New York, N.Y. 10004 (212) 747-7000

Salomon Brothers

SECURITIES AND EXCHANGE COMMISSION
RECEIVED

APR 17 1972

DIVISION OF CORPORATE REGULATION

April 12, 1972

Alan Rosenblat, Esq.
Chief Counsel
Division of Corporate Regulation
Securities and Exchange Commission
Washington, D. C. 20549

Dear Alan:

Pursuant to our telephone conversation last week I am writing this letter to request clarification of your published response to the letter from State Street Bank & Trust Company of November 3, 1971, concerning loans of portfolio securities by mutual funds. Salomon Brothers is a major borrower of securities, which we use primarily for delivery to purchasers when we have sold short for our own account or for a customer, or when a customer or other broker-dealer has failed to deliver the same security to us.

The fourth condition in your letter was that "the mutual fund receives reasonable interest on such a loan.... " The economic incentive for a mutual fund to lend its portfolio securities is the extra return that it can earn by investing the cash collateral in treasury bills or other money market securities. If the mutual fund also receives any interest, dividends or other distributions on the securities loaned, is the return that it earns on the invested cash collateral sufficient, or must it also receive additional interest from the borrower of the securities? An additional interest payment by the borrower might be construed as a rebate if it does any business in listed stocks with the mutual fund.

The sixth condition in your letter was that "the fund retains voting rights on the loaned securities." As I mentioned at the outset, we borrow securities for redelivery to third persons. Indeed, any other use of the securities might disqualify the cash collateral from the exemption in Section 220.6(h) of Regulation T when that section is relied upon for a margin exemption. The third person will be the new record holder of the security, and the voting rights must pass with the redelivery to the third person. Consequently, a requirement that voting rights be retained by the mutual fund, if strictly construed, would make it impossible for mutual funds to loan their securities and earn a riskless extra return on their portfolios. I do not however, believe that it is necessary to construe that requirement strictly. The standard stock loan agreement would allow the mutual fund to recall the securities at any time on short notice. Our standard stock loan

Act ICA-40
Section 17(f)
Rule
Public Availability 9/29/72

agreement provides for six business days notice. More time than that usually elapses between the announcement of a regular or special shareholders meeting and the record date for voting. If the mutual fund wishes to vote the shares, it can merely recall the loaned stock for that purpose. Thus, its voting rights are already adequately protected.

I should appreciate any clarification that you can furnish on the two points mentioned. It is clearly in a mutual fund's interest to be able to earn an extra return on its portfolio securities that is essentially riskless because of the full cash collateral and mark-to-the-market arrangements. It is also in the public interest for firms such as ours not to be prevented from contributing to market depth and liquidity because we are unable to borrow securities to make short sales in market making, block positioning and arbitrage transactions. The same public interest exists in providing an additional supply of securities so that every fail to receive does not also become a fail to deliver. If the two points raised in this letter can be clarified, both the interest of the mutual funds themselves and the public interest will be furthered.

We hereby waive the waiting period before this letter and your response can become public information.

Sincerely,

Don

Donald M. Feuerstein
Counsel

DMF:ls

The following is a clarification of my interpretation dated December 27, 1971 as to whether the Investment Company Act of 1940 prohibits a mutual fund from lending its portfolio securities.

Guideline (4) of my interpretation: "reasonable interest on such loan" could include the fund's investing the cash collateral in high yielding short-term investments which give maximum liquidity to pay back the borrower when the securities are returned. The type of investment for the cash collateral is a decision for directors of the fund and should not be delegated to anyone unless such person serves as an investment adviser under a contract meeting the requirements of Section 15 of the Investment Company Act. Guideline (6): While not taking any position on your interpretation of Section 220.6(h) of Regulation T, we would not object if voting rights pass with the lending of portfolio securities. However, this does not relieve the directors of a fund of their fiduciary obligation to vote proxies. If the fund management has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies.

Alan Rosenblat

Alan Rosenblat, Chief Counsel
Division of Corporate Regulation
Securities and Exchange Commission
May 23, 1972 - GHB:hb