

Client Alert

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DOL Issues Final Class Exemption for Securities Lending

Last week, the U.S. Department of Labor (the "DOL") issued final Prohibited Transaction Class Exemption 2006-16, which permits certain loans of securities by employee benefit plans to parties in interest (the "Exemption"). The Exemption both consolidates and incorporates the conditions of the DOL's previous securities lending class exemptions (PTCEs 81-6 and 82-63) including required daily marking to market, the provision of borrower audited financial statements, and T+5 settlement, and expands the scope of those exemptions, most notably to cover certain foreign securities lending transactions. The underlying premise of the Exemption – that neither the borrower nor any affiliate has or exercises discretionary authority or control with respect to the investment of plan assets involved in the securities lending transaction – remains intact. The Exemption becomes effective on January 2, 2007. The revocation of PTCEs 81-6 and 82-63 is effective on the same date.

General Conditions

Most of the core provisions of the Exemption remain unchanged from PTCE 81-6. A significant addition to this part of the Exemption is the new collateralization requirements that apply in connection with loans of securities (regardless of whether the borrower is a U.S.-based or foreign entity).

The collateralization requirements for securities loans differ depending on whether the collateral and the securities lent are denominated in the same currency, with higher collateral levels required where currencies differ. Under a special rule, however, these higher collateralization levels can be reduced if the lending fiduciary is a U.S. bank or broker-dealer that indemnifies the plan with respect to any difference between the replacement cost of the borrowed

securities and the market value of the collateral on the date of a borrower default.

The collateralization requirements for securities loans under the Exemption are:

Collateral	Requirement where no Lending Fiduciary Indemnification	Requirement if U.S. Lending Fiduciary Indemnifies
U.S. Collateral	100% of the then market value of the securities lent	100% of the then market value of the securities lent
Foreign Collateral, if same currency as securities lent	102% of the then market value of the securities lent	100% of the then market value of the securities lent
Foreign Collateral, if different currency than securities lent, provided currency is Euro, British Pound, Japanese Yen, Swiss Franc or Canadian Dollar ("Favored Currency")	105% of the then market value of the securities lent	101% of the then market value of the securities lent
Foreign Collateral, if different currency than securities lent and currency not Favored Currency	105% of the then market value of the securities lent	105% of the then market value of the securities lent

Although the DOL considered expanding the definitions of "U.S. Collateral" and "Foreign Collateral" to include all categories of types permitted under Rule 15c3-3 of the Securities Exchange Act of 1934 (the "Exchange Act"), the DOL was unable to

conclude that this would be sufficiently protective of participants and beneficiaries if a borrower were to default.

Nevertheless, in defining the term “U.S. Collateral,” the DOL clarified that the exemption includes “government securities,” as defined in Sections 3(42)(A) and (B) of the Exchange Act, as well as government securities as defined in Section 3(42)(C) of the Exchange Act issued or guaranteed as to principal and interest by the Federal Home Mortgage Corporation, the Federal National Mortgage Corporation, the Student Loan Marketing Association, or the Financing Corporation. (In contrast, PTCE 81-6 referred broadly to “securities issued or guaranteed by the United States Government or its agencies.”) “U.S. Collateral” has also been broadened to include certain mortgage-backed securities and readily marketable negotiable certificates of deposit and bankers acceptances payable in the U.S. Equity securities and other fixed income securities are excluded as collateral.

“Foreign Collateral” is generally limited to the following types of securities:

- 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 United States: The International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development and the International Finance Corporation.
- foreign sovereign debt securities, provided that at least one nationally recognized statistical rating organization has rated in one of its two highest categories either the issue, the issuer or guarantor.
- the British Pound, the Canadian Dollar, the Swiss Franc, the Japanese Yen or the Euro.
- irrevocable letters of credit issued by a foreign bank, other than the borrower or an affiliate thereof, which has a counterparty rating of investment grade or better as determined by a nationally recognized statistical rating organization.
- any type of collateral described in Rule 15c3-3 of the Exchange Act so long as there is an indemnifying U.S. Bank or U.S. Broker-Dealer as lending fiduciary.

Specific Conditions for Loans to Foreign Banks and Foreign Broker-Dealers

In addition to the Exemption’s general conditions, if the borrower is a “Foreign Bank” or “Foreign Broker-Dealer,” the transaction must meet additional conditions (described below under the heading “Additional Conditions for Borrowers that are Foreign Banks or Foreign Broker-Dealers”). First, however, it is important to understand which entities may qualify as Foreign Banks and Foreign Broker-Dealers.

Definition of Foreign Bank and Foreign Broker-Dealer

To qualify as “Foreign Bank,” the institution must have, as of the last day of its most recent fiscal year, equity capital which is the equivalent of no less than \$200 million, and must be subject to:

- regulation by the Financial Services Authority in the United Kingdom or the Office of the Superintendent of Financial Institutions in Canada, or
- regulation by the relevant governmental banking agency(ies) of a country other than the United States, and the regulation and oversight of these banking agencies were applicable to a bank that received an individual prohibited transaction exemption relating to securities lending or a final authorization by the DOL to engage in an otherwise prohibited securities lending transaction pursuant to EXPRO expedited exemption procedure (PTCE 96-62).

“Foreign Broker-Dealer” means a broker-dealer that has, as of the last day of its most recent fiscal year, equity capital that is the equivalent of no less than \$200 million and is:

- registered and regulated under the laws of the Financial Services Authority in the United Kingdom, or registered and regulated by a securities commission of a Province of Canada that is a member of the Canadian Securities Administration and is subject to the oversight of a Canadian self-regulatory authority; or
- registered and regulated under the relevant securities laws of a governmental entity of a country other than the United States, which securities laws and regulation were applicable to a broker-dealer that received an individual prohibited transaction exemption relating to securities lending or a final authorization by the DOL to engage in an otherwise prohibited securities lending transaction pursuant to EXPRO (PTCE 96-62).

Additional Conditions for Borrowers that are Foreign Banks or Foreign Broker-Dealers

Where the borrower is a Foreign Bank or Foreign Broker-Dealer, the lending fiduciary must maintain the written documentation for the loan agreement within the jurisdiction of the U.S. courts. Furthermore, before entering into the transaction, the Foreign Bank or Foreign Broker-Dealer must agree to submit to U.S. jurisdiction, appoint an agent for service of process in the U.S. and agree to allow the plan to enforce its rights under the securities lending agreement in a U.S. court, *provided, however*, that submission to U.S. jurisdiction need not occur if the U.S. Lending Fiduciary provides indemnification.

Finally, if the Foreign Bank or Foreign Broker-Dealer is not regulated in the UK or Canada, the lending fiduciary must be a U.S. bank or U.S. broker-dealer that has agreed to provide an indemnity to the plan. The final terms of Exemption make clear that this indemnification requirement does not encompass losses arising out of the investment of the collateral by a lending fiduciary or other party.

Specific Conditions Relating to Arrangements with Lending Fiduciaries

Part IV contains an exemption from ERISA's self-dealing prohibited transaction rule (ERISA Section 406(b)(1)) for the payment to a lending fiduciary of compensation for services rendered in connection with loans of plan securities. The conditions of Part IV are similar to the conditions of PTCE 82-63 in all material respects.

Other Issues

In response to comments it received, the DOL clarified that the Exemption can be used in connection with securities loans that are structured as repurchase agreements. Here, the DOL cited to a commenter's observation that except for the difference in the form of the arrangements, a repurchase agreement contains all of the same information and substantive requirements that would be found in a typical Master Securities Lending Agreement. While this is economically true in "flat" transactions collateralized at 100%, it is not true in other situations. In a securities loan, the dominant commodity is the security, and the owner of the securities is often over-collateralized, receiving cash collateral in excess of 100% of the market value of the loaned securities. By contrast, in a repurchase agreement, the dominant commodity is cash and the owner of securities, as the cash borrower, typically receives cash in an amount less than that of the market value of the loaned securities, to reflect over-collateralization demanded by the money lender. The Exemption presumably should be limited to those repurchase agreements at 100% collateralization.

The DOL also stated in the preamble that the Exemption will apply to "fee-for-hold" arrangements, provided that all the other conditions of the Exemption are satisfied. The DOL described "fee-for-hold" arrangements as transactions where the borrower pays a fee in exchange for the guaranteed availability of a particular security for a specified period of time or until the arrangement is terminated by either party, *i.e.*, exclusive borrowing arrangements. This is a long overdue recognition of market practice.

Applicability of QPAM Exemption

Although not expressly addressed in the text of the Exemption, note that the transactions described in the Exemption are not available for relief under the "qualified professional asset manager" or "QPAM" exemption (PTCE 84-14). The QPAM exemption has always excluded transactions described in PTCE 81-6. When the DOL amended the QPAM exemption in August 2005, it clarified that this exclusion would also apply to any successors exemptions to PTCE 81-6, such as the Exemption.

Future Applicability of Exemption

In the preamble to the Exemption, the DOL explicitly acknowledged that a securities lending transaction would not have to satisfy the conditions of the Exemption if the transaction were otherwise exempt under the new statutory service provider exemption (ERISA Section 408(b)(17), added by the Pension Protection Act of 2006). It is difficult to predict whether and to what extent Section 408(b)(17) will render the Exemption superfluous. This will depend in large part on the DOL's regulations defining "adequate consideration" for purposes of Section 408(b)(17). Presumably, these regulations could provide additional flexibility for parties to engage in securities lending transactions permitted under the Exchange Act without having to comply with the relatively more stringent requirements of the Exemption.

However, in order for the payment of compensation to a lending fiduciary to be exempt from ERISA's self-dealing prohibited transaction rules, the compensation arrangement will still have to satisfy the conditions of the Exemption applicable to arrangements with the lending fiduciary, regardless of whether a securities loan is otherwise structured in accordance with the Exemption or Section 408(b)(17).

Observations on Indemnification

The Exemption is not consistent when describing the scope of the indemnity to be provided by a U.S. Lending Fiduciary. With respect to lessened collateralization requirements set forth in the above table, the Exemption describes the indemnity as "the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of the borrower default." In the definition of "Foreign Collateral," the Exemption,

when addressing the ability to accept any type of collateral described in Rule 15c3-3 of the Exchange Act, describes the indemnity as “the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default *plus interest and any transaction costs which a plan may incur or suffer directly arising out of a borrower default.*” When addressing the circumstances under which the provision of indemnity can avoid submission to U.S. jurisdiction by a Foreign Broker-Dealer or Foreign Bank, the Exemption proffers yet a third formulation of the indemnity, namely, “the difference, if any, between the replacement cost of the borrower securities and the market value of the collateral on the date of a borrower default *plus interest and any transaction costs (including attorney’s fees of such plan arising out of the default on the loan or the failure to indemnify properly under the provision) which the plan may incur or suffer directly arising out of a borrower default.*”

The differences in indemnity formulation (*i.e.*, the “plus” language) may cause a problem for U.S. bank lending fiduciaries under applicable risk-based capital guidelines for indemnified securities lending programs.

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