive Action

The recently enacted Dodd–Frank Wall Street Reform and Consumer Protection Act includes requirements that will affect deliberations about stable value funds and requires that the SEC and the CFTC, in consultation with Labor and Treasury, conduct a study of stable value funds. To ensure additional protection for plan participants, appropriate information for plan sponsors, and to better inform the study required by the Dodd-Frank Act, we recommend that Labor take the following actions:

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- As it conducts its consultative analysis to assist the SEC and CFTC, also analyze stable value funds specifically in a 401(k) investment context to identify those situations or conditions that prevented plan sponsors from withdrawing from stable value funds, such as contract restrictions, and take appropriate regulatory steps to assist plan sponsors in fulfilling their fiduciary responsibilities.

- Amend its regulation on plan sponsor disclosure to participants to include a specific requirement for plan sponsors to provide information to participants that discloses the risks of investing in stable value funds.

- Provide guidance to plan sponsors on the risks, structure, and dynamics of stable value funds, consistent with the recommendations proposed by the ERISA Advisory Council regarding the disclosure of information about stable value funds.

Given the current practice of securities lending with cash collateral reinvestment, its role in 401(k) plan investments, and our findings that plans and plan participants can bear a disproportionate amount of any loss associated with the practice, Labor should take action to help plan sponsors of 401(k) plans and plan participants understand the role, risk, and benefits of securities lending with cash collateral reinvestment in relation to 401(k) plan investments. ERISA requires that the fees paid to plan service providers be reasonable with respect to the services performed and Labor, in its implementation of PTE 2006-16, its prohibited transaction class exemption for securities lending, specifically requires that compensation received by the parties involved in the securities lending transaction should be reasonable. According to Labor, PTE 2006-16 does not cover cash collateral reinvestment. Therefore, we recommend that Labor also take the following actions:

- Review the practice of securities lending with cash collateral reinvestment, to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) plan assets are utilized in this practice.

- Revise PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements utilizing cash collateral reinvestment on behalf of 401(k) plan participants not do so unless they ensure the reasonableness of the distributions of expected returns associated with this arrangement.

- Amend its regulation on plan sponsor disclosure to participants to include provisions specific to (1) the practice of cash collateral reinvestment

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utilized by fund providers' securities lending programs and (2) disclosing the potential for withdrawal restrictions.

- Provide plan sponsors with guidance alerting them to the risks of engaging in securities lending with cash collateral reinvestment and the types of information they should seek from their service providers about these investments.

Agency Comments and Our Evaluation

We provided a draft of this report to the Department of Labor, the Securities and Exchange Commission, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation for review and comment. Labor's formal comments are reproduced in appendix I of this report. We did not receive formal comments from the Securities and Exchange Commission, the Federal Reserve Board, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation, but received technical comments from four of the five agencies, which we incorporated as appropriate.

In its agency response letter, the Department of Labor agreed with our conclusions concerning the importance of transparency and disclosure. Consistent with our conclusions, Labor noted that it is committed to ensuring that participants have the information they need to make informed decisions about their retirement savings and that plan sponsors receive the information they need to assess the reasonableness of contracts or arrangements. Labor also noted that it has recently devoted significant resources to ensure that plan sponsors and participants have the information they need. Labor has agreed to consider amending PTE 2006-16 to require the securities lending agreement to provide enhanced disclosures to plan fiduciaries and to consider providing plan sponsors with guidance alerting them to the risks of engaging in securities lending and the types of information they should seek from their service providers about these investments. Labor disagreed with three of our recommendations.

Labor disagreed with our recommendation to amend its participant disclosure regulations to provide information disclosing the risks of investing in stable value funds. It stated that without further study and review, the department is not prepared to conclude that its participant disclosure regulations should be amended to specifically address stable value funds. Given the complexity of the issues involving stable value funds, we encourage Labor to initiate the study, review what it deems necessary, and to amend its disclosure regulations as appropriate. We note

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Labor's additional consideration to the recommendations proposed by the ERISA Advisory Council regarding information provided to plan sponsors and participants concerning stable value funds, and we believe that plan sponsors and participants would benefit from such guidance being issued in a prudent but expeditious manner. Given that the ERISA Advisory Council report on stable value funds was posted in April 2010, without additional guidance or assistance, plan sponsors may remain unaware of the risks and challenges associated with this investment option. Furthermore, because Labor will be consulting with SEC and CFTC with regard to their study of stable value funds, Labor has a unique opportunity to assist participants in their understanding of the restrictions, limitations, and risks of investing in such funds. We look forward to the findings, conclusions and proposed actions of Labor's consultation and believe that this effort represents a great opportunity for Labor to assist plan sponsors and participants in building retirement security.

Labor disagreed with our recommendation to amend its participant disclosure regulations regarding the practice of securities lending with cash collateral reinvestment and the potential for withdrawal restrictions. The Department stated that without further study and review, it is not prepared to conclude that its participant disclosure regulations should be amended to specifically address securities lending-related issues. While we believe that the evidence provided in our report is particularly compelling with regard to this recommendation, we strongly encourage Labor to initiate the study and review what it deems necessary, and, to amend its disclosure regulations as appropriate. As demonstrated in our report, securities lending with cash collateral reinvestment arrangements can be very complex transactions. Further, as we reported, Labor's participant disclosure regulations do not explicitly require plan sponsors to disclose information on the risks of securities lending with cash collateral reinvestment or withdrawal restrictions that can result from securities lending. We acknowledge Labor's comment that the current participant disclosure regulations require that information pertaining to investment risks and investment strategies be available to plan participants. However, as we reported, these regulations require only disclosure of investment options, and not all practices utilized by those investment options—of which securities lending is one practice—and it is unclear how much or to what extent securities lending fees and risks will be discussed in these disclosures. Furthermore, Labor only requires that information be made available to plan participants, not disclosed, which would require plan participants to know what information they need to avail themselves of in order to understand the fees and risks of securities lending. Without better disclosures on securities lending with cash collateral, participants

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may continue to be unaware of the practice of cash collateral reinvestment and the risks it poses, as well as the potential for withdrawal restrictions resulting from such practices.

Labor also did not agree with our recommendation to review the practice of securities lending with cash collateral reinvestment to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) assets are utilized in this practice. Labor noted that a plan sponsor, in deciding to offer any investment option, must make that decision in accordance with its fiduciary responsibility under ERISA, and that it would not be possible for Labor to provide specific guidance on reasonable levels of fees and reasonable distributions of returns in connection with any particular securities lending cash collateral reinvestment. We recognize the complexity of these transactions and the diligence that should be taken in developing such guidance. Nevertheless, key participants in securities lending transactions are already moving in the direction of providing additional guidance to plan sponsors. For example, as we reported, some securities lending agents have already begun to make changes to their securities lending programs in response to plan sponsors who have requested more disclosure about securities lending and cash collateral pools and have also requested that their securities lending programs take on less risk. In addition, securities lending agents are beginning to standardize guidelines for cash collateral pool investments, changes which they think would provide participants with some protection from losses. These industry driven developments clearly suggest that not only is such guidance possible, but that it is in the best interest of plan sponsors for Labor to provide some assistance on this issue.

Finally, Labor disagreed with our recommendation regarding the inclusion of cash collateral reinvestment into PTE 2006-16, regarding the reasonableness of expected returns associated with this arrangement. Labor believes that it is not feasible to ensure a certain level of expected return on any particular investment. It is not our intent that rates of return should be ensured in such transactions, but that the reasonableness of the distributions of expected returns be ensured. We note, however, that under ERISA, Labor is already responsible for enforcing the requirements that plan sponsors ensure that the fees paid with plan assets are reasonable and for necessary services. Applying the same standard to the parameters of transactions involving securities lending with cash collateral can help reduce the risk of loss to plan participants. As we note in our report, securities lenders are already implementing changes that could redefine the potential of loss and return to plan participants from these

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transactions. Action by Labor can help to ensure that it will not only be sophisticated plan sponsors who are likely to get the disclosures they need, while other plans sponsors continue to be unaware of what they need to ask for and understand regarding securities lending with cash collateral reinvestment.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 6 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of Labor, the Chairman of the Securities and Exchange Commission, and other interested parties. The report also will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff members have any questions concerning this report, please contact Charles Jeszeck at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

Sincerely yours,

Charles A. Jeszeck
Director, Education, Workforce,
and Income Security Issues

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Appendix I: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210

February 25, 2011

Mr. Charles A. Jeszeck
Director, Education, Workforce, and
Income Security Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "401(k) PLANS: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood" (GAO-11-291). Based on our review of the report, below are our comments and observations.

The draft report finds that during the recent financial crisis, plan sponsors and participants faced unexpected restrictions on withdrawals of plan assets from certain 401(k) investment options, specifically real estate accounts, money market funds, stable value funds and investment options that lend securities. It concludes, among other things, that greater transparency and disclosure are necessary to assist plan sponsors and plan participants in understanding restrictions, limitations, and risk of loss to plan participants associated with investment in stable value funds and investment options that lend securities.

In this regard, the Department has recently devoted significant resources to ensuring that all participants and beneficiaries in participant-directed individual account plans (e.g., 401(k) plans) have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings, and to ensuring that plan fiduciaries receive disclosures from service providers to assist the fiduciaries in assessing the reasonableness of contracts or arrangements, including the reasonableness of the service providers' compensation and potential conflicts of interest that may affect the service providers' performance.[1]

[1] *See* Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule, 75 FR 64910 (October 20, 2010); Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure; Interim Final Rule, 75 FR 41600 (July 16, 2010).

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Recommendation 1: The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act includes requirements that will affect deliberations about stable value funds and requires that the SEC and CFTC, in consultation with Labor and Treasury, conduct a study of stable value funds. To ensure additional protection for plan participants, appropriate information for plan sponsors, and to better inform the study required by the Dodd-Frank Act, we recommend that Labor:

- **As it conducts its consultative analysis to assist the Securities and Exchange Commission and the Commodity Futures Trading Commission, also analyze stable value funds specifically in a 401(k) investment context to identify those situations or conditions that prevented plan sponsors from withdrawing from stable value funds, such as contract restrictions, and take appropriate regulatory steps to assist plan sponsors in fulfilling their fiduciary responsibilities.**

The Department will consider whether further action would be appropriate after consulting with the SEC and the CFTC upon completion of their study as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

- **Amend its regulation on plan sponsor disclosure to participants to include a specific requirement for plan sponsors to provide information to participants that discloses the risks of investing in stable value funds.**

The Department disagrees with this recommendation. Without further study and review, the Department is not prepared to conclude that the regulations governing the disclosure of investment-related information to participants and beneficiaries must be amended to specifically address stable value funds. The current regulation specifically requires that information pertaining to investment risks, as well as investment strategies, be available to plan participants with respect to all investment alternatives offered under a participant-directed individual account plan, including stable value funds.

- **Provide guidance to plan sponsors on the risks, structure, and dynamics of stable value funds, consistent with the recommendations proposed by the ERISA Advisory Council regarding the disclosure of information about stable value funds.**

While the Department is not prepared at this time to commit to providing the recommended guidance, the Department will pursue further consideration of the recommendations prepared by the ERISA Advisory Council regarding stable value funds.

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Recommendation 2: Given the current practice of securities lending with cash collateral reinvestment, its role in 401(k) plan investments, and our findings that plans and plan participants can bear a disproportionate amount of any loss associated with the practice, Labor should take action to help plan sponsors of 401(k) plans and plan participants understand the role, risk, and benefits of securities lending with cash collateral reinvestment in relation to 401(k) investments. ERISA requires that the fees paid to the plan service providers be reasonable with respect to the services performed and Labor, in its implementation of PTE 2006-16, its prohibited transaction class exemption for securities lending, specifically requires that compensation received by the parties involved in the securities lending transaction should be reasonable. According to Labor, PTE 2006-16 does not cover cash collateral reinvestment. Therefore we recommend Labor:

- **Review the practice of securities lending with cash collateral reinvestment, to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) plan assets are utilized in this practice.**

The Department disagrees with this recommendation. The Department notes that a plan sponsor's decision to offer any investment option, which may engage in securities lending, is a decision that must be made in accordance with the fiduciary responsibility provisions of ERISA, based on all relevant facts and circumstances. Because each decision is made based on a number of variables, it would not be possible for the Department to provide specific guidance on reasonable levels of fees and reasonable distributions of returns in connection with any particular securities lending cash collateral reinvestment.

- **Revise PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements utilizing cash collateral reinvestment on behalf of 401(k) plan participants not do so unless they ensure the reasonableness of the expected returns associated with this arrangement.**

A plan sponsor's decision to engage in securities lending is a decision that must be made in accordance with the fiduciary responsibility provisions of ERISA, based on all relevant facts and circumstances. These provisions require, among other things, that a plan receive reasonable compensation for the level of risk associated with the investment. The Department's PTE 2006-16 provides relief from ERISA's prohibited transaction provisions for both the lending of securities by employee benefit plans to banks and broker-dealers and the receipt of compensation by a securities lending fiduciary in connection with services provided to a plan. As currently granted, the exemption does not address or provide relief for the reinvestment of the cash collateral.

Currently, section II(g) of the exemption requires that all fees and other consideration received by the plan in connection with the loan of securities are reasonable. The Department does not believe it is feasible to require additionally that plan sponsors

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ensure a certain level of expected return on any particular investment. Market forces and the choice of investments for the cash collateral will impact the return to the plan. However, the Department will consider whether to amend PTE 2006-16 to require the securities lending agreement described therein to provide enhanced disclosures to plan fiduciaries.

- **Amend its regulation on plan sponsor disclosure to participants to include provisions specific to (1) the practice of cash collateral reinvestment utilized by fund providers' securities lending programs and (2) disclosing the potential for withdrawal restrictions.**

The Department disagrees with this recommendation. Without further study and review, the Department is not prepared to conclude that the regulations governing the disclosure of investment-related information to participants and beneficiaries must be amended to specifically address securities lending-related issues.

- **Provide plan sponsors with guidance alerting them to the risks of engaging in securities lending with cash collateral reinvestment and the types of information they should seek from their service providers about these investments.**

The Department will consider this recommendation in light of its experience with security lending practices

EBSA is committed to protecting the employer-sponsored benefits of American workers, retirees, and their families. Again, thank you for the opportunity to review the draft report. Please do not hesitate to contact us if you have questions concerning this response or if we can be of further assistance.

Sincerely,

Phyllis C. Borzi

Phyllis C. Borzi
Assistant Secretary

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Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Charles Jeszeck, (202) 512-7215, or jeszeckc@gao.gov

Staff Acknowledgments

In addition to the individual named above, the following team members made significant contributions to this report: Tamara Cross, Assistant Director; Monika Gomez, Analyst-in-Charge; Jessica Gray; James Bennett; Susannah Compton; Sheila McCoy; Roger Thomas; and Walter Vance.

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Glossary

The terms below are defined for the purposes of this GAO report.

Asset-Backed Security	An asset-backed security is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.
Balanced Fund	Balanced funds are pooled accounts invested in stocks, bonds, and often additional asset classes. They are classified into two subcategories: target-date funds and non-target-date balanced funds.
Book Value	The book value of a stable value fund is the principal contributed to the investment option, plus accrued interest, minus withdrawals and fees. Accrued interest, minus withdrawals and fees, is calculated based on a methodology specified in the stable value fund contract and is reset on a periodic basis, which is usually quarterly or semiannually.
Broker-Dealer	The broker-dealer borrows securities on behalf of its customers, providing cash as collateral to the securities lending agent. A broker-dealer is a company or other organization that trades securities for its own account or on behalf of its customers. Although many broker-dealers are "independent" firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer.
Cash Collateral Pool Manager	The cash collateral pool manager invests the cash provided as collateral for the borrowed securities in order to earn additional return for the securities lending agent during the period of time that the securities are borrowed. The securities lending agent can be the cash collateral pool manager, but usually it is an affiliate of the securities lending agent.

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Collateral Deficiency	A situation when the securities lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption.
Collective Investment Fund	Collective investment funds (CIF) are bank investment trusts that pool the investments of retirement plans or other institutional investors.
Commingled Fund	Commingled or collective funds are designed to combine the assets of unrelated retirement plans, enabling participants to diversify and gain the economies of scale, i.e., the advantages that being part of a larger fund affords, such as greater profits and less cost.
Counterparty Risk	The risk to each party of a contract that the counterparty will not live up to its contractual obligations. In a securities lending transaction, this is the risk to the lender that the borrower will fail to return the securities.
Federal Agency Securities	Federal agency securities are debt instruments issued by federal credit agencies.
Illiquid Security	The term "illiquid security" generally includes any security which cannot be sold or disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within seven days.
Institutional Investor	An institutional investor is an organization that pools large sums of money and invests those sums in securities, real property and other investment assets. Institutional investors are typically banks, insurance companies, retirement or pension funds, hedge funds, foundations and mutual funds.
Intrinsic Value	Intrinsic value refers to the return on a securities loan excluding the benefit of active collateral management. It is the spread between the rebate rate and the benchmark rate, e.g. federal funds rate.

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Market Risk	The potential for portfolio losses resulting from the change in value of stock prices of the portfolio's assets, interest rates, foreign exchange rates, and commodity prices.
Market Value	The market value of a stable value fund is the price at which the underlying assets of the fund are trading in the market at a given time.
Money Market Funds	Money market funds are open-end management investment companies that are registered under the Investment Company Act of 1940 and regulated under rule 2a-7 under that Act. Money market funds invest in high-quality, short-term debt instruments such as commercial paper, treasury bills and repurchase agreements. Generally, these funds, unlike other investment companies, seek to maintain a stable net asset value per share (market value of assets minus liabilities divided by number of shares outstanding), typically $1 per share.
Mortgage-Backed Securities	Mortgage-backed securities are securities whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying mortgage loans, most commonly on residential propertyshares of a home loan sold to investors. For example, aA bank or other entitiy lends a borrower the money to buy a house and collects monthly payments on the loan. This loan and a number of others, perhaps hundreds, are sold to a larger bank that packages the loans together into a mortgage-backed security. The larger bank then issues shares of this security to investors who buy them and ultimately collect the dividends in the form of the monthly mortgage payments.
Mutual Fund	A mutual fund, legally known as an open-end investment company, is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. These investments comprise the fund's portfolio. Mutual funds are registered and regulated under the Investment Company Act of 1940, and are supervised by the SEC. Mutual funds sell shares to public investors. Each share represents an investor's proportionate ownership in the fund's holdings and the income those holdings generate. Mutual fund shares are "redeemable," which means that when mutual fund investors want to sell their shares, the investors sell them back to the fund, or to a broker acting for the fund,

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	at their current net asset value per share, minus any fees the fund may charge.
Participant-Directed 401(k) Plan	A 401(k) plan that generally allows a participant to choose how much to invest, within federal limits, and to select from a menu of diversified investment options chosen by the plan sponsor.
Nontarget-Date Balanced Funds	Nontarget-date balanced funds include asset allocation or hybrid funds.
Plan Participants	Plan participants contribute to their 401(k) and direct that contribution to certain investment options. In 401(k) plans the assets are held in trust for participants.
Plan Sponsor	A plan sponsor chooses which investment options to offer to its participants, and when making that choice, decides on whether to offer investments that engage in securities lending.
Plan Service Provider	A plan service provider purchases securities on behalf of 401(k) plan participants. A plan service provider may act as securities lending agent.
Private Placements	A private placement is a direct offering of securities directly to an institutional investor, such as a bank, mutual fund, insurance company, pension fund, or foundation.
Prohibited Transaction	Prohibited transactions under ERISA include a sale, exchange, or lease between a plan and a party-in-interest; lending money or other extension of credit between the plan and party-in-interest; and furnishing goods, services, or facilities between the plan and party-in-interest, among other prohibited transactions.
Real Estate Accounts	Real estate accounts are open-ended, commingled accounts that invest directly in real estate, such as funds that buy and manage commercial properties. Real estate accounts are equity accounts consisting primarily of high quality, well-leased real estate properties in the industrial, office, retail and hotel sectors. Real estate accounts may be offered by insurance

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	companies as separate accounts, and are regulated by the state insurance commissioner in the state they are created.
Rebate	A payment to the broker-dealer, as they would have earned a short-term rate of return on the cash they provided as collateral if they had kept it in their possession. The greater the demand for the security being lent, the lower the rebate paid to the broker-dealer by the securities lending agent. Securities that have an extremely high borrowing demand, or that are in short supply and therefore hard to borrow, can obtain "negative" rebates, requiring the borrower to not only pledge cash, but also pay a fee to plan participants.
Securities Lending	The lending of some of the assets held in investment options, on behalf of plan participants, to third parties, usually broker-dealers, for a period of time. In return, broker-dealers provide collateral to securities lending agents that they hold until broker-dealers return the borrowed securities. Collateral for the loan can be either cash or securities, such as bonds or stocks. If securities lending agents accept securities as collateral for the loan, broker-dealers will typically pay a fee to borrow the securities. However, in the U.S., cash is the primary form of collateral taken in securities lending transactions and if cash is taken as collateral, the securities lending agent does not receive a fee, but, instead, has the right to reinvest the cash to earn an additional return. This is sometimes called "cash collateral reinvestment," and is typically considered a separate, but related, activity to the securities lending transaction.
Securities Lending Agent	The securities lending agent coordinates loans of securities, hires a manager to invest cash collateral and may take on counterparty risk—or the risk that the borrower will not return the securities—on behalf of the plan. May be an affiliate of the custodian, i.e., an entity, usually a bank, that has legal responsibility for safekeeping a plan's securities.
Separate account GICs	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return, which may be fixed, indexed, or reset periodically based on the actual performance of the underlying assets. The insurance company owns and holds the underlying assets in a separate, customized account for the exclusive benefit of a single plan.

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Stable Value Fund	Stable value funds are a fixed income investment option, designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns set in the contract.
Statement of Additional Information	A Statement of Additional Information (SAI) is a supplementary document to a mutual fund's prospectus that contains additional information about the mutual fund and includes further disclosure regarding its operations.
Synthetic Guaranteed Investment Contracts	Plan sponsors contract with a bank or insurance company to guarantee participants principal protection and a rate of return relative to a portfolio of assets held in an external trust owned by the plan. The rate of return, which is based on the actual performance of the underlying assets, is reset periodically.
Target Date Funds	Target date funds are often mutual funds and hold a mix of stocks, bonds, and other investments. Over time, the investment allocation gradually shifts according to the fund's investment strategy. Target date funds are designed to be investments for individuals with particular retirement dates in mind.
Traditional Guaranteed Investment Contracts	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return regardless of the performance of the underlying assets, which the insurance company owns and holds within their general account.
Trustee-Directed 401(k) Plan	A 401(k) plan wherein an employer appoints trustees who decide how the plan's assets will be invested.

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Securities Lending with Cash Collateral Reinvestment in Retirement Plans: Withdrawal Restrictions and Risk Raise Concerns

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SUMMARY OF COMMITTEE RESEARCH

PREPARED BY THE

MAJORITY STAFF

OF THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

MARCH 2011

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SPECIAL COMMITTEE ON AGING HEARINGS ON RETIREMENT SAVINGS

On October 24, 2007, the Senate Special Committee on Aging held a hearing on "Hidden 401(k) Fees: How Disclosure Can Increase Retirement Security," which examined the effect hidden 401(k) fees can have on retirement savings and the need for simple and clear disclosure. The Committee heard testimony from: Barbara Bovbjerg, Director of Education, Workforce and Income Security Issues, GAO; Bradford Campbell, Assistant Secretary of Labor, the Employee Benefits Security Administration; Jeff Love, Director of Research, AARP; Mercer Bullard, assistant professor, University of Mississippi School of Law; Michael Kiley, President, Plan Administrators, Inc.; and Robert Chambers, Esq., Partner, Helms, Mulliss & Wicker LLC and Chairman of the American Benefits Council.

LEGISLATIVE ACTION:

Increasing the Transparency of Pension Fees. In the 111th Congress, Rep. George Miller (D-CA, 7th Congressional District) introduced H.R. 1984, the *401(k) Fair Disclosure for Retirement Security Act*, and Senators Tom Harkin (D-IA) and Herb Kohl (D-WI) introduced S. 401, *the Defined Contribution Fee Disclosure Act*, to amend ERISA to require the disclosure of fees to both plan sponsors and participants. In 2010, the Department of Labor issued regulations that will bring greater transparency and disclosure of 401(k) fees. These regulations will make it easier for employers to ensure that their plans' fees are reasonable – and 401(k) participants will now know how much they are being charged to invest in their 401(k) plan.

On April 30, 2008, the Senate Special Committee on Aging held a hearing entitled, "Leading by Example: Making Government a Role Model for Hiring and Retaining Older Workers" evaluating the federal government's efforts to hire and retain older workers. The Committee heard testimony from: Barbara Bovbjerg, Director, Education, Workforce and Income Security Issues, US Government Accountability Office, Robert Goldenkoff, Director, Strategic Issues, US Government Accountability Office, Nancy Kichak, Associate Director, Strategic Human Resources Policy, Office of Personnel Management, Thomas Dowd, Administrator, Office of Policy Development and Research, Employment and Training Administration, US Department of Labor, Max Stier, President and CEO, Partnership for Public Service, Chai Feldblum, Co-Director, Workplace Flexibility 2010.

LEGISLATIVE ACTION:

Remove the pension penalty for seniors to continue working in a phased retirement: In the 111th Congress, Senator Herb Kohl (D-WI) joined Senator George Voinovich (R-OH), the ranking member of the Senate Homeland Security and Governmental Affairs Committee's Subcommittee on the Oversight of Government Management, the Federal Workforce and the District of Columbia, in introducing S. 469, which would remove the penalty for federal workers in the CSRS who would have otherwise had their pension reduced for working part time at the end of their career. This legislation was signed into law by President Barack Obama on October 28, 2009.

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On July 16, 2008, the Senate Special Committee on Aging held a hearing entitled "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?" to examine the reported increase in leakage and to explore ways to protect American's retirement savings. The Committee heard testimony from: Christian Weller, Senior Fellow, Center for American Progress; Mark Iwry, Principal, Retirement Security Project; David John, Principal, Retirement Security Project; Gregory Long, Executive Director, Federal Retirement Thrift Investment Board; John Gannon, Senior Vice President, Financial Industry Regulatory Authority; Bruce Bent, Chairman, The Reserve.

LEGISLATIVE ACTION:

Reducing the "Leakage" of Pension Savings. In conjunction with the July 2008 hearing, the Aging Committee requested that the U.S. Government Accountability Office (GAO) study the extent to which Americans tap into their accrued retirement savings prior to retirement. In August 2009, GAO issued *401(k) Plans: Policy Changes Could Reduce Long-term Effects of Leakage on Workers' Retirement Savings*, which suggested that Congress consider changing the requirement for the six-month contribution suspension following a hardship withdrawal, as well as recommended that the Secretary of Labor promote greater participant education on the importance of preserving retirement savings, and that the Secretary of the Treasury clarify and enhance loan exhaustion provisions to ensure that participants do not initiate unnecessary leakage through hardship withdrawals. In conjunction with the 2008 hearing, Senators Charles Schumer (D-NY) and Herb Kohl (D-WI) introduced S. 3278 in the 110th Congress, to limit the number of 401(k) loans to three and prohibit the widespread use of 401(k) debit cards.

On February 25, 2009, the Senate Special Committee on Aging held a hearing entitled "Boomer Bust? Securing Retirement in Volatile Economy," which examined the economic downturn's effect on retirement security, particularly for those on the brink of retirement. The Committee heard testimony from: Jeanine Cook, a Baby Boomer from Myrtle Beach, South Carolina; Dallas L. Salisbury, President & CEO, Employee Benefits Research Institute; Dean Baker, Co-Director, Center for Economic and Policy Research; Ignacio Salazar, President & CEO, SER - Jobs for Progress; Barbara B. Kennelly, President & CEO, National Committee to Preserve Social Security and Medicare; Deena Katz, CFP, Associate Professor, Texas Tech University, and Chairman, Evensky & Katz.

On May 20, 2009, the Special Committee on Aging held a hearing entitled "*No Guarantees: As Pension Plans Crumble, Can PBGC Deliver*," to consider whether the federal government's Pension Benefit Guaranty Corporation (PBGC) has the capability to fulfill its mission to insure the pensions of nearly 44 million Americans, at a time when several of the country's largest automobile companies are teetering on the edge of bankruptcy. The question of PBGC's governance came amidst allegations of mismanagement by the agency's former director, Charles E.F. Millard, who deviated from PBGC's conservative investment strategy just before the market downturn. In addition, the PBGC Inspector General alleged that Millard improperly influenced the procurement process surrounding the restructuring of the Corporation's investments. The Committee heard testimony from: Dallas L. Salisbury, President and CEO, Employee Benefits Research Institute; Barbara Bovbjerg, Director, Education, Workforce and Income Security, U.S. Government Accountability Office; Rebecca Anne Batts, Inspector General, Pension Benefit Guaranty Corporation; and Vincent Snowbarger, Acting Director, Pension Benefit Guaranty Corporation. Charles E.F. Millard, Former Director, Pension

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Benefit Guaranty Corporation, was invited to testify but availed himself of the privilege afforded to him under the Fifth Amendment of the Constitution not to give testimony that might tend to incriminate him.

LEGISLATIVE ACTION:

Strengthening the Pension Benefit Guaranty Corporation's Governance Structure. On the basis of the Committee's findings, Senators Herb Kohl (D-WI), Russ Feingold (D-WI), Claire McCaskill (D-MO), and Michael Bennet (D-CO) introduced S.1544 in the 111th Congress, which expands and strengthens PBGC governance and oversight, in part, by expanding the PBGC's board of directors, redefining the Inspector General's reporting structure, and adding additional procurement safeguards. We expect this bill to be reintroduced in the near future.

On October 28, 2009, the Special Committee on Aging held a hearing entitled "*Default Nation: Are 401(k) Target Date Funds Missing the Mark?*" to explore issues detrimental to target date fund's effectiveness. The Committee heard testimony from: Barbara Bovbjerg, Director of the Education, Workforce and Income Security, U.S. Government Accountability Office; Andrew Donohue, Director of Investment Management, U.S. Securities and Exchange Commission; Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, U.S. Department of Labor; John Rekenthaler, Vice President of Research, Morningstar; Ralph Derbyshire, Senior Vice President and Deputy General Counsel, FMR LLC; and Michael Case Smith, Senior Vice President of Institutional Strategies, Avatar Associates.

On June 16, 2010, the Special Committee on Aging held a hearing entitled "*The Retirement Challenge: Making Savings Last a Lifetime*," which examined how to help seniors manage their savings throughout their retirement. The Committee heard testimony from: Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, U.S. Department of Labor; J. Mark Iwry, Senior Advisor to the Secretary of the Treasury and Deputy Assistant Secretary for Retirement and Health Policy, U.S. Department of Treasury; Ted Beck, President and CEO, National Endowment for Financial Education; Kelli Hueler, Founder and CEO, Hueler Companies; William Mullaney, President of U.S. Business, MetLife (representing the American Council of Life Insurers); and Lisa Mensah, Executive Director, Aspen Institute's Initiative on Financial Security.

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AGING COMMITTEE MAJORITY STAFF INFORMATION PAPER

Executive Summary

In response to reports between 2007 and 2010 of employers that sponsor 401(k) plans being restricted from withdrawing their plan assets from investment options that lent securities (the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests), the Majority Staff of the Aging Committee (the Committee) conducted an investigation of securities lending within retirement plans. The Committee requested information on securities lending from employers that sponsor 401(k) plans and banks in the securities lending market.

The Committee surveyed employers that sponsored the 30 largest 401(k) plans with assets that totaled over $330 billion. All 30 employers stated that at least one of the investment options they offered to participants within their plans engaged in securities lending at some time between 2006 and 2010. However, five of these employers no longer offered an investment option that engaged in securities lending within their 401(k) plans in 2010. The five employers that transitioned out of securities lending cited the changing market environment and credit crisis in 2008 and 2009, low and negative returns on the cash collateral reinvestment and liquidity restrictions as their reasons for no longer participating in securities lending within their plans.

The Committee also surveyed the seven largest banks in the securities lending market. In total, these banks had over $1 trillion of securities on loan in 2010. Six of the seven banks we surveyed currently provide direct securities lending services to defined contribution, defined benefit and other retirement plans. In 2010, the total number of retirement plans that these banks provided services to was 570 and these plans had a total asset size of about $1.3 trillion.

Our investigation uncovered withdrawal restrictions in defined contribution retirement plans. Over 1/3rd of the employers we surveyed indicated that they had been restricted at the plan-level from withdrawing from at least one investment option that participated in securities lending between 2006 and 2010. In addition, three of the seven banks we surveyed restricted defined contribution and defined benefit plans from exiting funds that engaged in securities lending. The types of restrictions included only permitting employers to take in-kind (rather than cash) distributions or only permitting employers to withdraw a maximum percentage of between two and four percent per month of the value of its interest in the fund. These results are troubling as employers must be able to change investment options offered in their 401(k) plans to meet their duties under ERISA in prudently selecting such options.

In the case of securities lending with cash collateral within 401(k) plans, participants bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer. However, in the event that there are gains from the investments of the cash collateral pool, participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents. The data we received from the surveyed employers

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and banks is generally consistent with these conclusions. For example, most of the employers we surveyed stated that any losses within the cash collateral pools were ultimately borne by the participant. In terms of revenue sharing arrangements between the plans/participants and the securities lending service provider, it ranged from 50-50 percent split to a division of 92 percent to the plan/participants and eight percent to the service provider.

Finally, for the investment options that lent securities in 2010 within the surveyed employers' plans, the average percent of the investment option's assets that was lent out was 9.93 percent. The range of the percentages of investment option's assets that was lent out in 2010 was 0.04 to 97 percent. That is, one of the investment options offered by an employer lent out 97 percent of its underlying assets.

Recommendations

Based on our research on securities lending practices, the Committee makes the following recommendations:

- Employers should increase their knowledge of securities lending within their defined contribution retirement plans.
- Participants should be given information about securities lending within their defined contribution retirement plan investment options.
- The Department of Labor should issue guidance to employers on securities lending practices within qualified retirement plans.
- Companies in the business of securities lending should report information about their businesses practices.

Introduction

With the shift from traditional defined benefit pension plans to defined contribution retirement plans, today much of the burden for preparing for a financially secure retirement falls on American workers. The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pre-tax compensation to the plan. According to estimates by industry experts, 49 million Americans were active 401(k) plan participants in 2009 and, by year end, 401(k) plan assets amounted to $2.8 trillion.[1] Unlike those covered by traditional defined benefit pension plans, participants in 401(k) plans personally contribute to their individual accounts and are responsible for selecting from an array of investment options, such as mutual funds, money market accounts and stable value funds. Furthermore, the investment risk generally falls solely on participants in 401(k) plans.

[1] Employee Benefit Research Institute. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009*, Issue Brief No. 350 (Washington D.C., November 2010).

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Securities lending is the practice of lending plan assets to third parties in exchange for collateral that a fund reinvests. The collateral for the loan can be either cash or other securities, such as bonds or stocks. However, in the U.S., cash is the primary form of collateral taken in securities lending. Many defined contribution and defined benefit plans participate in securities lending programs within their plans to generate additional revenue to cover fees or increase earnings.

During the financial crisis, some of the cash collateral pools of retirement plan assets participating in securities lending programs experienced significant losses. This was as a result of the cash collateral being invested in risky assets that subsequently lost value and became difficult to trade. The losses and illiquid assets in the cash collateral pools led to many employers being restricted from withdrawing or transferring their retirement plan assets from investment options that lent securities. Some plans and participants also experienced realized losses when terminating their securities lending arrangements.

These losses in cash collateral pools and withdrawal restrictions highlight the risks associated with securities lending with cash collateral reinvestment within retirement plans. This is especially true of 401(k) plans where the investment risk falls on participants. However, many employers and participants are not even aware that securities lending is going on within their plans – and if they are aware, they may not recognize the risks.

Government Accountability Office Report

In response to participant and employer concerns over withdrawal restrictions, in June 2009, Chairman Kohl asked the Government Accountability Office (GAO) to determine what happened during the financial crisis to participant accounts and to employers' control over the investment options offered to 401(k) plan participants. GAO was asked to answer the following questions:

- What are some of the specific investments and practices that prevented employers and participants from accessing 401(k) plan assets?

- What changes, if any, could the Department of Labor make to assist employers in understanding the challenges posed by certain investments and practices?

Some of the descriptions in this report are derived from GAO's March 2011 report entitled, "401(k) Plans: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood."

Aging Committee Report

To supplement GAO's research, the Aging Committee conducted its own investigation of securities lending within retirement plans, the findings of which are summarized in this report. Currently, there is no comprehensive, public data source available with respect to securities lending, including securities lending within the retirement plan market. Therefore, the

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Committee requested information on securities lending from employers that sponsor 401(k) plans and banks within the securities lending market.

In November and December 2010, the Committee sent out two sets of letters related to securities lending within retirement plans to better understand the potential problems. The first set of letters was sent to the employers that sponsor the thirty largest 401(k) plans in the U.S. (by asset size). These employers were asked a series of questions about securities lending practices within their plans, including requests for information on:

- The size of their plans;
- Whether their plans participates in securities lending;
- The investment options within their plans that participate in securities lending, including the total revenue (loss) from securities lending and the average percent of the funds' assets that were lent out;
- The types of disclosures (employer and participant) on securities lending; and
- Whether plan sponsors and/or participants experienced withdrawal restrictions.

The second set of letters was sent to the seven largest banks within the securities lending market. These banks were asked a series of questions about their securities lending business within the retirement plan market, including requests for information on:

- The size of their defined contribution and defined benefit retirement plan business;
- The range of revenue sharing arrangements for splitting securities lending revenue;
- The total amount of gains and losses from their securities lending programs involving defined contribution and defined benefit plan assets; and
- Whether they have restricted any defined benefit and defined contribution plans from exiting funds that engage in securities lending.

Background

Retirement Plans – In General

Private sector employers generally offer their employees two broad types of retirement plans, defined benefit and defined contribution. Employers that offer defined benefit plans typically invest their own money in the plan and, regardless of how the plans' investments perform, promise to provide eligible employees retirement benefits. These benefits are generally fixed levels of monthly retirement income based on years of service, age at retirement, and, frequently, earnings.

In contrast, employers that offer defined contribution plans do not promise employees a specific benefit amount at retirement – instead, the employee and/or their employer contribute money to an individual account held in trust for the employee. The employee's retirement income from the defined contribution plan is based on the value of their individual account at retirement, which reflects the contributions to, performance of the investments in, and any fees charged against their account. Over the past three decades, there has been a general shift by

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employers away from defined benefit plans to defined contribution plans. The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of the Internal Revenue Code.[2]

Employers that offer 401(k) plans have responsibilities under ERISA. The law establishes that a plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets. Typically, the employer is a fiduciary under this definition. ERISA requires that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries. In accordance with ERISA and related Labor regulations and guidance, employers and other fiduciaries must exercise an appropriate level of care and diligence given the scope of the plan and act for the exclusive benefit of plan participants and beneficiaries, rather than for their own or another party's gain. Responsibilities of a fiduciary include, but are not limited to, selecting and monitoring investment options the plan will offer and ensuring that the plan has a broad range of investment options.

401(k) Investment Practice: Securities Lending With Cash Collateral Reinvestment

Many of the investment options offered by employers within their 401(k) plans, including mutual funds, money market accounts and stable value funds, engage in a practice called securities lending, where some of the assets held in these investment options on behalf of plan participants are lent out for a period of time by a securities lending agent to a third party, usually a broker-dealer. In return the broker-dealer provides collateral to the securities lending agent to hold until it returns the borrowed securities. The collateral for the loan can be either cash or other securities, such as bonds or stocks. However, in the U.S., cash is the primary form of collateral taken in securities lending. Many plans participate in securities lending to generate additional revenue to cover fees or increase earnings.

Some of the $2.8 trillion in assets held in 401(k) plans at the end of 2009 were utilized in securities lending programs, but the specific amount is unknown. The percentage of assets lent out at any given time varies by type of 401(k) investment option. The SEC limits the amount of assets that can be lent from a mutual fund at one time to one-third of the fund's total asset value. Other 401(k) investment options that are not registered with SEC, such as some equity, bond, and stable value funds, are generally not limited in the percentage of assets that can be utilized by securities lending programs.

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[2] Other defined contribution plans include 403(b) plans, profit-sharing plans and employee stock ownership plans.

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Findings

Employer Findings

In response to the Aging Committee's request, the employer sponsors of the thirty largest 401(k) plans in the U.S. provided the following information.

Plan Information

Of the 30 employers we surveyed, 25 provided information about their plans for the time period of 2006 through 2010 (the 25 Employers). The total amount of 401(k) assets in 2010 for the 25 Employers was $332.6 billion. Table 1 shows the total 401(k) assets from 2006 through 2010 for the 25 Employers. As expected, asset levels dropped significantly in 2008 but increased in 2009 and 2010 – and almost recovered to 2006 levels by the end of 2010. The average amount of 401(k) assets per plan in 2010 for the 25 Employers was $13.3 billion. Table 2 shows the range of 401(k) assets per plan in 2010. Asset size ranged for the 25 Employers from $2.4 billion to $33 billion.

Table 1. Total 401(k) assets from 2006 to 2010 for the 25 Employers

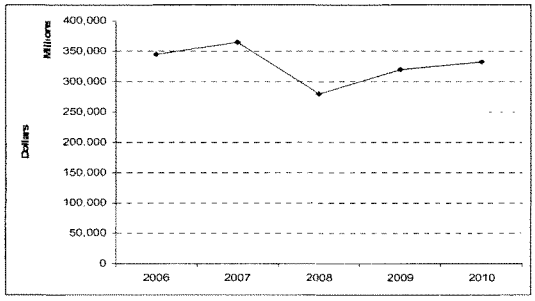

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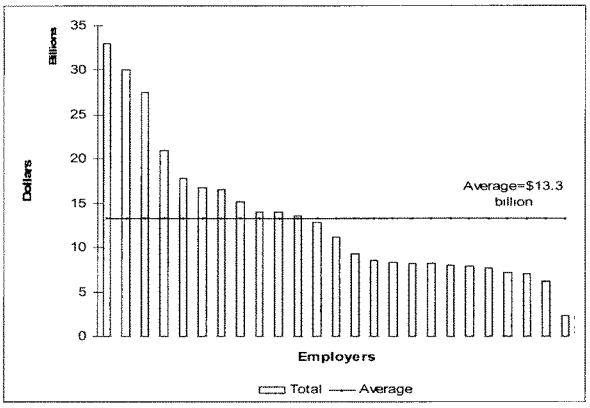
Table 2. Range of amount of 401(k) assets per plan in 2010 for the 25 Employers



The total number of participants in the plans offered by the 25 Employers in 2010 was 4.2 million. From 2006 to 2010, the total number of participants increased from about 4.0 million to 4.2 million (Table 3). The number of participants per plan in 2010 ranged from 32,500 to 1.3 million (Table 4). The average number of participants per plan in 2010 for the 25 Employers was 168,300.

Table 3. Total number of 401(k) plan participants from 2006 to 2010 for the 25 Employers

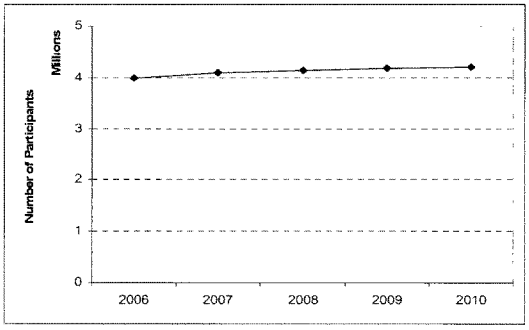


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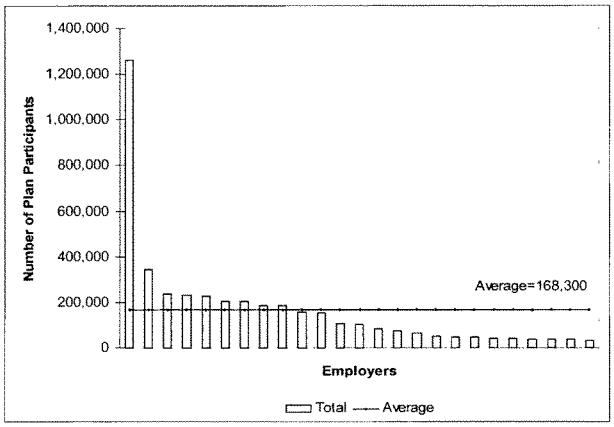
Table 4. The range of number of 401(k) plan participants per plan in 2010 for the 25 Employers



Participation in Securities Lending Programs

Of the 30 employers we surveyed, all of them stated that at least one of the investment options they offered to participants within their 401(k) plans engaged in securities lending at some time between 2006 and 2010. However, five of these employers no longer offered an investment option that engages in securities lending within their 401(k) plans in 2010. Of the 25 employers that do have securities lending options, all offer indirect lending options (e.g., a mutual fund or collective investment trust that participates in securities lending) and three of those 25 employers offer direct lending options (e.g., a separate account that participates in securities lending). For those 25 employers that engaged in securities lending in 2010, the number of investment options that engaged in securities lending per plans ranged from one to 122 with an average of 21.8 (Table 5).

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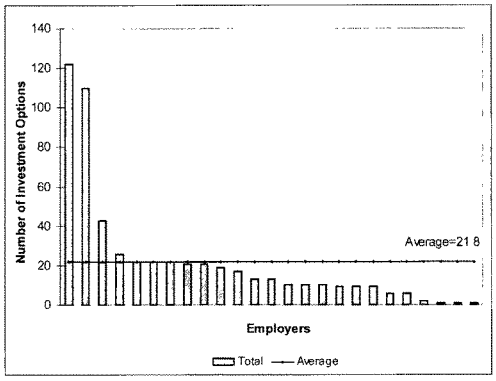
Table 5. Range of number of investment options that engaged in securities lending per employer in 2010.



Transitioning Out of Securities Lending

Five of the employers we surveyed did not offer any investment options that engaged in securities lending within their 401(k) plans in 2010 (although all of these employers had participated in securities lending within their plans in the past). In addition, 16 employers indicated that they stopped securities lending for at least one of the investment options they offered within their plans between 2006 and 2010. This includes five employers that stopped indirect lending completely and six employers that stopped direct lending completely.

The reasons the five employers transitioned out of securities lending completely within their 401(k) plans were similar. A few stated that they initially saw securities lending as a low-risk way to offset fees and gain additional earnings for participants. However, due to the changing market environment and credit crisis in 2008 and 2009, the benefits of securities lending programs became less certain and therefore, they decided to cease securities lending within their plans. One employer also cited low and negative returns on the cash collateral reinvestment and liquidity restrictions as one of the reasons they decided to no longer participate in securities lending within their plans.

Percentage of Assets Lent Out

For the investment options that lent securities in 2010 within the surveyed employers' plans, the average percent of the investment option's assets that was lent out was 9.93 percent. The range of the percentages of investment option's assets that was lent out in 2010 was 0.04 to 97 percent. That is, one of the investment options offered by an employer lent out 97 percent of its underlying assets.

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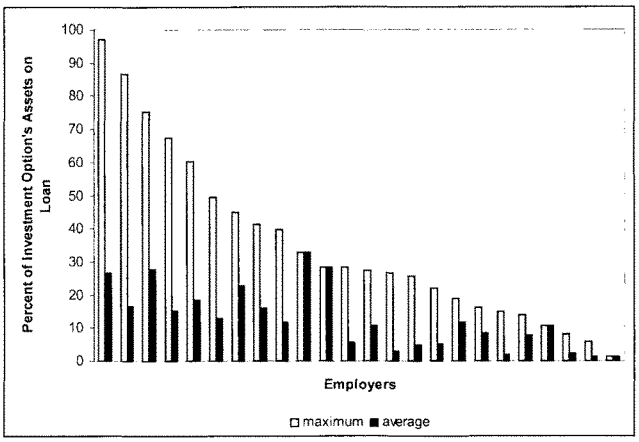
Table 6. Maximum and average percent of an investment option's assets on loan by employer in 2010



The range of securities lending varied by type of investment.

- Mutual funds. For the 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. Therefore, the highest percentage of assets lent out for a mutual fund was 28.3 percent.
- Collective investment trusts. For 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. Therefore, the highest percentage of assets lent out for a collective investment trust was 97 percent.

While these are significant differences, they are not entirely surprising. The SEC limits the amount of assets that can be lent from a mutual fund at one time to one third of the fund's total asset value. And collective trusts, which are generally overseen by the bank regulators, are not subject to such limitations.

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Withdrawal Restrictions

Employer Level

We have found that over the last five years, some service providers that offered the investment options that lent securities did not allow employers to withdraw or transfer all of the 401(k) plan's assets that were invested in those investment options. These service providers placed restrictions on employer withdrawals because the cash collateral pools had been invested in assets that subsequently lost value and became difficult to trade, causing cash collateral pool losses. As a result of the losses, the pools were not worth the amount that the investment option needed to return the cash collateral and pay rebates to borrowers.

Of the 30 employers we surveyed, over 1/3rd (11 employers) indicated that they had been restricted at the plan-level from withdrawing from at least one investment option that participated in securities lending between 2006 and 2010. All employers that faced withdrawal restrictions used one of two providers.

From those surveyed, the withdrawal restrictions were placed on employers beginning in the fourth quarter of 2008 and the restrictions were removed between the summer of 2010 and the first quarter of 2011. The restrictions varied amongst the employers we surveyed. For some, employer withdrawal requests from lending funds were limited to a per month maximum of between two and four percent of the total account's net asset value in the fund at the time of the redemption request. Another employer, for about nine months beginning in October 2008, was not permitted to transfer any funds out of several investment options that participated in securities lending. After nine months, the service provider permitted the employer to request redemptions of up to 15 percent of each investment option's assets two times per month (however, the service provider reserved the right to authorize a lesser percentage).

Participant Level

Of the 30 employers surveyed, none reported participant withdrawal restrictions from investments within their plans that participated in securities lending. However, one employer reported that their securities lending service provider notified them that if participant withdrawals and/or transfers out of the funds with securities lending programs rose to a certain unspecified level, then the service provider would deem the participant activity to be at the plan-level and thus, subject to restrictions on plan-level redemptions. The employer did note though that this never occurred and therefore, participant-directed withdrawals and transfers out of the investment funds with securities lending arrangements continued without restriction.

Average Gains and Losses from Securities Lending

Table 7 summarizes the average revenue gain and loss from securities lending per investment option for each employer that provided plan-level data (25 employers). In 2006, employers on average experienced only gains and no losses from securities lending. And in 2007, 2009 and 2010, only one employer each year experienced average losses per investment

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option from securities lending. In 2008, four employers experienced average losses per investment option from securities lending. These average losses ranged from $171,753 to $1,666,667.

Table 7. Average revenue gain (loss) from securities lending per investment option for the 25 employers surveyed that provided plan-level data

	Average revenue gain (loss) from securities lending per investment option, when the data provided was at the plan level				
	2006	2007	2008	2009	2010
1	261,194	329,339	527,969	527,489	253,829
2	337,588	558,707	1,151,730	758,836	236,207
3	333,333	333,333	(1,666,667)	1,666,667	Not lending securities
4	66,372	90,333	215,269	101,188	42,518
5	136,929	364,433	731,943	640,064	307,595
6	1,045,251	(345,498)	2,382,103	Not lending securities	Not lending securities
7	427,222	1,135,708	3,722,016	1,709,610	504,500
8	86,217	109,838	142,730	175,376	39,742
9	N/A	59,501	305,315	312,690	65,570
10	81,868	101,988	162,283	80,856	37,897
11	135,276	89,149	(265,906)	(1,607)	46,081
12	145,640	212,968	(171,753)	114,919	98,932
13	90,965	272,883	424,093	184,516	223,401
14	26,360	26,237	45,076	124,732	58,000
15	42,402	122,840	336,732	106,262	59,444
16	837,454	608,827	(404,342)	218,966	(15,924)

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17	120,557	55,974	247,616	137,692	57,289
18	39,788	98,067	229,073	136,689	45,780
19	297,464	631,468	1,138,619	933,050	469,044
20	8,580	22,713	74,324	52,882	24,080
21	191,627	201,017	492,950	337,796	207,464
22	59,080	107,875	452,767	272,363	73,877
23	282,978	114,321	26,470	219,198	33,537
24	102,103	133,911	42,550	313,433	73,991
25	N/A	N/A	111,500	65,045	56,381

Revenue Sharing and Liability for Losses

In the case of securities lending with cash collateral within 401(k) plans, participants bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer, which is the risk that remains with plan participants. However, in the event that there are gains from the investments of the cash collateral pool, participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents.

Our survey results are generally consistent with these conclusions. Most of the employers we surveyed stated that any losses within the cash collateral pools were ultimately borne by the participant. In terms of revenue sharing arrangements between the plans/participants and the securities lending service provider, it ranged from 50-50 percent split to a split of 92 percent to the plan/participants and eight percent to the service provider. It should be noted that a few employers invested in mutual funds where the revenue sharing arrangements provided that 100 percent of the cash collateral revenue in excess of costs was allocated back to the mutual funds as revenue (and ultimately to participants).

Disclosures Provided to Employers and Participants on Securities Lending

Our survey found that employers are provided with some disclosures about securities lending. The most common form of disclosure is fund documentation (e.g., a Prospectus or Statement of Additional Information). Some securities lending service providers also provide periodic reports to their clients. And nine of the employers we surveyed had signed securities lending agreements with their service providers. Table 8 summarizes the examples of

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disclosures about securities lending provided to the 30 respondents to our survey – and the number of surveyed employers that indicated receiving such disclosure.

Table 8. Examples of disclosures provided to employers about securities lending.

Type of disclosure	Number of employers that indicate they receive that type of disclosure
Fund documentation (e.g., a Prospectus or Statement of Additional Information)	20
Meetings (in person and conference call)	6
Signed securities lending agreements	9
Periodic reports	13
Investment guidelines	3
Fee and other disclosures	5
Letters	4

In general, the 30 employers we surveyed also provide some documentation about securities lending to their participants. Like the employer disclosures, the most common disclosure is fund documentation. Six employers provide a description of securities lending in their summary plan descriptions or plan participant investment guides. Five employers stated that they provide no information to participants on securities lending.

Table 9. Examples of disclosures provided to participants about securities lending

Type of disclosure	Number of employers that indicate they provide that type of disclosure
Fund documentation (e.g., a Prospectus or Statement of Additional Information)	20
Provide no securities lending disclosures	5
Financial statements	4
Form 5500	1
Summary plan descriptions and plan participant investment guides	6

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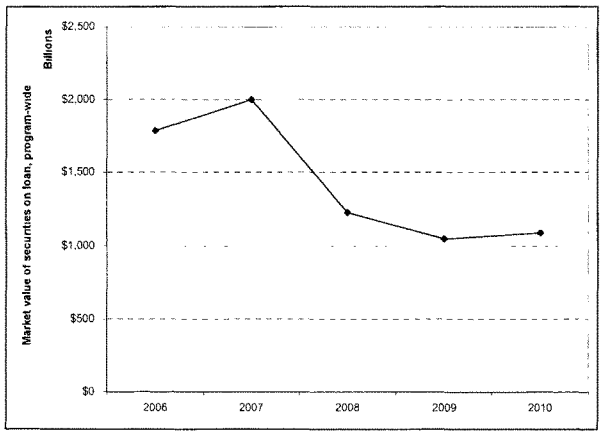
Bank Findings

In response to the Aging Committee's request, the seven largest banks within the securities lending market provided the following information.

Size of Securities Lending Business – In General

Six of the seven banks that we surveyed had a total of about $1.1 trillion of securities on loan in 2010 (six of seven banks provided information, direct and indirect securities lending). This is down from the high point in 2007 when nearly $2 trillion of securities were out on loan (Table 10). In 2010, the average value of securities on loan per bank was about $181 billion.

Table 10. Market value of securities on loan, program wide (six of seven banks provided information, direct and indirect securities lending)



Types and Sizes of Plans Serviced by Banks

Six of the seven banks we surveyed provided direct securities lending services to defined contribution, defined benefit and other retirement plans in 2010. The one bank that did not provide these services did provide such services to retirement plans during the period of 2006 through 2008.

In 2010, these six banks provided securities lending services to a total of 570 retirement plans (defined benefit, defined contribution and other retirement plans) (Table 11) and these plans had a total asset size of about $1.3 trillion (Table 12). The average number of retirement plans per bank that were provided securities lending services was 95 plans in 2010. The range in

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2010 included one bank that provided securities lending services to 259 plans -- and one bank that provided services to just four plans.

Table 11. Number of defined benefit, defined contribution and other retirement plans for which each bank provided direct securities lending services

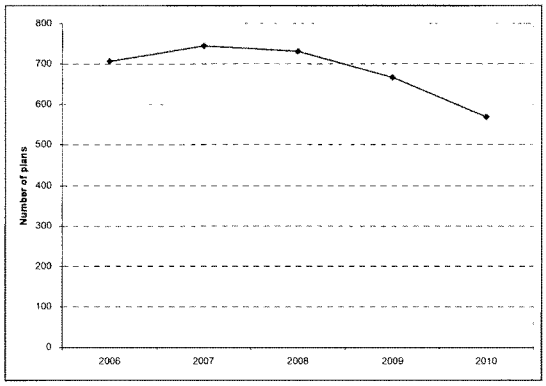

Table 12. Asset size of defined benefit, defined contribution and other retirement plans for which each bank provides direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$1,585.3	$1,671.4	$1,133.9	$1,213.5	$1,260.1
average	$396.3	$417.8	$283.5	$303.4	$252.0
maximum	$723.1	$742.9	$554.1	$604.3	$594.8
minimum	$17.2	$17.3	$14.4	$21.7	$10.4

Five of the seven banks surveyed provide direct securities lending services to defined contribution plans. The total number of defined contribution plans that these banks provided securities lending services to was 48 in 2010, with the average number of plans per bank being 9.6 (Table 13). The total asset size of all of the defined contribution plans directly serviced by these banks in 2010 was nearly $38 billion (Table 14).

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Table 13. Number of defined contribution plans for which each bank provides direct securities lending services

	2006	2007	2008	2009	2010
sum	56	57	55	50	48
average	11.2	11.4	11	10	9.6
maximum	19	19	18	19	17
minimum	1	2	2	3	3

Table 14. Asset size of the defined contribution plans for which each bank provided direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$47.9	$52.0	$41.1	$51.4	$37.7
average	$12.0	$13.0	$10.3	$12.9	$9.4
maximum	$16.6	$17.4	$11.5	$17.2	$16.0
minimum	$5.5	$8.5	$9.1	$10.8	$0.5

In terms of defined benefit plans, six of the seven banks surveyed currently provide direct securities lending services to these plans. The total number of defined benefit plans that these banks provided services to was 518 in 2010, with the average number of plans per bank being about 86.3 (Table 15). The total asset size of all of the defined benefit plans directly serviced by these banks in 2010 was about $1.2 trillion (Table 16).

Table 15. Number of defined benefit plans for which each bank provides direct securities lending services

	2006	2007	2008	2009	2010
sum	646	684	671	612	518
average	129.2	136.8	134.2	122.4	86.3
maximum	243	258	268	255	247
minimum	73	77	73	64	4

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Table 16. Asset size of the defined benefit plans for which each bank provides direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$1,503.6	$1,585.3	$1,073.8	$1,143.7	$1,208.1
average	$375.9	$396.3	$268.5	$285.9	$241.6
maximum	$683.8	$705.5	$526.0	$568.6	$564.4
minimum	$5.1	$5.2	$3.9	$9.3	$9.9

It should be noted that most of the banks we surveyed only provided data on the retirement plans to which they provide ***direct*** securities lending services. Most banks did not provide information on their ***indirect*** securities lending business in the retirement plan market. For example, many banks provide securities lending services to some of its pooled funds in which defined contribution plans and defined benefit plans may invest. Therefore, the above data is only one segment of the securities lending business in the retirement plan market.

Withdrawal Restrictions

Three of the seven banks we surveyed restricted defined contribution and defined benefit plans from exiting funds that engaged in securities lending. These restrictions began in the fall of 2008. One bank reported that all restrictions have now ended. Another bank reported that most of the restrictions have been removed; however, withdrawals continue to be subject to a determination as to whether there is sufficient liquidity to allow the withdrawals to be processed entirely in cash. The third bank removed some of the restrictions at different times but it appears that the final restrictions were removed in January 2011.

The rationale behind the withdrawal restrictions was similar between the three banks. One bank stated that it instituted the restrictions to protect its securities lending clients in the face of unprecedented market conditions. This bank stated that it had instituted its "safeguards" to forestall the possibility of a run on the collateral pools in which exiting clients would use up all of the available liquidity, leaving the remaining clients with assets that could only be sold (if at all) at "firesale" prices. Another bank similarly stated that it implemented restrictions in response to illiquidity in the market for fixed income securities, sharply declining equity markets, and borrower deleveraging.

In terms of the types of restrictions, one bank stated that withdrawal restrictions were only triggered if employers chose to exit securities lending within their plans. Under the restrictions, employers were only permitted to take in-kind (rather than cash) distributions, which included employer's shares of both liquid and illiquid assets in the applicable cash collateral pool. In addition to in-kind distributions, this bank also provided employers with the option of participating in a staged withdrawal program (e.g., gradually reducing their loan balance over a

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period of time). Another bank only permitted employers to withdraw a maximum percentage of between two percent and four percent per month of the value of its interest in the fund.

In terms of participant withdrawal restrictions, one of the three banks stated that all transactions requested by participants in 401(k) plans were processed in the normal course. Another of the three banks notified their employer clients that to the extent that the bank observed a volume of participant-directed withdrawal activity from any plan or plans that it believed to be out of the ordinary course and detrimental to the liquidity of the bank's cash collateral pools, the bank could apply the plan-level withdrawal restrictions to participants. This bank did not state what level of participant-directed withdrawal activity would trigger these restrictions. However, it appears from the bank's response that they never triggered these restrictions.

Cash Contributions to Cash Collateral Pools

In response to cash collateral losses during the financial crisis, three of the seven banks surveyed made cash contributions to cash collateral pools that contained defined contribution and defined benefit plan assets. One of the banks made a one-time $330 million cash contribution and another bank made a one-time payment of $150 million. These banks made clear in their responses that they were not required to make these cash contributions but did so voluntarily. In addition to cash contributions, two of the three banks stated that they also purchased securities from certain cash collateral pools. For example, one of the banks purchased four securities from one of their collateral vehicles for a total purchase price of approximately $113 million. And one of the banks stated that it reduced its fee split for a period of time to increase the securities lending revenue that its retirement plan clients received.

Range of Revenue Sharing Arrangements and Other Costs

In the case of securities lending with cash collateral within retirement plans, participants and plans bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse the plan or plan participants for losses that the cash collateral reinvestment pool may suffer. However, in the event that there are gains from the investments of the cash collateral pool, plans and participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents. The information we received from the surveyed banks is generally consistent with these conclusions.

For the seven banks we surveyed, the amount that the lender (e.g., a retirement plan) receives from the fee split or revenue split for securities lending ranges from 60 percent to 100 percent. That means the bank share ranges from zero to 40 percent. Furthermore, one bank pointed out that it is industry practice for compensating securities lending agents that the lending agent receives no compensation for its services when there are no positive net revenues from the cash collateral reinvestment activities.

Other types of costs paid to third parties in a typical securities lending transaction include cash collateral pool manager fees. These fees may include investment management,

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administration and custody fees for the collateral pool. These fees range from one to six basis points of assets under management. Five of the seven banks indicated that they do not always charge clients an investment management fee for the cash collateral pool. However, one bank indicated that it recovered certain out-of-pocket costs it incurred, including transaction accounting and reporting expenses, auditing fees, brokerage fees and other commissions.

Rebates

The surveyed banks also indentified rebates as an additional cost to lenders, including retirement plans, within securities lending transactions. A rebate is the portion of the return earned on the cash collateral reinvestment that is paid to the broker-dealer. This payment is made because the broker-dealer would have earned a short-term rate of return on the cash had they held on to it themselves. The greater the demand for the security being lent, the lower the rebate paid to the borrower. Securities that have an extremely high borrowing demand can obtain "negative" rebates, requiring the borrower to not only pledge cash, but also pay a fee to the lender.

In 2009, the total amount of rebates paid by surveyed banks for all of their retirement plan business was about $70.4 million. Note that the minimum in total rebates paid by one of the banks in 2009 was negative $29.6 million. That means that this bank must have received a significant number of negative rebates (Table 17).

Table 17. Total amount paid/received in rebates for all retirement plans

(millions)	2006	2007	2008	2009
sum	$15,497.9	$18,236.1	$6,456.8	$70.4
average	$3,099.6	$3,647.2	$1,291.4	$11.7
maximum	$5,854.4	$7,021.3	$2,496.5	$54.7
minimum	$1,916.2	$2,232.5	$705.0	($29 6)

In 2009, the total amount of rebates paid for defined contribution plans that participated in securities lending by the banks was about $11.3 million – and for defined benefit plans it was $61.2 million. The average amount paid in rebates for defined contribution plans by each bank for 2009 was $2.3 million – for defined benefit plans, it was $10.2 million (Tables 18 and 19).

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Table 18. Total amount paid/received in rebates for defined contribution plans by surveyed banks

(millions)	2006	2007	2008	2009
sum	$796.9	$936.4	$349.5	$11.3
average	$159.4	$187.3	$69.9	$2.3
maximum	$441.6	$522.1	$157.7	$9.1
minimum	$44.1	$43.7	$15.2	($0.5)

Table 19. Total amount paid/received in rebates for defined benefit plans by surveyed banks

(millions)	2006	2007	2008	2009
sum	$14,506.4	$17,014.2	$6,003.0	$61.2
average	$2,901.3	$3,402.8	$1,200.6	$10.2
maximum	$5,610.4	$6,680.9	$2,323.6	$54.1
minimum	$1,474.6	$1,710.4	$564.0	($30.0)

Recommendations

As a result of our investigation into securities lending practices, the Committee makes the following recommendations.

Employers Should Increase their Knowledge of Securities Lending within their Defined Contribution Retirement Plans

The Committee found through its investigation and discussions with industry experts and stakeholders that many employers that sponsor defined contribution retirement plans do not know whether the investment options in their plans engage in securities lending. For those that did, they understood the benefits of these transactions, but many were not aware of the risks involved with securities lending and in particular, the risks associated with the cash collateral reinvestment portion of their service providers' securities lending programs.

This is alarming, as employers are required understand whether their plans engage in securities lending and the consequences of such engagement to meet their fiduciary responsibilities under ERISA. The Committee thinks it is important for all employers (small and large) to, at a minimum, know the answers to the following questions:

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- Are the investment options in my defined contribution retirement plan(s) engaged in securities lending?

- If the answer is yes, for each investment option engaged in securities lending:

    - What is the percentage of underlying assets that are being lent out?

    - In exchange for the loan, does the plan's service provider receive cash collateral (or collateral in another form)?

    - If cash collateral, what is the cash reinvested in and what are the returns (gains and losses) on such investments? How are the gains and losses divided between the plan/participants and the service providers? What fees do the plan service provider, the broker dealer, the cash collateral pool manager and the securities lending agent receive?

Participants Should be Given Information about Securities Lending within their Defined Contribution Retirement Plan Investment Options

To satisfy their responsibilities under ERISA, plan sponsors should provide participants with sufficient information for them to make informed decisions about the investment options within their defined contribution plans. Although securities lending is a complicated topic, participants should be provided with easy to understand information and tools about securities lending and cash collateral reinvestment and the benefits and risks associated with the practice, including the potential for withdrawal restrictions.

The Department of Labor Should Issue Guidance to Employers on Securities Lending Practices within Qualified Retirement Plans

To help employers comply with their fiduciary responsibilities, the Committee recommends that the Labor Department develop basic information and tools for employers on securities lending within qualified retirement plans. Such information should alert employers to the benefits and risks involved with securities lending, including those related to securities lending with cash collateral reinvestment. The Labor Department also should provide plans sponsors with guidance on the types of information they should seek from their service providers about securities lending and cash collateral reinvestment within retirement plans.

Companies in the Business of Securities Lending Should Report Information about their Businesses Practices

Currently, there is no comprehensive, public data available about securities lending, including securities lending within the qualified retirement plan market. Although this is a common practice in retirement plans, this Committee had to directly survey plans sponsors and banks. Companies in the business of securities lending should be required to report information on such practices to the Securities and Exchange Commission and bank regulators. Such

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disclosures should include information on the cash collateral reinvestment portion of such companies' securities lending programs. Sponsors of qualified retirement plans that engage in securities lending also should be required to report basic information on securities lending within their plans to the Department of Labor.

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April 1, 2011

Senator Herbert Kohl
Chairman, Senate Special Committee on Aging
G31 Dirksen Senate Office Building
Washington, D.C. 20510

Senator Robert Corker
Ranking Member, Senate Special Committee on Aging
G31 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senators Kohl and Corker:

ING Insurance-US appreciates the opportunity to submit its views on securities lending practices and activities in the markets generally, including with respect to 401(k) plans and other pension plans. We commend the Special Committee and others for the consideration given to this important area.

In the U.S., the ING family of companies offer a comprehensive array of financial services to retail and institutional clients, which includes life insurance, retirement plans, mutual funds, managed accounts, alternative investments, institutional investment management, annuities, employee benefits and financial planning. ING holds top-tier rankings in key U.S. markets, serves nearly 22 million customers across the nation, and employs approximately 8,500 people.

ING Insurance-US and its subsidiaries participate in securities lending activities primarily in the following ways. First, the assets of various insurance company general accounts may be lent through securities lending agent banks in order to increase returns, provide liquidity or reduce expenses. Second, with client or fund consent and approval, the asset management subsidiaries of ING Insurance-US may establish relationships with lending agents to lend securities on behalf of investment companies and other advisory clients. Finally, to the extent that accounts or funds may engage in short sales, these accounts or funds may borrow securities through broker-dealers who are able to obtain them through securities lending relationships with a myriad of lenders.

Benefits of Securities Lending

As a lender of securities (out of the general account), as an asset manager for accounts or funds that lend securities, and as a borrower either directly or for client accounts and funds, we have found that when conducted prudently and with appropriate

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internal oversight, securities lending can provide significant economic benefits. For example, while the demand to borrow particular securities—and thus the economics of any given transaction—will differ, we estimate that on average a typical lending account or fund may see a return of several basis points over the course of a year. In an intensely competitive investment market, these additional returns can help funds and accounts achieve their investment targets and goals. In particular, index-based and other quantitative funds, which may have low portfolio turnovers and low fees and which are a popular alternative in 401(k) plans, can especially benefit from securities lending since their relatively stable portfolios are attractive to borrowers (as a result of the reduced likelihood of a security's recall due to a sale) and the returns from securities lending help them minimize potential tracking error versus their benchmark.

Aside from the immediate benefits noted above that accrue to accounts and funds engaged in securities lending, *all* funds and accounts benefit indirectly insofar as a well-functioning securities lending market enhances the efficiency of the trading markets overall. First, although for years there has been an ongoing debate about the advantages and disadvantages of short selling, few would dispute that in many cases short sellers are critical to the market's price discovery function; securities lending helps this segment of the market serve its essential function. Second, securities lending allows many transactions to be settled without a "fail;" in essence, where a seller of a security for some reason cannot deliver the security at settlement, its broker-dealer can borrow the security to complete the trade. Without a robust securities lending market, there would likely be substantially more "failed" transactions; over time, these market inefficiencies add costs to all participants in the market, including accounts and funds that do not lend out securities.

Compensation Structure

Recent reports and hearings have focused on the compensation framework of "cash collateral" securities lending arrangements, which is the most common version of securities lending.[1] In a typical securities lending arrangement with cash collateral, the lending agent reinvests the cash collateral received from the borrower and, after paying the borrower an agreed-upon rebate, retains a portion for its services and passes along the balance to the lending fund or account.

Although ING Insurance-US is primarily a lender or borrower, either directly or for client accounts or funds, and thus does not typically earn revenues in a lending agent capacity, we nonetheless believe that any proposal to require changes to the compensation framework of securities lending arrangements may prove to be counterproductive and should be considered very carefully and, if pursued, done so with extreme caution.

[1] The other, albeit less frequent, securities lending arrangement is known as a "bonds borrowed" arrangement, whereby the borrower posts securities--instead of cash--as collateral and pays a fee to the lender. Unlike cash collateral arrangements, a "bonds borrowed" arrangement generally does not entail reinvestment risk of the collateral.

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The securities lending industry is intensely competitive and the basic compensation framework has been tried, tested and refined over decades. While lenders may have lost money on the reinvestment of cash collateral during financial crises, these situations have been extremely infrequent and typically result more from the general market turmoil than from the structure of the compensation; the best corrective is usually more carefully tailored and monitored reinvestment guidelines. By and large, the compensation framework in place for securities lending arrangements has worked well to foster an efficient and competitive market providing benefits to lenders, agents and borrowers.

Furthermore, the compensation structure of securities lending arrangements cannot be viewed in isolation; rather, securities lending arrangements are often but one component of a broader service relationship. For example, the lending agent is often also the custodian or trustee for a fund, plan or account. Given the competitive market for custody and other services, the custody fee negotiated often takes into account the split on the securities lending revenues that the agent bank will earn; in other words, without the securities lending arrangement, the custody fee negotiated for a particular fund or account may end up being higher. Given the highly competitive nature of this market, mandating a revision to the economic structure of securities lending economics at one point may lead to unanticipated and undesired consequences at other points.

Transparency and Disclosure

Another concern raised has been whether plans and 401(k) participants are adequately informed of the risks in securities lending arrangements, including those relating to potential restrictions on withdrawal. To the extent evidence suggests that the information about securities lending arrangements is inadequate or confusing, either in general or with respect to a particular account or fund, we believe it is appropriate to consider practical means of addressing perceived deficiencies. We agree with Senator Corker's remarks at the recent hearing on this topic, however, that more disclosures do not necessarily equate with better disclosures.

There are many proposed alternatives and approaches to achieving enhanced disclosure. At this stage, it is too early to assess which hold the most promise. However, we believe it is useful to keep in mind the respective roles and capacities of a plan's named fiduciaries and the plan's participants. By its nature, a plan's named fiduciary will likely be in a much better position than a plan participant to consider and evaluate detailed information about the securities lending activities the plan's investment alternatives may engage in. While it may be desirable to enhance the disclosure to plan participants that various 401(k) investment alternatives engaging in securities lending may entail additional risks, we believe that the named fiduciary will be in a far better position to assess and monitor the securities lending activities engaged in by accounts or funds included in a 401(k) menu.

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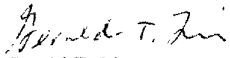
We hope this information will prove helpful to the Special Committee as it considers this important issue and, if it has any questions or would like additional information, we would be pleased to provide it.

Sincerely,



Gerald T. Lins
General Counsel
ING Investment Management-US

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