DOL Updates Securities Lending Class Exemption

by Bob Valer

The Department of Labor recently finalized Prohibited Transaction Class Exemption ("PTE") 2006-16, which consolidates and restates PTEs 81-6 and 82-63, and applies to securities lending transactions entered into on or after January 2, 2007. 71 Fed. Reg. 63786 (Oct. 31, 2006). The restated exemption does not change the conditions of PTE 82-63, which provides relief from ERISA self-dealing (sec. 406(b)(1)) for the lending agent's compensation arrangement. However, the final exemption provides relief from the party-in-interest and other section 406(a) prohibitions by expanding the types of collateral that a plan may accept, and enabling plans to loan securities to certain foreign banks and foreign broker-dealers. In the latter respect, it goes well beyond the proposed exemption and PTE 81-6. The consolidated exemption also clarifies that "fee-for-hold" arrangements, as well as loans structured as repurchase agreements, can qualify for the relief.

Overview

Section I of PTE 2006-16 describes the transactions covered by the exemption:

- Section I(a) tracks the language of PTE 81-6 by permitting ERISA plans to lend securities to a "U.S. Broker-Dealer" or a "U.S. Bank," if the general conditions of Section II are met. The general conditions expand the types of collateral beyond what PTE 81-6 permitted.

- Section I(b) expands PTE 81-6 by permitting securities loans to a "Foreign Broker-Dealer" or a "Foreign Bank," if both the general conditions of Section II and additional specific conditions of Section III are met.

- Section I(c) permits the plan to pay the lending agent's compensation, provided the conditions of Section IV are met. The conditions of Section IV, including the special rules for commingled investment funds, are the same as the conditions of PTE 82-63.

Most of the general conditions of Section II of PTE 2006-16 are the same, or nearly the same, as those in PTE 81-6. These include: (1) neither the borrower, nor the affiliate of the borrower, may have or exercise discretionary authority or discretionary control, or render investment advice, with respect to the plan assets involved; (2) prior to making the loan, the borrower must furnish the lending agent with certain financial information regarding the borrower's financial condition; (3) the loan must be made pursuant to a written loan agreement, the terms of which are at least as favorable to the plan as an arm's-length transaction with an unrelated party would be; (4) the plan must receive a reasonable fee or have an opportunity to derive compensation from the investment of currency collateral; (5) the plan must receive the equivalent of all distributions (e.g., dividends, interest payments, stock splits) on the loaned securities; (6) the plan must be able to terminate the loan at will upon not more than 5 days' notice; and (7) if the borrower fails to return the loaned securities or their equivalent, the plan must be able to apply the collateral to purchase equivalent securities, and the defaulting borrower must be obligated to pay any remaining obligations and expenses resulting from the default. Also, like PTE 81-6, Section II of PTE 2006-16 specifies that the loaned securities and collateral must be marked-to-the-market daily throughout the term of the loan, and the borrower must provide additional collateral if specified collateral maintenance requirements are not satisfied. However, there are new collateral maintenance requirements when the borrowers are "Foreign Banks" or "Foreign Broker-Dealers," or when the collateral is "Foreign Collateral."

Eligible Foreign Banks and Foreign Broker-Dealers

"Foreign Banks" and "Foreign Broker-Dealers" may borrow the plan's securities if the new special conditions of Section III of PTE 2006-16 are satisfied. Foreign banks and broker-dealers are –

- banks and broker-dealers subject to specified government regulatory authorities in the United Kingdom or Canada, and
- banks or broker-dealers registered and/or subject to government regulation in other foreign countries in which a bank or broker dealer has received an individual ERISA exemption involving securities lending from a plan. Currently, countries in this category are Japan, Germany, the Netherlands, Sweden, Switzerland, France, Australia, Canada, and the United Kingdom.

For loans to banks and broker-dealers in the first category described above, the exemption requires that either (a) the bank or broker-dealer agrees to submit to jurisdiction of the United States, agrees to appoint an agent for service of process in the United States, and agrees that the plan may elect to enforce the securities lending agreement exclusively in United States courts, or (b) the lending agent be a U.S. Bank or U.S. Broker-Dealer that agrees to provide the plan with an indemnity in the form specified in the exemption in the event of borrower default. In the second category described above, the lending agent must be a U.S. Bank or U.S. Broker-Dealer that agrees to provide the specified indemnity. The lending agent also is required to maintain the situs of the loan agreement within the jurisdiction of U.S. courts.

Expanded Permitted Types of Collateral

PTE 2006-16 delineates and expands permissible collateral:

- "U.S. Collateral" is generally defined as (1) U.S. currency; (2) certain government securities; (3) government securities issued or guaranteed as to principal or interest by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Student Loan Marketing Association, or the Financing Corporation; (4) certain mortgage-backed securities; (5) certain negotiable certificates of deposit and bankers acceptances; (6) irrevocable letters of credit issued by a U.S. Bank other than the borrower or an affiliate thereof, or (7) any combination of the foregoing.

- "Foreign Collateral" is generally defined as (1) securities issued by or guaranteed as to principal and interest by specified Multilateral Development Banks; (2) certain foreign sovereign debt securities; (3) the British pound, the Canadian dollar, the Swiss franc, the Japanese yen or the Euro; (4) irrevocable letters of credit issued by certain Foreign Banks other than the borrower or an affiliate thereof; or (5) any type of collateral described in Rule 15c3-3 of the Securities Exchange Act of 1934 ("Exchange Act"), provided that the lending agent is a U.S. Bank or U.S. Broker-Dealer who agrees to provide the plan with an indemnity specified in the exemption in the event of borrower default. Presumably, it also means any combination of the foregoing. The "indicia of ownership" of Foreign Collateral must be maintained in accordance with section 404(b) of ERISA and regulations thereunder.

In the preamble to the exemption, the DOL stated that it had determined not to include equity securities and fixed income securities as permissible collateral.

Levels of Collateral That Must be Pledged

Under PTE 81-6, if the market value of the collateral ever fell below 100 percent of the market value of the loaned securities as of the close of any business day, the borrower had to add to the collateral to bring it back up to at least 100 percent by the end of the following business day. Under PTE 2006-16, if "U.S. Collateral" is pledged, the rule is the same. If "Foreign Collateral" is pledged, the general rule is that the market value of the collateral must be maintained at least (1) 102 percent of the market value of the loaned securities (if the posted collateral and loaned securities are denominated in the same currency), and (2) 105 percent (if the posted collateral and loaned securities are denominated in different currency). Lower collateral maintenance requirements apply if the lending agent is a U.S. Bank or U.S. Broker-Dealer that agrees to provide the indemnity specified in the exemption in the event of borrower default. If the same type of collateral falls within the definitions of both "U.S. Collateral" and "Foreign Collateral," the collateral maintenance requirements applicable to U.S. Collateral may be used.

"Fee-For-Hold" and Repurchase Arrangements

The preamble to PTE 2006-16 defines a "fee-for-hold" as an arrangement where a borrower pays a fee in exchange for the guaranteed availability of a particular security and states that these arrangements are within the scope of the exemption if the conditions are otherwise met. This appears to be an appropriate result, even though fee-for-holds are not loans at all, but rather an agreement by the plan not to loan its securities. In addition, securities loans structured as repurchase agreements can be within the scope of the exemption.

Still Unanswered Questions

- Whether (or to what extent) pledged collateral is considered to be a "plan asset" of the lending plan is not addressed in the final exemption or discussed in the preamble, and there also is little direct DOL guidance elsewhere on it. The answer may turn on whether legal title to the collateral passes to the lending plan when it is pledged. In certain foreign jurisdictions, title may well pass. If the collateral is a "plan asset" of the lending plan, the lending agent (or other entity charged with investing the collateral) probably should be a QPAM and appointed to be an "investment manager" of the lending plan.

- It is unclear whether (or to what extent) plans and their lending agents actually will use the Sections I(a) and I(b) of PTE 2006-16 to provide exemptive relief for the plan's securities loans. The new statutory "service provider exemption" (ERISA sec. 408(b)(17) and Code sec. 4975(d)(20)), added by the Pension Protection Act of 2006, provides broad exemptive relief for a variety of transactions (including securities loans) between the plan and specified parties-in-interest, without imposing many of the conditions of PTE 2006-16. For example, the Service Provider Exemption does not require any particular amount or type of collateral, and counterparties are not required to be U.S. banks or broker-dealers. That said, plans and their lending agents will still need to utilize section I(c) of PTE 2006-16 to get ERISA section 406(b)(1) exemptive relief for the lending agent's compensation arrangement.