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Client Alert

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April 2006

FinCEN and SEC Offer Guidance on Customer Identification Program for Securities Loans

On April 25, 2006, the Financial Crimes Enforcement Network ("FinCEN") and the Securities and Exchange Commission ("SEC") issued written guidance ("Guidance") regarding the scope of "customers" under the applicable customer identification ("CIP") rule issued jointly by the U.S. Department of the Treasury and the SEC pursuant to the Agency Lending Disclosure ("ALD") initiative.

The Guidance concludes that where a broker-dealer borrows securities from an agent lender (a U.S. bank or broker-dealer acting on behalf of its clients), the "customer" of the broker-dealer as borrower for purposes of the CIP rule is the agent lender and *not* the agent lender's customer. The Guidance states that a broker-dealer is not required to look through to the real party in interest *(i.e.*, the actual securities owner/lender which is the client of the agent lender) but is only required to verify the identity of its named accountholder, which is the agent lender who executes the master securities lending agreement with the broker-dealer.

It was noted that in a typical securities lending transaction, the borrower does not know the specific identity of the agent lender's customer until after the terms of the loan have been agreed to and accepted. In practice, the broker-dealer as borrower typically records the loan transaction in an account of the name of the agent lender. The identity of the agent lender's customer whose securities are the subject of loan to the broker-dealer as borrower is generally disclosed at the end of the day or the next business day to limited personnel of the broker-dealer who are responsible for credit risk and regulatory capital reporting.

While the Guidance makes CIP compliance easier for the broker-dealer as borrower, it does somewhat mask the realities of the transaction. Although a broker-dealer may initially record the loan transaction in an account in the name of the agent lender, the party to whom the broker would have recourse in the event of a loan default would not be the agent lender but rather the agent lender's customer whose securities were loaned out. Especially in the aftermath of *Drysdale* (in the repo context), agents are now careful to make sure that they are not acting for undisclosed principals when dealing with counterparties. Securities lending programs are generally designed so that the borrower knows that the securities owner/lender is one of the entities listed on a schedule that is given to the borrower by the agent lender, with the identity of the specific lender being disclosed subsequent to conclusion of loan negotiation. In this way, the agent lender acts as an agent for a partially disclosed principal under applicable law and does not assume liability as a principal.

The Guidance should be welcomed by broker-dealers as borrowers because of the greater certainty and reduced burden it provides in connection with CIP responsibilities under the ALD. By the same token, agent lenders will need to make sure of their compliance with applicable know-your-customer rules.

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