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

GAO

Accountability * Integrity * Reliability

GAO Accountability • Integrity • Reliability

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.

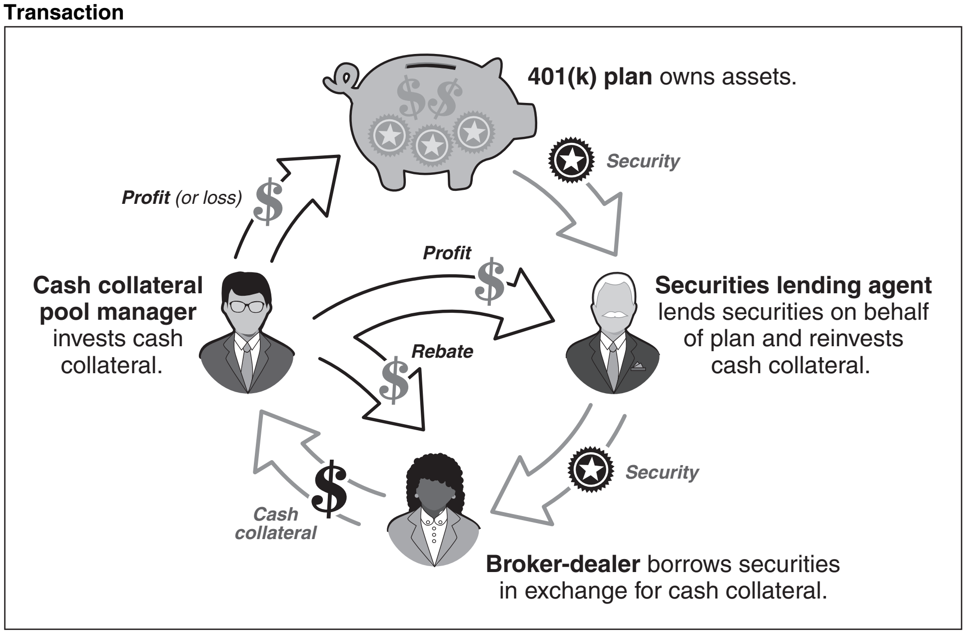
What GAO Found

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.

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.

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).

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.

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.

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.

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.

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 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.

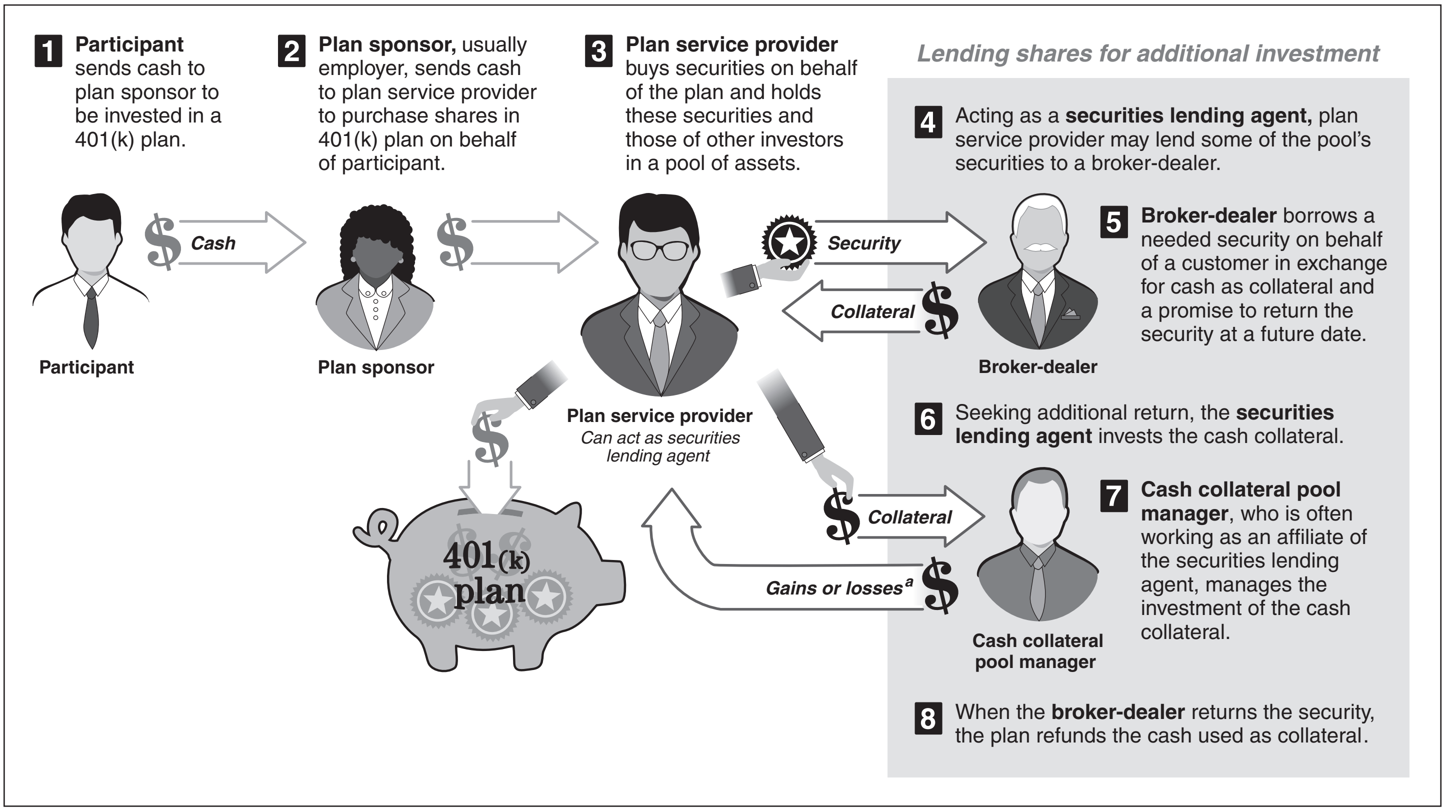
4. The broker-dealer provides cash as collateral to the securities lending agent, for the length of the agreement, which would specify, among other things, that the lending agent has responsibility with respect to the cash collateral.[22]

[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.

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.

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.

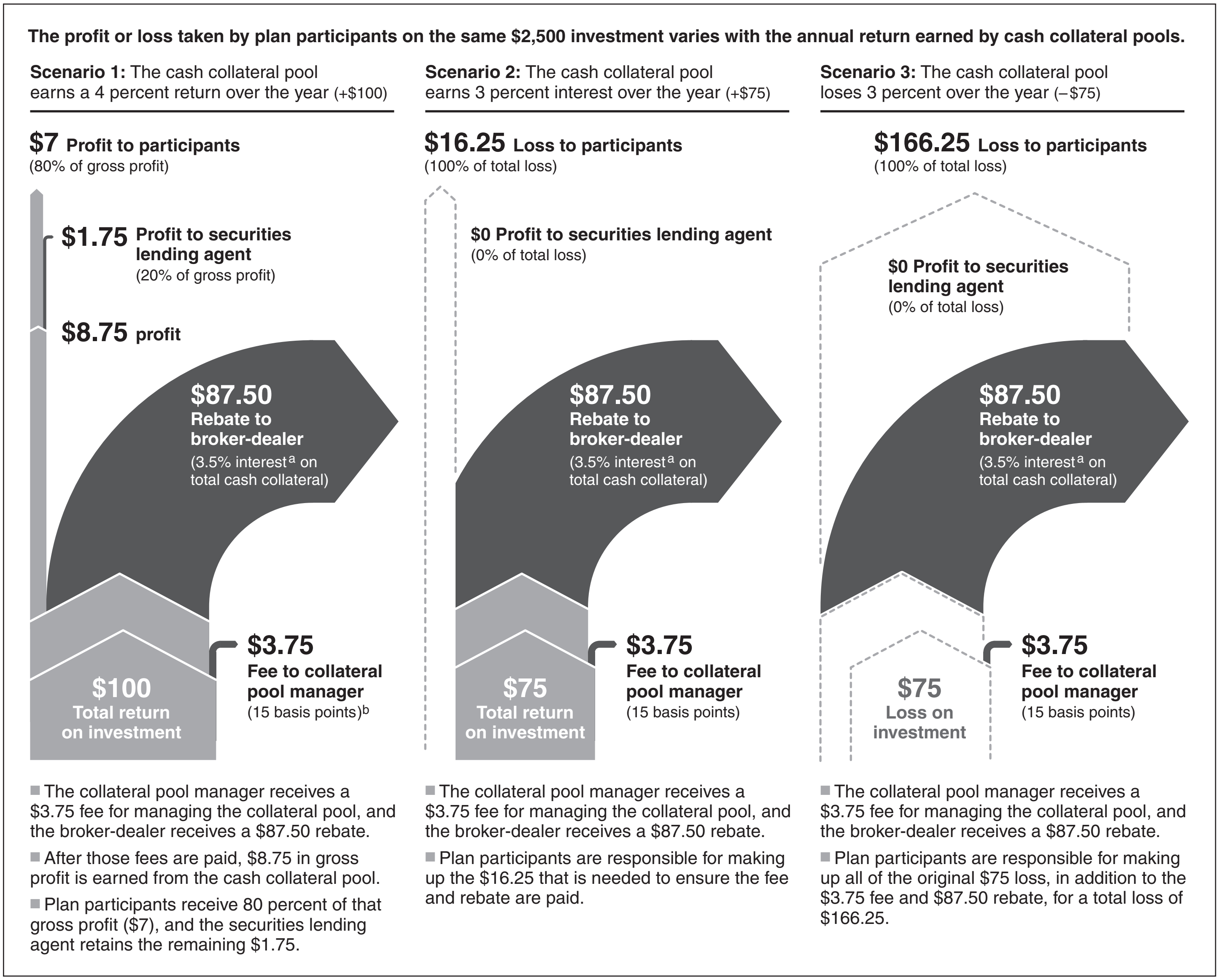
A direct securities lending arrangement works in a similar manner as an indirect securities lending arrangement, except that the plan sponsor or designated fiduciary has a more direct role. In a direct securities lending arrangement, such as when a plan offers an index fund through a separate account 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.

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.

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,

- 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.

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.

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.

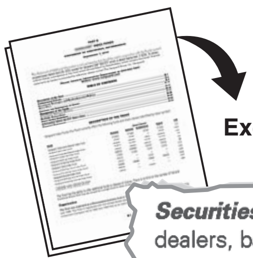
More Transparency and Disclosure May Help Plan Participants and Plan Sponsors Face Challenges with Securities Lending with Cash Collateral Reinvestment

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.[32] 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.

[32]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.

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 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.

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.

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.

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.

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.

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.

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.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548