

Notice to Members

JUNE 2005

SUGGESTED ROUTING

Legal & Compliance
Operations
Systems
Senior Management

KEY TOPICS

Agency Securities Lending
Net Capital Rule
Stock Borrow Deficits

GUIDANCE

Agency Securities Lending

Agency Securities Lending Disclosure Initiative

Executive Summary

This *Notice* advises broker-dealers engaged in the business of agency securities lending that the Agency Lending Disclosure Taskforce (Industry Taskforce), composed of, among others, representatives of the securities industry, regulators, and the Depository Trust & Clearing Corporation (DTCC), has recommended, through its Agency Lending Disclosure Initiative, certain uniform processes and a proposed calendar of milestones, to help broker-dealers engaged in agency securities lending activities comply with existing rule requirements relating to books and records, net capital requirements, and internal and supervisory controls.¹

Questions/Further Information

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Background and Discussion

Agency lending of securities involves the use of an intermediary, or agent, that acts on behalf of both the borrower and lender(s) and does not have title to the securities being loaned. It is common practice for broker-dealers to rely on agents to locate securities they wish to borrow, pay collateral to these agents, and record agency securities lending transactions at the agent level. Often, borrowing broker-dealers record little or no details regarding the underlying principal lender(s). The borrowing broker-dealer may not even know the identity of the actual lender(s).²

SEC staff has raised concerns regarding the level of transparency and information disclosure in agency securities lending transactions and the impact on credit and regulatory capital monitoring, given that broker-dealers generally conduct lending transactions through an agent, rather than with the principal lender(s). SEC staff has concluded that in order to comply with existing financial responsibility rules, particularly the net capital rule and related interpretations, broker-dealers engaged in the business of agency securities lending must (i) maintain books and records of loan activity with each underlying principal lender, (ii) monitor credit exposure as to each underlying principal lender, and (iii) calculate regulatory capital exposure as to each underlying principal lender.

Regulators and industry representatives, including staff of the SEC, the NYSE, NASD, the Federal Reserve Bank of New York, and the Securities Lending Division and Capital Committee of the Securities Industry Association (SIA), began meeting to discuss this issue in January 2003. These discussions led to the formation, in January 2004, of the Industry Taskforce. The Industry Taskforce consists of representatives from the SIA's Securities Lending Division and Capital Committee, the Risk Management Association's Committee on Securities Lending, The Bond Market Association, DTCC, and technology vendors that support securities lending.

The Industry Taskforce was created to coordinate efforts and facilitate the development of processes and technical standards to support compliance with the SEC's regulatory requirements. In order to accomplish this goal, the Industry Taskforce is organized into five working groups: Regulatory Capital, Credit, Infrastructure, Legal, and Testing. In May 2004, the Industry Taskforce engaged Capco as a project manager to provide support for the Agency Lending Disclosure Initiative. The purpose of the Agency Lending Disclosure Initiative is to establish uniform processes to assist broker-dealers in complying with existing rule requirements related to books and records, net capital, and internal and supervisory controls when engaged in agency securities lending activities.

Dialogue between regulators and the Industry Taskforce has been ongoing in order to reach a consensus on an industry approach to improve agency securities lending disclosure and satisfy SEC financial responsibility requirements. Industry Taskforce discussions have focused on improving transparency by having agent lenders provide data to broker-dealers that will permit them to accurately and adequately monitor credit exposure and calculate capital requirements based on securities loans with the underlying principal lender executed under securities lending agreements; e.g., by giving borrowers the name of the underlying lender and the ability to assess its credit worthiness.

In order to ensure agreement with the regulators, the Industry Taskforce has developed a specific timeline for the Agency Lending Disclosure Initiative. Broker-dealers that engage in the business of agency securities lending should be aware of the Agency Lending Disclosure Initiative and the timeline. The timeline requires broker-dealers to be ready to accept and retain data from agent lenders by the first quarter of 2006.

Again, it is important to note that the purpose of the Agency Lending Disclosure Initiative is to establish uniform processes to assist broker-dealers in their compliance with existing rule requirements related to books and records, net capital, and internal and supervisory controls when engaged in agency securities lending transactions.

Based upon the current project plan, broker-dealers that engage in the business of agency securities lending should be aware of the following upcoming milestones established by the Industry Taskforce:

Credit

July 2005 By July 1, borrowers will need to have completed testing of the systems for credit eligibility checks and need to be able to receive incremental add/delete requests for credit pre-qualification for **new** principals. This includes borrowers connecting directly to DTCC, as well as through vendor systems, such as EquiLend or SunGard systems.

August 1, 2005 through October 31, 2005 During this period, borrowers will need to perform credit eligibility checks for all **existing** principals who had been previously approved counterparties lending through agent lenders.

Regulatory Capital

September 2005 By September 1, borrowers will need to have in place the systems and procedures to test the daily loan data file receipt process with their vendors or directly with DTCC, as applicable.

September 1, 2005 through January 31, 2006 During this period, borrowers will be conducting testing and preparing for implementation.

March 2006 By March 1, borrowers should be fully integrated with their vendors or DTCC and fully implemented.

For information regarding infrastructure and technology, please contact your vendor or DTCC. For any other information, or answers to questions regarding the Agency Lending Disclosure Initiative, please visit their Web site at www.agencylending.capco.com or contact the Capco Project Management Office. All contacts are available at www.agencylending.capco.com/contacts.htm.

Endnotes

- 1 The New York Stock Exchange (NYSE) has published Information Memo 05-39, dated June 6, 2005, which provides substantially the same information.

2 The SEC's Division of Market Regulation addressed the appropriate method of calculating borrowed securities deficit charges for net capital purposes in a December 7, 1983, letter to the Chicago Board Options Exchange (CBOE). The letter states, in relevant part:

A broker-dealer which has borrowed securities (borrower) must mark the borrowed securities to market each business day, as of the close of the prior day's business, and determine the amount of collateral held by any securities lender (lender) which exceeds the current market value of the securities borrowed from that lender (excess collateral). The borrower must deduct from its net worth in computing net capital;

(a) the amount of excess collateral held by any one lender which exceeds one hundred and five percent (105%) of the current market value of the securities borrowed from that lender;

(b) or, if greater, the amount of excess collateral held by any one lender to the extent the excess collateral is greater than twenty percent (20%) of the borrower's excess net capital (net capital greater than the minimum required); plus,

(c) the total amount of excess collateral held by all lenders in aggregate which exceeds three hundred percent (300%) of the borrower's excess net capital reduced by the charge that the broker-dealer has already incurred under the above standards.

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