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Securities Lending Alert

A report for clients and friends of the firm

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DOL Proposes Class Exemption To Permit Securities Lending To Certain Foreign Broker-Dealers and Banks And To Permit Pledge Of Certain Foreign Collateral

The Department of Labor ("DOL") has published a proposal with respect to PTE 81-6. Currently, under PTE 81-6, employee benefit plans are limited to securities lending transactions in which a plan loans securities to a U.S. broker-dealer or a U.S. bank which is a party in interest to the plan. Only collateral consisting of cash, securities issued or guaranteed by the United States Government or its agencies or instrumentalities, or irrevocable bank letters of credit may be accepted by the plan. The DOL has now proposed to expand the scope of PTE 81-6 to encompass foreign broker-dealers and foreign banks and to allow plans to accept additional forms of collateral. Existing PTE 82-63 (dealing with compensation to the lending fiduciary) and PTE 81-6 would be merged and replaced by a new class exemption.

As proposed, assets of an employee benefit plan could be lent to a "Foreign Broker-Dealer" or a "Foreign Bank," in addition to U.S. Banks and U.S. Broker-Dealers. The term "Foreign Broker-Dealer" means a broker-dealer registered and regulated under the laws of the Financial Services Authority in the United Kingdom that has, as of the last day of its most recent fiscal year, equity capital which is equivalent to no less than $200 million. The term "Foreign Bank" means an institution having substantially similar powers to a bank as defined in Section 202(a)(2) of the U.S. Investment Advisers Act, is subject to regulation by the Financial Services Authority in the United Kingdom and has, as of the last day of its most recent fiscal year, equity capital which is equivalent to no less than $200 million.

Both U.S. Broker-Dealers and U.S. Banks, and Foreign Broker-Dealers and Foreign Banks, may pledge "Foreign Collateral." The term "Foreign Collateral" means the currency of the United Kingdom, Euros, securities issued or guaranteed by the Government of the United Kingdom or one of its agencies or instrumentalities, sovereign debt of a member country of the European Monetary Union that is denominated in Euros, or 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. Foreign Collateral may be maintained on behalf of a plan in a regulated foreign securities depositary or clearing agency acting as a securities depositary.

Collateral may be denominated in a currency different than that of the underlying loaned securities. If U.S. Collateral is received, it must have a value equal to not less than 100% of the market value of the securities lent. If Foreign Collateral is received, the lender must receive either (i) 102% of the value of the loaned securities if the collateral posted is denominated in the same currency as the securities lent or (ii) 105% of the market value of the securities lent if the collateral posted is denominated in a different currency than the securities lent. (Apparently,

if U.S. Collateral is received in respect of a loan of non-US dollar-denominated securities, the required collateralization level is 100%, notwithstanding the exchange risk.) Daily marking to market to maintain the required collateralization level (100%, 102% or 105% determined as aforesaid) must occur; the higher requirements for Foreign Collateral loans will likely act as an impediment to use of such collateral.

Prior to making any loan to a permitted foreign borrower, the borrower must furnish to the lending fiduciary its most recent available audited statement of financial condition as audited by a firm which is eligible for appointment as a company auditor under the laws of the United Kingdom. Such borrower must also represent that, at the time any loan is negotiated, there has been no material adverse change in its financial condition since the date of the most recent financial statement furnished to the plan that has not been disclosed to the lending fiduciary.

Foreign borrowers would be required to submit to the jurisdiction of the United States (and appoint an agent for service of process in the United States), or, as an alternative, the lending fiduciary (the securities lending agent) may, if domiciled in the United States, agree to indemnify each plan against any shortfall in the collateral or losses incurred by the plan arising from a foreign borrower's default, plus interest and any transaction costs incurred (including attorney's fees). The scope of the indemnity is not spelled out, although for purposes of bank capital computation, any indemnity must not include losses from cash collateral reinvestment in order to take advantage of capital relief provisions.

Comments to the proposal are sought by December 8, 2003. In particular, the DOL seeks information on whether broker-dealers and banks in countries other than the United Kingdom are subject to a scheme of regulatory oversight comparable to that found in the United States so that the definition of Foreign Broker-Dealer and Foreign Bank might be broadened. In this regard, it is hoped that the DOL consults with the Federal Reserve Board which, pursuant to its responsibilities under the Foreign Bank Supervisory Enhancement Act, has already made determinations as to the comprehensiveness of regulation of banks in many foreign jurisdictions.

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