

intermediaries that would be qualified investors.

In the proposing Release, we specifically acknowledged that engaging in securities lending transactions involves taking risks that require effective internal controls, and highlighted the fact that we were not proposing a requirement that banks meet the conditions that are applicable to broker-dealers engaging in stock lending. We proposed an exemption for banks because we believe that it will assist institutional investors in obtaining stock loan services from banks that do not act as their custodians and because it would cause less disruption to the market if banks were permitted to continue to engage in these transactions.

#### 1. Discussion of Comments Received on the Amendment to Rule 15a-11—Exemption From the Definitions of “Broker” and “Dealer” for Banks Engaging in Securities Lending Transactions

Several commenters strongly supported the Commission for proposing the adoption of the exemption for securities lending to allow banks to continue engaging in custodial and non-custodial securities lending activities.<sup>54</sup>

One of these commenters specifically urged the Commission to adopt the securities lending exemption to provide banks with greater legal certainty in connection with their activities as custodians, clearing agents, and noncustodial agents or intermediaries, and in facilitating securities lending and borrowing transactions.<sup>55</sup> The same commenter also stated that by confirming that banks may engage in securities lending transactions regardless of whether they are also custodians or clearing agents, the proposed exemption will help ensure that institutional investors can continue to “unbundle” securities lending services from other bank services and obtain such services in the manner that best addresses their needs.<sup>56</sup>

The General Counsels, however, expressed the view that an SEC-granted exemption for non-custodial agency activities is unnecessary because the custody exception in Exchange Act Section 3(a)(4) is sufficiently broad to encompass situations where a bank acts as a non-custodial agent in securities lending transactions.<sup>57</sup> They stated that

the statute “protects securities lending services that a bank provides as agent and ‘as part of’ the bank’s custodial and safekeeping activities. They also stated that both the custodial and non-custodial securities lending services offered by banks have grown out of, and remain integrally related to, the custody business of banks and, thus, are offered ‘as part of’ customary custody services.”<sup>58</sup>

We disagree with the interpretation of the Exchange Act bank exceptions advanced in this comment letter. The exceptions found in the GLBA and the additional exemptions granted by the Commission apply to specific, qualifying transactions that permit banks to engage in these transactions without having to register as broker-dealers under the securities laws. The exceptions found in the GLBA and the additional exemptions granted by the Commission are limited by their terms to the transactions listed and do not extend to transactions that are related, incidental, or the economic equivalent of the transactions listed in an exception or exemption. They are also not activity-based exceptions and exemptions that should be read to include any related transactions that might be performed by the same employees that engage in transactions that are covered within the terms of the exceptions or exemptions.

Specifically, paragraph (cc) of Exchange Act Section 3(a)(4)(B)(viii) limits securities lending to two situations.<sup>59</sup> A bank is permitted, without being considered a broker, to effect securities lending or borrowing transactions: (1) As part of customary banking activities 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 as part of customary banking activities.

In response to the exemption we proposed, General Counsels advanced a general argument that no securities lending exemption was necessary, except with respect to conduit transactions. This argument fails to address the limits that Congress imposed on securities lending transactions within the custody exception, or to give effect to all of the terms found in the statutory provisions.

<sup>58</sup> *Id.*

<sup>59</sup> Exchange Act Section 3(a)(4)(B)(viii)(cc) [15 U.S.C. 78c(a)(4)(B)(viii)(cc)] provides that a bank may effect “securities lending or borrowing transactions with or on behalf of customers as part of services provided to customers pursuant to division (aa) or (bb)” or invest “cash collateral pledged in connection with such transactions.”

Thus, we believe that this argument disregards the plain meaning of the statute.

Moreover, the argument advanced by the General Counsels, even if we were to accept it, would not give banks legal certainty for engaging in securities lending transactions because the argument fails to address all of the uncertainty that banks have identified. For example, their interpretation would only permit a bank to be excepted from the definition of broker without having custody of the underlying securities when it invests cash collateral pledged in connection with a securities lending transaction. Their interpretation would not address any other actions the bank might take in connection with the securities lending transaction, and also would not address any transactions that would not be excepted from the bank definition of dealer. In contrast, we believe that our interpretation gives effect to all of the statutory provisions, and that the exemption we are adopting will permit banks to continue to engage in securities lending transactions with the legal certainty they requested.

Two commenters agreed with limiting the exemption to transactions with qualified investors.<sup>60</sup> In particular, a pension fund in support of the exemption stated that: “[a]s a supplier of securities for lending, CalPERS believes that a leveling of the playing field for non-custodial banks should lead to increased competition between custodial and non-custodial banks, expanded liquidity, greater trading efficiencies, and lower borrowing and execution costs. As a major institutional investor, CalPERS believes the limitation of the exemption to “qualified investors” ensures that the regulatory gap between banking law (concerned about bank solvency) and securities law (concerned about investor protection) has been successfully narrowed.”<sup>61</sup> The state securities administrators also specifically agreed with limiting the securities lending exemption to “qualified investors.”<sup>62</sup>

The General Counsels, however, stated that they believed that an exemption for conduit lending activities is appropriate but should not be limited to qualified investors.<sup>63</sup>

Although they conceded that the securities lending market is institutional in nature, they stated that the proposed “qualified investor” restriction is inconsistent with the statutory framework and should be deleted

<sup>54</sup> See the Coalition of Banks’ Letter, the NYCH Letter, the CalPERS Letter, the ICBA Letter, the NASAA Letter, the IIB Letter, and the ABA/ABASA Letter.

<sup>55</sup> See the Coalition of Banks’ Letter.

<sup>56</sup> See the Coalition of Banks’ Letter.

<sup>57</sup> See the General Counsels’ Letter.

<sup>60</sup> See the CalPERS Letter and the NASAA Letter.

<sup>61</sup> See the CalPERS Letter.

<sup>62</sup> See the NASAA Letter.

<sup>63</sup> See the General Counsels’ Letter.