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Securities Lending Alert

A report for clients and friends of the firm

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The SEC recently approved publishing for comment a change to Rule 15c3-3 under the Securities Exchange Act to expand the permissible categories of collateral that broker-dealers may pledge when borrowing from customers fully paid and excess margin securities. At the present time, permissible collateral is limited to cash, U.S. Treasury bills and notes, or irrevocable bank letters of credit. The amendment would allow such other collateral as the Commission by order would designate based on the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness. Current collateral requirements in Rule 15c3-3 make it more cost-effective for broker-dealers to borrow securities from other broker-dealers (which are not customers) because customers must be provided with the limited range of collateral. Expanding the categories of collateral would be expected to increase the supply of eligible lenders, which decreases costs due to enhanced competition. In addition, because customers will have the opportunity to enter into more lending transactions with broker-dealers, the resulting increased opportunities to borrow and lend securities should add liquidity to the securities lending markets.

The SEC will be specifically soliciting comment on the following ten new categories of collateral. The SEC will be seeking comment, as well, regarding the 1% and 5% over-collateralization requirements for cross-currency transactions and will consider whether there should be any limitations on securities borrowings by broker-dealers from institutional customers. The additional categories of collateral would include:

1. "Government securities" as defined in Section 3(a)(42)(A) and (B) of the Securities Exchange Act may be pledged when borrowing any securities.

2. "Government securities" as defined in Section 3(a)(42)(C) of the Securities Exchange Act issued or guaranteed as to principal or interest by the following corporations may be pledged when borrowing any securities: (i) the Federal Home Loan Mortgage Corporation, (ii) the Federal National Mortgage Association, (iii) the Student Loan Marketing Association, and (iv) the Financing Corporation.

3. Securities issued by, or guaranteed as to principal and interest by, the following Multilateral Development Banks — the obligations of which are backed by the participating countries, including the U.S.— may be pledged when borrowing any securities: (i) the International Bank for Reconstruction and Development, (ii) the Inter-American Development Bank, (iii) the Asian Development Bank, (iv) the African Development Bank, (v) the European Bank for Reconstruction and Development, and (vi) the International Finance Corporation.

4. Mortgage-backed securities meeting the definition of a "mortgage related security" set forth in Section 3(a)(41) of the Securities Exchange Act may be pledged when borrowing any securities.

5. Negotiable certificates of deposit and bankers' acceptances issued by a "bank" as that term is defined in Section 3(a)(6) of the Securities Exchange Act, and which are payable in the United States and deemed to have a "ready market" as that term is defined in 17 CFR 240 15c3-1 ("Rule 15c3-1"), may be pledged when borrowing any securities. (Basically, federally regulated banks with investment grade ratings or shareholders' equity of $400 million.)

6. Foreign sovereign debt securities may be pledged when borrowing any securities, provided that, (i) at least one nationally recognized statistical rating organization ("NRSRO") has rated in one of its two highest rating categories either the issue, the issuer or guarantor, or other outstanding unsecured long-term debt securities issued or guaranteed by the issuer or guarantor; and (ii) if the securities pledged are denominated in a different currency than those borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3-3 (100%) by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

7. Foreign sovereign debt securities that do not meet the NRSRO rating condition set forth in Item 6 above may be pledged only when borrowing non-equity securities issued by a person organized or incorporated in the same jurisdiction (including other debt securities issued by the foreign sovereign); provided that, if such foreign sovereign debt securities have been assigned a rating lower than the securities borrowed, such foreign sovereign debt securities must be rated in one of the four highest rating categories by at least one NRSRO. If the securities pledged are denominated in a different currency than those borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3-3 by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

8. The Euro, British pound, Swiss franc, Canadian dollar or Japanese yen may be pledged when borrowing any securities, provided that, when the securities borrowed are denominated in a different currency than that pledged, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3-3 by 1%.

9. Foreign currency other than the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen may be pledged only when borrowing non-equity securities denominated in the same currency.

10. Non-governmental debt securities may be pledged when borrowing any securities, provided that, in the relevant cash market they are not traded flat or in default as to principal or interest, and are rated in one of the two highest rating categories by at least one NRSRO. If such securities are not denominated in U.S. dollars or in the currency of the securities being borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3-3 by 1% when the securities pledged are denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when they are denominated in any other currency. (*E.g.*, corporate debt rated AAA or AA can be pledged.)

Liberalization of collateralization by the SEC might also spur the Department of Labor to expand the scope of permissible collateral which ERISA securities lenders are able to receive under Prohibited Transaction Exemption 81-6.

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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.

Charles E. Dropkin

Proskauer is an international law firm with more than 540 attorneys who handle a full spectrum of legal issues worldwide.