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The FORUM *for* FUND INDEPENDENT DIRECTORS

Report
of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on the Oversight of Securities Lending

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Introduction

Securities lending plays a significant role in today's capital markets. In general, securities lending is believed to improve overall market efficiency and liquidity. In addition, securities lending plays a critical role in certain hedging strategies, acts as a useful tool in risk management and helps facilitate the timely settlement of securities trades. As of January 2012, the balance of securities on loan globally exceeded $1.8 trillion, demonstrating the manner in which securities lending has evolved from a back office, operational function to an investment management and trading function.

At the same time, securities lending – including securities lending by mutual funds – has received increased attention in recent years, some of it negative. While securities lending is a long-established practice, can boost the performance of lenders' portfolios and is collateralized, the practice is not without risk. In particular, the crisis in the financial markets following the failure and default of Lehman Brothers in 2008 highlighted many of the risks inherent in securities lending. Prior to 2008, participants in securities lending, especially the lenders of securities, tended to focus on the risk that lent securities would not be returned or could not be recalled when desired – discrete risks that the lenders of securities tended to view as both small and manageable. The crisis, however, highlighted both these risks and the risks surrounding the investment of the collateral received by lenders in securities lending transactions – particularly the risk that there could be losses on the invested collateral or that it could be locked up in collateral pools for longer than expected. In short, the market turbulence of 2008-2009 demonstrated that lenders of securities could, in fact, experience real losses.

Mutual fund directors are thus left with the question of whether to permit the funds they oversee to engage in securities lending, and if so, how to oversee that activity effectively. In order to make these decisions, directors must have a strong understanding of how the market for securities lending works – in particular, the mechanics of loans, the manner in which collateral for loans is handled and how securities are recalled and loans unwound. In addition, directors need to be aware of the risks inherent in securities lending, how severe these risks are and how they might be mitigated.

The goal of this publication[1] is to help directors address these questions and build the necessary knowledge to make informed decisions about securities lending. We begin by describing the securities lending market and the mechanics of securities loans. We also highlight the various risks to which lenders can be exposed. We then seek to provide directors with practical guidance on their decision-making around and oversight of securities lending. Our goal is not to provide an authoritative answer on whether directors should permit the funds they oversee to lend – indeed, there is no correct answer to this question, and directors may well reach different conclusions based on the facts and circumstances of each fund they oversee. Likewise, our goal is not to dictate how boards oversee any lending in which their funds engage. Instead, our goal is to provide some helpful pointers that may assist directors in determining how to oversee securities lending activities and deciding what questions to ask the adviser, their portfolio managers and others involved in the process.[2]

The Mechanics of Securities Lending

Borrowers and Lenders

Virtually any long-term, beneficial holder of securities can lend securities. Owners of securities have an incentive to lend securities as the fees received in return for lending can boost portfolio performance (or otherwise offset the costs of managing a portfolio). Lenders of securities earn a return in two complementary ways – from fees often received in connection with lending securities, particularly those that are in high demand, and from the investment return on cash collateral received in return for a loan. Most securities can be lent, including domestic and foreign equities, American and global depository receipts, exchange-traded fund shares, government and agency bonds, supranational bonds, mortgage-backed securities and corporate bonds.

Not surprisingly, mutual funds are significant players in this market – indeed, as of January 2012, United States registered mutual funds represented 22% of the lending market. Other significant lenders include U.S. and foreign-based pension plans, foreign-registered mutual funds, insurance companies and central banks. Like other owners of securities, most mutual funds lend for a simple purpose: to improve the performance of their underlying investment portfolio.

Typical borrowers of securities include broker-dealers, prime brokers, hedge funds and others who use borrowed securities to implement specific investment strategies. Securities are often borrowed to facilitate the shorting of those securities because someone who shorts a security must still deliver the security to the purchaser at the other end of a short sale. Hence, a short seller must borrow the security in order to meet its delivery obligation. In addition, there are other reasons that market participants need to borrow securities. For example, securities lending facilitates the market-making businesses of broker-dealers, permits investors to engage in certain types of arbitrage strategies and permits borrowers to use a borrowed security to collateralize a separate transaction.

The Structure of a Loan of Securities

Securities lending is, most fundamentally, a collateralized transaction that takes place between two parties. In a loan of securities, the beneficial owner of those securities (the "lender") temporarily transfers title to a security as well as the associated rights and privileges of ownership to a borrower. Loans typically have a number of important features:

- The borrower will either be required to return the borrowed securities on demand (an "open loan") or on a specific, agreed date (a "term loan"). Contracts governing term loans can, however, have provisions requiring return of the security on demand. Most loans are made on an open basis although there are borrowers that prefer term facilities.

- While the borrower receives all interest, dividends and corporate action rights on the security, the borrower is required to repay the economic value of these benefits back to the lender.[3]

- The borrower also holds any voting rights attached to the security while the loan is in place.

- Even if structured as a term loan, the loan contract typically permits the lender to recall the security at any time for any reason. Term trades will sometimes operate with a "right to substitution" which allows the lender to change the security as long as it is of a similar type. Mutual funds that are lenders, for example, often recall lent securities in order to cast important proxy votes with respect to the security.

In return for lending the security, the lender receives collateral from the borrower. The value of the collateral typically exceeds the value of the lent security. This collateral typically takes the form of cash – indeed, in the majority of cases it consists of cash in the United States and most of this section focuses on this as a result — but can sometimes consist of highly liquid securities such as short-term government bonds. In addition:

- The value of the collateral typically ranges from 102%-105% of the value of the lent securities.

- The amount of collateral can depend upon a variety of factors, including whether it is denominated in the same currency as the lent security, the credit-worthiness of the borrower and other factors the lender considers relevant.

- The value of the security lent (as well as the value of any securities provided as collateral) is marked-to-market daily, and the amount of collateral backing the loan is adjusted accordingly.

When a securities loan is collateralized by cash, the lender earns its return, in part, from the investment of the collateral. (Issues associated with the investment of collateral are discussed below.) Normally, however, the lender must share part of this return with the borrower and/or with third parties that arrange the transaction. Lenders can earn a higher return on securities that are in high demand by borrowers either through payment of a lower rebate back to the borrower or through other compensation received from the borrower in return for lending these "specials."

Management/Investment of Cash Collateral

A lender typically receives collateral for the loan simultaneously with or prior to delivery of the borrowed securities. Thus, from the outset of the loan, a lender of securities also needs to manage the cash collateral that it receives during the time that securities are lent out. While the lender of securities benefits from the loan by retaining some portion of the investment return earned on the invested collateral, the lender will nonetheless want to limit the risk of loss on the invested collateral. Hence, collateral is typically invested in a money-market fund or cash pool operating under investment constraints similar to that of a money market fund. Among the options available to lenders are:

- Affiliated or unaffiliated money market funds;
- An affiliated but unregistered cash pool managed by the fund's adviser (or other investments as directed by the adviser); or
- An unregistered cash pool managed by a third party (often the fund's custodian or other party otherwise managing the fund's lending program).

Each of these approaches does have some risk associated with possible loss of capital. We discuss many of these risks in section III, below.

Routes to Market

Very few fund complexes have the expertise or resources to operate and manage a securities lending program by themselves. Most funds that wish to engage in securities lending therefore need to choose a route to market – that is, they need to choose who will run the program on their behalf. There are three basic options:

Custodian Agency Model – The most traditional – and perhaps the easiest – way of operating a securities lending program is to retain the fund's custodian to run the program. Typically, the custodian pools a participant's securities with those held by other clients. The custodian then allocates loans made among its clients using an automated algorithm designed to ensure that all its clients are treated fairly. In this type of arrangement, cash collateral is sometimes invested in a commingled pool that may be advised by an affiliate of the custodian. Lenders may, however, seek to enter into alternative arrangements for the management of the cash collateral they receive.

Custodial pools are typically large, which can be attractive to borrowers who are looking to ensure liquidity and availability of securities. Custodians often price their lending services on a bundled basis together with other services they provide to their clients. Depending upon the viewpoint of a fund's adviser and board, this can be either a benefit or a drawback – while some prefer the simplicity of a single price for all custody and custody-related services, others conclude that they cannot determine whether they are getting a fair deal on the costs of their securities lending program unless this aspect of their custodian's services is priced separately.

Third-Party Agency Model – Alternatively, a fund can hire a third party agent to operate and manage its securities lending program. A third party agent typically manages its lending activities similarly to the custodian model. As with custodians, third party agents may offer lenders the ability to invest cash collateral in a pool they manage or may make other options available.

"Principal Exclusive" Model — In a "principal exclusive" arrangement, the lender (or its agent) negotiates an exclusive arrangement with a principal counterparty. The borrower pays a fee for exclusive access to a particular portfolio or subset of the portfolio. The lender may thus be able to establish a number of different exclusive arrangements with various borrowers (for example, each lending fund in a complex may have its own relationship). While this approach ensures that the lender receives a stable and consistent fee during the term of the relationship, it also means that the lender is foregoing any potential profits it could make in the market over and above the agreed-upon fee.

Managing Risk in Securities Lending Programs

As with virtually any investment activity, there are risks associated with securities lending. For the most part, when a fund or fund complex engages in securities lending, the adviser will have primary responsibility for identifying and taking steps to monitor and mitigate the risks associated with the activity. However, in order to engage in effective oversight, fund directors need to be aware of the key risks associated with securities lending. We therefore outline the primary risks below.

Counterparty Risk

Counterparty risk is the risk that the borrower of the securities defaults and fails to return the securities it borrowed. If this occurs, the lender will need to apply the collateral (or liquidate it, if it is other than cash) to repurchase the lent securities. As a result, counterparty risk also entails some degree of market risk – that is, the risk that the market value of the security will increase following default such that the collateral is not sufficient to cover the cost of repurchasing the security.

A lender can take a variety of steps to mitigate the counterparty risk that it faces. Most simply, in the typical lending arrangement, the value of the collateral exceeds the value of the lent security by a specified percentage and is marked-to-market on a daily basis. Hence, from an operational perspective, the lender must have appropriate processes and controls in place to ensure that the lent security is marked-to-market on a daily basis and that the amount of collateral is adjusted as appropriate. In addition, the lender or its agent can engage in extensive and ongoing credit reviews of potential borrowers and can limit its lending activities to well-capitalized, high quality borrowers. Finally, the lender's agent may be willing to indemnify the lender by contract against the risk of default.

Reinvestment Risk

Reinvestment risk is the risk that losses are incurred on the cash collateral that is invested during the term of the loan. Reinvestment risk also encompasses the risk that the invested collateral underperforms relative to other investment options or earns less than the rebate that is paid to the borrower if the rebate is a fixed or minimum amount rather than a percentage of the return on the invested collateral. Because cash collateral is typically invested in money-market funds, unregistered pools that invest in accordance with rule 2a-7 or in other similar instruments, this risk can easily seem negligible. However, as the market disruptions of 2008-2009 demonstrated, lenders of securities face real risks in this area. Risks include both that the advisers to the pools in which cash collateral is invested may limit their ability to withdraw the cash at will because of problems in the underlying fixed income markets and that actual losses will be experienced with respect to these investments.

Reinvestment risk highlights the need for lenders to establish appropriately conservative reinvestment guidelines. Often, this can be accomplished by investing cash collateral in carefully-screened and selected money market funds.[4] If cash collateral is invested in other types of pools, a lender should ensure that it understands the risks and investment goals of the pool, and that the pool provides sufficient transparency to permit ongoing monitoring of how cash collateral is being invested. In other cases, lenders may choose to use in-house investment capabilities in order to exercise more control over how cash collateral is invested. In such cases, the lender will need to focus on such typical money market issues as the maintenance of liquidity, the credit quality of the underlying money market instruments, issuer diversification in the underlying portfolio and the weighted average maturity of the portfolio. As part of their oversight of securities lending programs, boards should understand these risks, including the risk that the reinvested collateral will underperform. They should also understand who bears the risk of deterioration in the market value of the collateral.

Operational Risk

Operational risk is the risk that processing, bookkeeping, compliance or other types of internal problems will arise. In most cases, an adviser should take the same steps in identifying and mitigating operational risk as it does with the rest of its operations, and directors can oversee these efforts in the same manner.[5]

As with some other investment activities, securities lending can pose legal and contractual risks; that is, the risk that the parties are out of compliance, either inadvertently or purposefully, with either the contracts governing their relationship or with the law generally. Included within this category are the risks that the contracts either do not provide the lender with sufficient protection or that the lender does not fully understand its rights and obligations under the contracts. In many cases, these risks can be mitigated by ensuring that personnel are fully trained, that appropriate legal counsel has been retained and that the contracts and other documents supporting the lending program have been carefully reviewed and understood by the adviser's personnel. Lenders can also mitigate this risk through the use of standardized contracts and through robust audit and compliance reporting.

One specific risk worth noting is the risk attendant to exercising rights on the collateral in the event of a borrower default. Even if the market value of the collateral is appropriate, it may take time to realize that value, and the process may be subject to litigation risk, particularly in a case involving bankruptcy of the borrower.

The Legal Requirements Imposed on Securities Lending by Registered Funds

The discussion that follows outlines the legal restrictions that United States law places on the ability of registered mutual funds to lend portfolio securities.[6] These laws and regulations are not necessarily applicable to other lenders. Moreover, in establishing and conducting a securities lending program, a fund, its board of trustees and adviser should always consult with counsel.

- **Funds are permitted to lend securities –** The Securities and Exchange Commission ("SEC") has long interpreted the Investment Company Act of 1940 ("1940 Act") to permit a registered investment company to lend its portfolio securities. However, the fund's policies must permit securities lending (that is, a lending fund must not have adopted a fundamental policy that precludes the lending of securities) and the fund's disclosure documents must accurately reflect the existence of the securities lending program and its principal risks. In addition, a fund must earn a reasonable return on the securities it lends. This reasonable return can consist of any combination of returns on invested collateral and fees and interest received in return for the loan. (Of course, separate from the reasonable return, the lending fund must receive all dividends, interest and other distributions paid in connection with the security during the time it is lent.)

- **Boards must approve and oversee securities lending programs –** Funds clearly cannot lend securities without the approval of their boards. Specifically, boards should review and approve appropriate securities lending policies and procedures. These policies and procedures may be more or less detailed and should establish standards and limitations that address a wide range of issues, including permissible borrowers, the selection of and fees to be paid to the fund's lending agent and/or other service providers, how collateral will be invested and what route(s) to market lending funds will use. Boards should oversee the fund's compliance with these policies and procedures and review them as appropriate.

- **Loans must be appropriately collateralized** — At the time each loan is entered into, the investment company lender must receive from the borrower not less than 100% of the market value of the securities loaned at the time the loan is made; furthermore, the loan must be marked-to-market on a daily basis, and the collateral must continue to equal at least 100% of the value of the lent securities. (Since industry practice is for collateral to equal between 102% and 105% of the value of the lent securities, this is typically not a problem.)[7] Moreover, funds may accept only cash, U.S. government or agency securities or irrevocable bank letters of credit as collateral.

- **Lending programs must comply with the leverage restrictions of the 1940 Act** – The SEC staff has required that funds limit their securities lending in the same manner that they are required to limit borrowings. More specifically, an investment company may not loan securities with a value in excess of one-third (33 1/3%) of its total asset value, including collateral received from such loans (in other words, the fund may loan up to 50% of net assets). This limitation is the same as the 300% asset coverage requirement imposed under section 18 of the Act.

- **A lending fund must be able to terminate a loan —** An investment company that has lent securities must be able to terminate the loan at any time and recall the loaned securities within the normal and customary settlement time for securities transactions. Funds typically recall securities because, consistent with their proxy voting policies, they need to participate in a vote with respect to the issuer of the security. Hence, a lending fund's policies and procedures should be designed to permit the fund sufficient time to recall any security that its policies require to be voted. However, a fund may need to recall securities for other reasons, including the need to deliver the security after it has been sold.

- **Restrictions on affiliate transactions apply to securities lending —** An investment company lender may engage an affiliate as its lending agent or to perform administrative or ministerial functions in connection with securities lending activities. However, fees paid by an investment company to such an affiliate may not be based on the revenue or profit derived by the fund from securities lending unless an exemptive order has been obtained from the SEC specifically approving such arrangements.[8] Finally, securities generally may not be lent to an affiliate of the fund absent exemptive relief.

Notes

[1] This publication has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member group serves on the Forum's Steering Committee. The Forum's current membership includes over 675 independent directors, representing 97 independent director groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

[2] This report was developed by leaders in the independent director community with advice given by members of the Forum's Advisory Board, with extensive assistance from eSecLending, Inc. For more information on securities lending, eSecLending has published a paper entitled *Securities Lending Best Practices: A Guidance Paper for US Mutual Funds.*

[3] Payments received by the borrower for the foregone interest or dividends on the lent securities are deemed "in lieu of payments" which do not qualify for reduced tax rates on qualified dividend income for underlying fund shareholders. Some expenses of securities lending may, however, be offset against these payments, thus limiting the detrimental tax impact.

[4] Funds can experience losses even when collateral is invested in money market funds because the adviser to the money market fund may be unable or unwilling to guarantee the $1 per share price.

[5] *See generally* Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* at 8-9 (Apr. 2010) (discussing the identification and monitoring of operational risk in fund complexes).

[6] Most of the legal guidelines regarding securities lending, including those we discuss below, derive from a series of no-action letters issued by the SEC staff over the past 40 years. These letters include *State Street Bank and Trust Co.* (Jan. 29, 1972), *State Street Bank and Trust Co.*(Sept. 29, 1972), *Salomon Brothers* (Sept. 29, 1972), *Norman F. Swanton Associates* (Oct. 13, 1973), *Standard Shares, Inc.* (Aug. 28, 1974), *Adams Express Co.* (Oct. 9, 1974), *Salomon Brothers* (May 4, 1975), *Merrill Lynch Capital Fund, Inc.* (Mar. 9, 1978), *Adams Express Co.* (Oct. 20, 1979), *SIFE Trust Fund* (Feb. 17, 1982), *Twentieth Century Investors, Inc.* (Nov. 26, 1982), *Norwest Bank Minnesota, N.A.* (May 25, 1995), *Morgan Guaranty Trust Co. of New York* (Apr. 17, 1996), *The Brinson Funds* (Nov. 25, 1997), *Chase Manhattan Bank* (July 24, 2001) and *Investment Company Institute* (Dec. 14, 2005). *See also Division of Investment Management, Generic Comment Letter to Chief Financial Officers* (Nov. 7, 1997).

[7] Should the possibility ever arise, a board should consider whether collateral levels below 102% are adequate in light of the operational costs and risks which may attach to realizing the value of the collateral.

[8] We do not addresss the standards that the SEC uses in granting such exemptive relief in this report. However, as of the date of this publication, the SEC does not appear to be granting this type of relief to funds. Funds that wish to engage in affiliate transactions of any sort as part of the securities lending program should consult with counsel.

Appendix
Board Considerations Regarding Securities Lending Programs

1. **The board should determine whether some or all of the funds it oversees will be permitted to engage in securities lending.**

   The board has an important role in overseeing a fund's securities lending activities. As noted in the text of this report, a fund may not lend securities unless lending is permitted by its investment policies. Prior to the fund engaging in securities lending, the board, working in conjunction with management, the funds' portfolio managers and others, should determine whether, in their business judgment, lending securities is likely to be of benefit to the funds and their shareholders. In most cases where an adviser wishes its funds to engage in securities lending, fund management will present to the board its case for why the funds will benefit from loaning securities and how it intends to manage the risk of the lending program.

   As part of determining whether to permit its funds to lend securities, the board should seek to understand the costs of the securities lending program (i.e., what fees will be paid to third parties that help manage the program) and what the funds are likely to earn by lending securities. Thus, the board will want to understand, at least in general terms, which securities will likely be lent (including whether the fund will limit its focus to highly-demanded securities or seek more broadly to lend the securities in its portfolio). In addition, the board should review how cash collateral will be invested, what the anticipated return on those investments is and how those earnings are to be divided among the borrower, the funds and the funds' agents.

   In the broadest terms, boards should make sure that they have discussed with the adviser why the adviser is recommending that some or all of the funds in the complex lend securities, what route to market the adviser plans to use, what key service providers the adviser plans to use and – with respect to all of these issues – what alternatives the adviser considered. Before approving a securities lending program, the board must have confidence that securities lending will benefit the fund and the adviser is able appropriately to manage the risks of securities lending.

   At the end of the day, the board cannot and should not attempt to run or manage the securities lending programs of the funds they oversee any more than they should attempt to manage other investment activities of the fund. Rather, once the board decides that securities lending is permissible, it should leave the daily management of the program to the fund's adviser and to other third parties retained to run the program. Put differently, the actual operation of a securities lending program is akin to a fund's normal investment operations.

Boards should recognize that particular portfolio managers may not wish to lend securities from their portfolios or may choose not to lend certain securities (although the adviser, who has ultimate responsibility for management of the fund, may choose to override the wishes of individual portfolio managers). For example, in some cases, a portfolio manager or adviser may be concerned that lending activity will aid short-sellers of the security to the detriment of the fund. Indeed, some boards discuss the risk that participating in securities lending may harm the funds that they oversee, particularly funds that invest in smaller markets or less liquid securities where short selling may have a disproportionate impact of the value, at least in the short term, of the lent security.

2. **The board should review and approve the contracts between the fund and the third parties that will implement and manage the fund's securities lending program.**

Whether a fund uses its custodian or some other party, the third parties who implement the securities lending program are service providers like any other service provider that that the fund hires. In considering which third party to engage for a fund's securities lending program, directors may find it helpful to review quotes from several agents or consult a service that reviews and ranks the performance of securities lending agents.

Once the third party has been selected, the board should therefore review and approve the contract(s) in the same manner that it reviews and approves contracts with other service providers. And, as is the case with other service providers, this is not a one-time activity at the time the contract is initially executed. Rather, the board should review and approve these contracts on a regular basis, and should include in its review process an analysis of whether the service provider is performing as expected and whether the fees it charges remain appropriate. As part of this process, boards may also wish to review whether the fund is and will likely continue to benefit from lending securities.

3. **The board should have an understanding of the risks associated with securities lending and understand the manner in which the fund's adviser will identify, monitor and mitigate those risks.**

As described more fully above, securities lending poses operational risks, counterparty risks (that is, the risk that a borrower of a security will not return it) and risks associated with the investment of cash collateral. The board needs to understand these risks and have confidence that fund management also understands and can manage the risks – in particular, the board should have a strong understanding of how fund management identifies and tracks risks and how it mitigates those risks.

Working in conjunction with fund management, the board may also wish to adopt guidelines (or place limits on the securities lending program) with respect to certain of the risks. For example, the board may wish to place limits on how cash collateral is invested during the term of any loan or require that someone other than the fund's lending agent be used to manage and invest the collateral that the fund receives. The board should also generally review a list of acceptable borrowers and review the form of agreement between the fund and borrowers.

Likewise, because the board also has the obligation to oversee a fund's compliance with the securities laws, the board should seek assurances that securities lending programs are subject to appropriate controls.

4. **Securities lending should be conducted pursuant to written policies that have been reviewed by the board.**

Written policies can play a critical role in managing and mitigating the risks of securities lending programs. Boards and management generally use written policies to govern such important factors as which securities can be lent out, what types of collateral are acceptable, how cash and non-cash collateral is to be invested or handled, limits on counterparty exposure, and so forth. In many cases, boards also review and approve a list of acceptable borrowers that has been prepared by the adviser.

5. **Funds should be treated fairly in the context of larger securities lending programs.**

At times – particularly when an adviser uses its custodian to conduct a securities lending program – securities owned by the funds may be placed in the same pool for lending as securities owned by other clients of the adviser. In these circumstances, securities owned by the fund must be lent in a fair and equitable rotation with those of non-fund clients (or loans of individual securities owned by both funds and non-fund adviser clients must be divided fairly). It may, however, be very difficult for the board or the adviser to determine whether the fund is, in fact, being treated fairly.

6. **The board should seek to ensure that appropriate policies are in place to recall securities in order to vote proxies as appropriate and desired.**

The right to vote the proxies of the securities it owns is an important asset of a mutual fund. In the ordinary course, boards have an obligation to ensure that proxies are voted appropriately; often, boards adopt policies directing how proxies will be voted on specific issues.

As has been discussed above, however, the proxies of securities that have been loaned out cannot be voted. Funds that engage in securities lending should therefore have policies outlining when securities will be recalled in order to vote proxies. These policies can range from a requirement that any security be recalled when a proxy could be voted to criteria that require recall for certain types of votes to criteria that require recall when the fund's stake in a company is particularly high. There is no correct answer to this question; rather, boards, working with the adviser and portfolio managers, should exercise their business judgment to balance the value of voting proxies against the benefits of allowing securities to remain out on loan.

7. **The board should obtain regular reports about the securities lending program from fund management.**

   In order effectively to oversee a securities lending program, the board should seek regular reports from management. These reports may cover topics including compliance, risk management, operational information (e.g., whether there have been fails or other problems), collateral reinvestment, income earned and, as appropriate, performance benchmarking. The board may also seek information, when appropriate, on changes and trends in securities lending generally and other trends in the securities lending marketplace.

8. **The board should review the performance of the securities lending program on a regular basis.**

   Because revenue from securities lending is part of the investment return of the fund, boards should review those returns in the same manner as they review other components of the fund's performance. In reviewing the earnings from securities lending, boards may wish to consider, among other factors, the utilization rate of securities in the fund's portfolio, the extent to which earnings on lending are attributable to specific contract terms in the loans and the extent to which those returns are attributable to the reinvestment of cash collateral. The board may also wish to review whether the earnings actual earnings from the program are consistent with the returns initially predicted.

9. **The board should actively use the CCO to help it oversee securities lending programs.**

   Securities lending can be complicated and dynamic and these programs can generate significant amounts of information regarding performance, compliance and other operational issues. Given these complexities, the fund's CCO is an invaluable resource in assisting the board in its oversight responsibilities and in identifying potential problems or red flags before they become significant.

More specifically, the fund's CCO is in an excellent position to monitor compliance with relevant law, compliance with lending policies adopted by the board and the adviser, compliance with proxy voting and related security recall procedures and the adequacy and appropriateness of loan collateralization. The CCO can also assist the board in overseeing the adviser's management of the risks of the securities lending program. In general, the CCO ought to report to the board on securities lending at least yearly (and more frequently if problems or red flags are identified).

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