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**M E M O R A N D U M**

February 28, 2003

To Our Clients and Friends

Re: SEC Final Rule: Exceptions for Banks As Dealers and Brokers

The Securities and Exchange Commission (“Commission”) has issued a final rule addressing certain of the exceptions for banks from the terms “brokers” and “dealers” that were added to the Securities Exchange Act of 1934 (“Exchange Act”) by the Gramm-Leach-Bliley Act (the “GLB Act”). Specifically, the final rule

- Amends the *de minimis* exemption for riskless principal transactions;
- Broadens the definition of terms used in the asset-backed transaction exception; and
- Adds an exemption for banks engaging in securities lending transactions.

While the rule is effective March 26<sup>th</sup>, banks are required to comply with the final rule by September 30<sup>th</sup>.

**GENERAL EXCEPTIONS**

The GLB Act provides four exceptions to banks from the definition of “dealer”:

- Permits the purchase and sale of securities for investment purposes and for customer trust and fiduciary accounts;
- Permits the purchase and sale of exempted securities, certain Canadian government obligations and Brady bonds;
- Permits the purchase and sale of certain banking products as defined in section 206 of the GLB Act; and
- Permits banks through a grantor trust or other entity to issue and sell to qualified investors certain asset-backed securities.

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### **RISKLESS PRINCIPAL TRANSACTIONS**

In addition to the above exceptions, the Commission also exempts a bank from the definition of dealer if it effects no more than 500 securities transactions per calendar year as riskless principal. A riskless principal transaction will count as only one transaction even if it involves two separate counterparties. In computing the 500 transactions per year, a bank will be required to include transactions it engages in as an agent for a customer as well as those in which it acts as riskless principal.

### **ASSET-BACKED TRANSACTIONS**

The GLB Act 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 (*i.e.*, 85%) by a bank, an affiliate of the bank other than a broker-dealer, or a syndicate in which bank is a member for some types of products. The exception does not permit banks to “deal in” asset-backed securities.

The Commission expands the definition of “originated” by considering obligations that a bank initially approves and underwrites, or agrees to purchase, to be “originated” by the bank as long as the obligation conforms to the bank’s underwriting standards and as long as the obligation is funded in a timely manner, not to exceed six months after the obligation is created.

The Commission further clarified the definition of “member of a syndicate of banks” to make clear that the individual banks and their affiliates other than their broker or dealer affiliates, originate the obligations, rather than the syndicate. The purpose of the syndicate must be limited to issuing and selling the obligations, not originate the obligations.

### **EXEMPTION FOR SECURITIES LENDING TRANSACTIONS**

The Exchange Act currently permits a bank, without being considered a broker, to effect securities lending or borrowing transactions by custodian banks with or on behalf of customer in two situations – as part of the services provided to safekeeping and custody customers and 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.

The Commission’s final rule adds 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 security lending activities. Specifically, the rule states that a bank is exempt from the definition of the terms “broker” and “dealer” to the extent that, as a

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conduit lender,<sup>1</sup> or as an agent, the bank engages in or effects securities lending transactions, and securities lending services in connection with such transaction, with or on behalf of a person the bank reasonably believes to be: 1) a “qualified investor,” or 2) any employee benefit plan that owns and invests on a discretionary basis, not less than \$25 million in investments.

This final rule can be found at [www.schwartzandballen.com/WhatsNew.htm](http://www.schwartzandballen.com/WhatsNew.htm).

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

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<sup>1</sup> A “conduit lender” is 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.