

# Securities Lending Alert

A report  
for clients  
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of the firm

February 2003

## SEC Adopts New Exemption for Securities Lending Transactions

The Gramm-Leach-Bliley Act provided for functional regulation of securities activities by eliminating the complete exception for banks from the definitions of "broker" and "dealer" and replacing them with specific transaction-based exceptions. Amending the statutory definitions created eleven "broker" and four "dealer" exceptions for banks. Because the exceptions from the definitions of "broker" and "dealer" are exceptions to the Securities Exchange Act of 1934, as amended, the SEC is statutorily charged with interpreting them. The SEC has just adopted Rule 15a-11, which creates a new exemption for securities lending transactions.

Rule 15a-11 largely reflects the proposed rule discussed in the Securities Lending Alert of November 2002. In brief, a bank is now exempt from the definitions of "broker" and "dealer" under the Securities Exchange Act to the extent that, as a conduit lender, or as an agent, it engages in or effects other securities lending transactions and any securities lending transaction services in connection with such transactions, with or on behalf of a person reasonably believed to be a "qualified investor" (i.e., any corporation, company, partnership, or other entity that owns or invests on a discretionary basis not less than \$25 million in investments) or any employee benefit plan that owns and invests on a discretionary basis not less than \$25 million in investments.

Rule 15a-11 applies to both traditional agency lending and third-party lending (where the lending bank is not the custodian of the loaned securities). The Rule also applies to activities of a bank in its capacity as a conduit lender (essentially matched riskless principal lending and borrowing transactions) but not to stand-alone (unmatched) transactions effected on the bank's own behalf for hedging or other purposes. The scope of permitted conduit lending was broadened to permit substi-

tutions of collateral to occur on both sides of the transaction (rather than only on the securities borrowing side of the transaction as originally proposed) and to permit counterparty substitution with respect to the underlying securities so long as this occurs within one business day following termination of the predecessor counterparty. The commentary accompanying the applicable SEC release makes it plain that so-called "term loans" are subsumed within the definition of "securities lending transaction" under the Rule. Finally, the SEC confirmed that it would not impose conditions that would require banks to conform their securities lending activities to the standards applicable to registered broker-dealers.

For purposes of Rule 15a-11, "*securities lending transaction*" means a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties. "*Securities lending services*" means:

- (1) Selecting and negotiating with a borrower and executing, or directing the execution of, the loan with the borrower;
- (2) Receiving, delivering, or directing the receipt or delivery of loaned securities;
- (3) Receiving, delivering, or directing the receipt or delivery of collateral;
- (4) Providing mark-to-market, corporate action, record-keeping or other services incidental to the administration of the securities lending transaction;
- (5) Investing, or directing the investment of, cash collateral; or
- (6) Indemnifying the lender of securities with respect to various matters.

"*Conduit lender*" means a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as

principal, for its own account. A bank that qualified under this definition as a conduit lender at the commencement of a transaction will continue to qualify, notwithstanding whether:

- (1) The lending or borrowing transaction terminates, so long as the transaction is replaced within one business day by another lending or borrowing transaction involving the same securities; and
- (2) Any substitutions of collateral occur.

This Rule takes effect on or about March 17, 2003.

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WASHINGTON BOCA RATON  
NEWARK PARIS**

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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**  
212.969.3535 - [cdropkin@proskauer.com](mailto:cdropkin@proskauer.com)

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**1585 Broadway  
New York, NY 10036-8299  
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**2049 Century Park East  
32nd Floor  
Los Angeles, CA 90067-3206  
310.557.2900**

**2255 Glades Road  
Suite 340 West  
Boca Raton, FL 33431-7383  
561.241.7400**

**1233 Twentieth Street NW  
Suite 800  
Washington, DC 20036-2396  
202.416.6800**

**One Newark Center  
18<sup>th</sup> Floor  
Newark, NJ 07102-5211  
973.274.3200**

**68, rue du Faubourg Saint-Honoré  
75008 Paris, France  
331.53.05.60.00**

You can also visit our Website at [www.proskauer.com](http://www.proskauer.com)

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