

SCHWARTZ & BALLEN
1990 M STREET, N.W. · SUITE 500
WASHINGTON, DC 20036-3418

(202) 776-0700

FACSIMILE
(202) 776-0720

schwartzandballen.com

MEMORANDUM

November 7, 2002

To Our Clients and Friends

Re: Broker-Dealer Exemptions for Banks

The Gramm-Leach-Bliley Act (“GLBA”) narrowed the general exemption banks had from the definitions of broker and dealer under the Securities Exchange Act of 1934 (the “Exchange Act”) but did specify certain situations under which banks would be granted an exception.¹ The Securities and Exchange Commission (“SEC”) is statutorily charged with interpreting these exceptions. On May 11, 2001 the SEC adopted interim final rules (the “Rules”) to define certain key terms used in these exceptions and requested comment on its rules. Based on comments received, the SEC is now proposing modifications to the Rules. Comments on the proposed rule are due December 5. In connection with its proposal, the SEC has extended a temporary exemption from the definition of the term “dealer” until February 10, 2003.

THE *DE MINIMIS* EXEMPTION FOR RISKLESS PRINCIPAL TRANSACTIONS

The GLBA does not provide an exception from the definition of “dealer” for riskless principal transactions.² However, under the Rules, riskless principal transactions are “dealer” transactions, and banks are allowed to use the *de minimis*

¹ The GLBA bank “dealer” exceptions are: 1) investment transactions (permits banks to buy and sell securities for investment purposes for the bank and for its customers’ trustee and fiduciary accounts); 2) permissible securities transactions (permits banks to buy and sell exempted securities, certain Canadian government obligations, and Brady bonds); 3) identified banking products (permits banks to buy and sell certain “identified banking products,” as defined in Section 206 of the GLBA); and 4) asset-backed transactions (permits banks through a grantor trust or other separate entity to issue and sell to qualified investors certain asset-backed securities representing obligations predominantly originated by a bank, an affiliate of the bank other than a broker-dealer, or a syndicate in which the bank is a member for some types of products.)

² “Riskless principal” transactions are generally described as trades in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction.

SCHWARTZ & BALLEN

transaction exception contained in the Exchange Act for these transactions. (The *de minimis* exception exempts a bank from the definition of broker if the bank effects no more than 500 securities transactions per calendar year, other than transactions that qualify for one of the other statutory exceptions).

The SEC is amending the way transactions would be counted against the 500 transaction limit by counting a riskless principal transaction (when combined with certain agency transactions), even if the transaction involves two separate counter-parties, as one transaction rather than as two.

DEFINITION OF TERMS USED IN ASSET-BACKED TRANSACTION EXCEPTION

The asset-backed transaction exception contained in the GLBA permits a bank to create, issue, and sell through a grantor trust or other separate entity asset-backed securities predominantly originated by the bank and its affiliates. Under the Rules the term “predominantly originated” means that a bank can engage in the issuance or sale of asset-backed securities without registering as a dealer if at least 85% of the obligations underlying the securities were originated by the bank or its affiliates, other than broker-dealer affiliates.

The SEC is proposing to expand the definition of “originated” to include assets purchased by defining “originated” as:

- Funding an obligation at the time that the obligation is created; or
- Initially approving and underwriting the obligation, or initially agreeing to purchase the obligation, provided that;
 - The obligation conforms to the bank’s underwriting standards or is evidenced by the bank’s own loan documents; and
 - The bank funds the obligation in a timely manner, not to exceed six months after the obligation is created.

The Rules will continue to consider 85% as the test for “predominantly.” However, the SEC is redefining the term “member of a syndicate of banks” to make it clear that banks may join together for the purpose of issuing securities backed by the pool of obligations, rather than having to join together before the obligations are created.

The SEC is proposing to retain the requirement that when a syndicate of banks issues asset-backed securities, each bank in the syndicate (and its affiliates) that actively sells the securities must have originated at least 10% of the value of the pool of obligations backing the securities.

SCHWARTZ & BALLEN

EXEMPTION FROM THE DEFINITIONS OF “BROKER” AND “DEALER” FOR BANKS ENGAGING IN SECURITIES LENDING TRANSACTIONS.

The SEC is proposing to add an exception from the definition of broker for banks engaging in non-custodial securities lending activities as well as an exception from the definition of dealer for banks engaging in certain custodial and non-custodial securities lending activities. The exemption, which is not contained in the GLBA, would:

- be limited to transactions with “qualified investors”³
- require a written securities lending agreement, which would be any contract to conduct securities lending transactions on behalf of a qualified investor under which the 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 or 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.

The proposed rule can be found at <http://www.schwartzandballen.com/WhatsNew.htm>.

If you have any questions concerning the proposed rule, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.

³ A “qualified investor” is defined in § 3(a)(54) of the Exchange Act.