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Securities Lending Alert

A report for clients and friends of the firm

November 2002

Proposed SEC Exemption Precludes Push-out for Securities Lending Activities of Non-custodial and Conduit Bank Lenders

Much has been written about the uncertainty created by the "push out" provisions of the Gramm- Leach-Bliley Act as it relates to non-custodial securities lending by banks (see Securities Lending Alert of May 2002 and the article by Charles E. Dropkin in the October 2000 issue of Banking and Financial Services entitled "Banks as Securities Lending Agents: To Register or Not as a Broker"). To briefly recap, Gramm-Leach-Bliley exempts from the definition of "broker" under the Securities Exchange Act a bank engaged in securities lending activities as agent in connection with custody, safekeeping, and certain securities clearing services. This exemption applies to banks' securities lending transactions "on behalf of customers as part of [custody or clearance] services provided to customers." The issue is whether "customers" means customers in general or only those customers to whom custody and clearance services are actually being provided by the bank when it is lending securities.

The SEC has just published a proposed rule which exempts from the definition of "broker" banks engaging in non-custodial securities lending as agent and exempts from the definition of "dealer" banks engaging in certain custodial and non-custodial securities lending activities as principal. The exemption is limited to transactions with "qualified investors," which is construed as any corporation, company, partnership, or other entity (such as a trust or a foreign-based pension plan) that owns and invests on a discretionary basis not less than $25 million in investments.

The exemption applies both where the bank acts as a traditional securities lending agent and where it acts as a "conduit lender." Conduit lender activities are akin to those of a riskless principal and are defined to mean situations where a bank borrows (or loans) securities as principal for its own account and contemporaneously loans (or borrows) the same securities as principal for its own account. The bank that qualifies as a conduit lender at the commencement of a transaction continues to have that character as long as the original securities lending transaction remains outstanding, notwithstanding that substitution of collateral may have occurred on the securities borrowing side of the transaction. The exemption does not protect a bank which lends or borrows securities on its own behalf for hedging or other reasons. Hedging transactions may or may not require push-out to a dealer and, as a threshold matter, will depend on whether the bank is "engaged in the business" of performing this activity "as part of a regular business." This is often referred to as the dealer/trader distinction -- dealers (i.e., persons who are engaged in the business of buying and selling securities for their own account as part of a regular business) have to register as such with the SEC whereas traders (i.e., persons who do not make markets or otherwise conduct professional market activities such as rendering investment advice or arranging credit) do not.

In its release, the SEC stated that it did not propose conditions to the exemption that would require banks to conform to standards applicable to registered broker-dealers that engage in securities lending transactions, such as Rule 15c3-3 under the Exchange Act. The SEC noted that "we are proposing an exemption because we believe it will assist institutional investors in obtaining stock loan services for banks that do not act as their custodians . . . [and it] is appropriate to the public interest and is consistent with the protection of investors because it is limited to qualified investors." Comments on new proposed Exchange Act Rule 15a-11 are due by December 5, 2002. In the meantime, the SEC, by separate order, extended until February 12, 2003 the current exemption from the definition of "dealer" provided in Exchange Act Rules 15a-7 and 15a-9 (the SEC had previously indicated that, until May 12, 2003, banks would continue to be exempted under the Exchange Act with respect to the definition of broker).

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Client Alert

Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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