

clients are often required to borrow the securities needed to engage in such short selling activity. Accordingly, one of the services that the Prime Brokerage Clients seek is the ability to borrow the required securities from their prime broker. This, in turn, frequently causes the prime broker to borrow the required securities on the institutional securities lending market from lenders such as the Client Plans. It is represented that a significant component of the institutional securities lending market consists of the lending of securities to broker-dealers who require such securities in order to meet the short selling needs of their prime brokerage clients.

As noted above, one of State Street's Affiliated Broker Dealers proposes to provide prime brokerage services to its Prime Brokerage Clients. Eventually, this Affiliated Broker Dealer intends to self-clear all of the securities transactions (including the securities borrowing and lending transactions) required of a prime broker. It is represented that, at that time, the Affiliated Broker Dealer anticipates that it will borrow the required securities on the institutional lending market, including borrowing such securities from the Client Plans, pursuant to PTE 97-63.²

It is represented that the Affiliated Broker Dealer will not initially have all of the administrative and back-office capability required to perform such self-clearing functions. As a result, until these functions and capabilities are developed, the Affiliated Broker Dealer will limit its role to acting as Introducing Broker for its Prime Brokerage Clients and will utilize a Clearing Broker to actually borrow securities to meet the Prime Brokerage Clients' short selling needs. It is represented that the Clearing Broker will be well-known within the industry as providing complete clearing services for introducing broker-dealers. It is further represented that the provision of such clearing services will be a core focus of such Clearing Broker's business.

It is represented that the Introducing Broker will select the Clearing Broker based on all of the relevant facts and circumstances, including such factors as the Clearing Broker's: (1) Financial stability; (2) ability to execute

effectively the trading activities of the Prime Brokerage Clients; (3) ability to meet such clients' needs for financing of margin transactions; (4) ability to meet such clients' needs to borrow securities to implement short selling strategies; (5) internal systems and controls; (6) reporting capabilities; and (7) credibility within the industry. It is represented that the Clearing Broker will be registered as a broker-dealer under the Security Exchange Act of 1934 and will satisfy all of the Securities Exchange Commission and NASD requirements for clearing brokers. In addition, the Clearing Broker will be required to have net capital at least equal to \$10 million.

As indicated above, it is anticipated that the Clearing Broker will frequently borrow securities to meet the Prime Brokerage Clients' short selling needs. To the extent that it is necessary for the Clearing Broker to borrow securities for this purpose, the Clearing Broker will act as a principal in borrowing the requisite securities from institutional lenders, such as the Client Plans. In this regard, the Applicants have requested relief that encompasses securities lending transactions, as described in PTE 97-63, and also encompasses securities lending transactions between the Client Plans and the Clearing Broker, in situations where an Affiliated Broker Dealer is acting as the Introducing Broker for the Clearing Broker, provided that certain conditions are satisfied.³

The Applicants have also requested relief for receipt of compensation by the Introducing Broker in connection with an arrangement with the Clearing Broker. In this regard, it is anticipated that the Introducing Broker will receive consideration from the Clearing Broker based upon the revenue generated by the Clearing Broker through its use of the securities borrowed from the Client Plans. The Applicants have provided the following example of how the cash flow would operate in the context of the interim transition period when both the Clearing Broker and the Introducing Broker are involved in a securities lending transaction covered by this exemption.

Example: Assume one of the Introducing Broker's Prime Brokerage Clients desires to borrow a particular security in order to consummate a short

sale. The Prime Brokerage Client contacts the Introducing Broker who, as agent for the Prime Brokerage Client, contacts the Clearing Broker. The Clearing Broker can satisfy the request (*i.e.*, lend the required securities) using: (A) Securities that the Clearing Broker already holds in its own inventory, (B) securities that the Clearing Broker borrows from GSL (*i.e.*, from the Client Plans) pursuant to its securities loan agreement with GSL, or (C) securities that the Clearing Broker borrows from some other securities lender.

Further, assume that the Clearing Broker elects to borrow the securities from GSL, pursuant to this proposed exemption, and that the loan is collateralized with cash. Under the applicable securities loan agreement, GSL will invest the cash collateral and will agree to pay the Clearing Broker a specified rate (the rebate rate) throughout the term of the loan. In turn, the Clearing Broker will loan the securities that it has just borrowed from GSL to the Introducing Broker's Prime Brokerage Client, will receive cash collateral from the Prime Brokerage Client, and will agree to pay the Introducing Broker, as agent for its Prime Brokerage Client, a rebate rate (typically lower than the rebate rate that the Clearing Broker will receive from GSL) with respect to the cash collateral throughout the term of the loan. The Introducing Broker will pay a portion of this rebate rate to its Prime Brokerage Client, retaining the difference as its compensation for serving as the Introducing Broker.

Utilizing hypothetical numbers for illustrative purposes, GSL might agree to pay the Clearing Broker a rebate rate of 200 basis points while the Clearing Broker in turn might pay the Introducing Broker, as agent for its Prime Brokerage Client, a rebate rate of 185 basis points of which the Introducing Broker might retain 5 basis points. Accordingly, if one assumes that GSL earns 250 basis points by investing the cash collateral during the term of the loan, GSL will pay 200 basis points to the Clearing Broker (leaving 50 basis points as the securities lending income to be split between the Client Plan and GSL). The Clearing Broker will, in turn, pay 185 basis points to the Introducing Broker, as agent for its Prime Brokerage Client, with 15 basis points remaining with the Clearing Broker as its compensation. Finally, the Introducing Broker will pay 180 basis points to its Prime Brokerage Client, with 5 basis points remaining with the Introducing Broker as its compensation.

The Applicants believe that the receipt of consideration by the

² The Department notes that the proposed exemption, if granted, will replace PTE 97-63. Accordingly, the Applicants must comply with the terms and conditions of this exemption, if granted, in order to obtain relief for securities lending transactions between Client Plans and an Affiliated Broker Dealer, acting as a prime broker for the Prime Brokerage Clients.

³ The Department, herein, is not providing relief for securities lending transactions engaged in by the Clearing Broker, beyond that available, pursuant to Prohibited Transaction Exemption 81-6 (PTE 81-6) (46 FR 7527, January 23, 1981, as amended at 52 FR 18754, May 19, 1987) and Prohibited Transaction Exemption 82-63 (PTE 82-63) (47 FR 14804, April 6, 1982); provided the condition of these class exemptions are satisfied.