

this test, and only one trade group urged us to relax this requirement. Because the definition closely tracks the statutory provision, we are retaining the current test.

We received no comments on the technical, clarifying changes that we proposed. First, we revised the definition of “predominantly originated” in Rule 3b-18(g) to expressly set forth the meaning of the term in the context of a syndicate of banks. Second, we substituted the definitions of “member” as it relates to the term “syndicate of banks” for the definition of “member of a syndicate of banks” found in Rule 3b-18(c). Third, we proposed a change to Rule 3b-18(c) to clarify that the affiliates of banks other than broker-dealer affiliates, also may originate the obligations in a pool of obligations issued by a syndicate of banks. We are adopting each of these amendments without substantive change.<sup>47</sup>

*C. Rule 15a-11—Exemption From the Definitions of “Broker” and “Dealer” for Banks Engaging in Securities Lending Transactions*

Institutional investors often place securities in custody with banks. These custodian banks effect and administer securities loans in return for an agreed fee. Banks also may engage in securities lending transactions when they do not have custody of the securities. A non-custodial securities lending arrangement permits a customer to divide custody and securities lending management between two expert entities. For example, a custodian may be selected for efficiency and low cost, while a lending agent may be selected for its ability to maximize the profitability of the portfolio.

Although banks play a role in both custodial and non-custodial securities lending transactions, the GLBA bank exceptions to the definitions of broker and dealer provide only one exception for securities lending and borrowing transactions. Exchange Act Section 3(a)(4)(B)(viii) addresses securities lending by custodian banks as an

exception to the definition of broker.<sup>48</sup> Under paragraph (cc) of this section, a bank is permitted, without being considered a broker, to effect securities lending or borrowing transactions by custodian banks with or on behalf of customers in two situations: (1) As part of the services provided to safekeeping and custody customers; and (2) when facilitating the transfer of funds or securities as a custodian or a clearing agency in connection with the settlement of customers’ transactions in securities.

We proposed the exemption in Rule 15a-11 in part because we had been advised that the existence of this limited statutory bank exception from the definition of broker creates uncertainty for banks that may engage in securities lending, or borrowing transactions without having custody of the underlying securities or in situations where a bank might meet the definition of dealer under the securities laws. To provide legal certainty to banks engaging in securities lending transactions, we proposed to add an exemption from the definition of broker for banks engaging in non-custodial securities lending activities as well as an exemption from the definition of dealer for banks engaging in certain custodial and non-custodial securities lending activities. This exemption was also intended to enhance legal certainty for banks that have custody of collateral or that have custody of the securities subject to a lending arrangement for less than the entire period of the stock loan.

Industry representatives advised our staff that banks’ primary role in securities lending transactions, whether operating with or without custody of the securities, is to act in an agency capacity.<sup>49</sup> Less frequently, banks may engage in securities lending as principal while acting as a conduit between the parties.<sup>50</sup> We did not propose extending the securities lending exemption to a bank borrowing securities for, or lending from, its own accounts, except as a conduit lender. For the purposes of this exemption, we proposed to define the term conduit lender as 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.<sup>51</sup> When banks conduct conduit transactions, they are conducting principal transactions that involve principal risk, including reliance by the counterparty on the creditworthiness of the bank.<sup>52</sup> We proposed that a bank that qualifies under our definition of a conduit lender at the commencement of a transaction would continue to qualify as long as the original securities lending transaction remains outstanding, even though substitutions of collateral may occur on the securities borrowing side of the transaction.

The proposed exemption required a written securities lending agreement, which would be any contract to conduct securities lending transactions on behalf of a qualified investor. In connection with a securities lending transaction, a bank may select and negotiate with a borrower and execute, or direct the execution of, the loan with the borrower; receive, deliver, or take custody of loaned securities; receive, deliver, or take custody of collateral; provide mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; reinvest, or direct the reinvestment of, cash collateral; or indemnify the lender of securities with respect to various matters.

We proposed to limit the exemption to transactions with “qualified investors,” as defined in Exchange Act Section 3(a)(54).<sup>53</sup> We proposed a requirement that a bank deal with a qualified investor on both sides of the transaction as a condition of this exemption because we are making this exemption available for banks’ current securities lending business. Broker-dealers are currently the most frequent borrowers of securities. We understand that borrowers of securities that are not qualified investors do not directly borrow securities from noncustodial banks. Any borrowers of securities that do not meet the qualified investor test generally borrow securities through

Section 103(n)(2) of the GLBA expressly provides that a firm is predominantly engaged in financial activities when at least 85% of the annual gross revenues of the consolidated company derive from financial activities, excluding any revenue from banks. To be consistent, we applied the same numerical test found in Section 103(n)(2) of GLBA for loan product originations for the purpose of the asset-backed securities exception from the definition of dealer.

<sup>47</sup> We are, however, making a technical amendment to paragraph (e) of the rule to conform the language in the definition of “originate” to include obligations of an affiliate of a bank, other than a broker-dealer affiliate within the broader reading of the term.

<sup>48</sup> 15 U.S.C. 78c(a)(4)(B)(viii).

<sup>49</sup> Under banking law, with some limited exceptions, banks are not permitted to own equity securities.

<sup>50</sup> See the Coalition of Banks’ Letter, which stated that by confirming that banks may continue to engage in securities lending as riskless principals, the proposed exemption will help ensure that institutional lenders can still achieve the benefits of credit intermediation and anonymity when lending through banks.

<sup>51</sup> This conduit role is similar to a riskless principal transaction, but does not involve activities that could be characterized as running a matched book. Running a matched book of repurchase agreements or other stock loans is a dealer activity because the “book running dealer” holds itself out as willing to buy and sell and thus as engaged in the business of buying and selling securities.

<sup>52</sup> This is not meant to indicate that an agent for an undisclosed principal would not also have direct personal liability to the parties with whom it dealt because the counterparty would be relying on the credit of the agent, rather than the principal. See Restatement (Second) of Agency § 322 (1958).

<sup>53</sup> See discussion at Section D, *infra*.