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SIFMA
Securities Industry and Financial Markets Association

Guidance Notes to Annex VIII

Transactions in Equity Security

In view of legislative and regulatory developments that have substantially expanded the opportunities for repo market participants to engage in Transactions involving Equity Securities, The Bond Market Association and the Securities Industry Association have prepared a new Annex VIII to the Master Repurchase Agreement (the "Agreement") for use in connection with such Transactions. Although the current scope of the Agreement encompasses Transactions in any securities, it was drafted in the context of a repo market comprised almost exclusively of Transactions in debt instruments. Annex VIII modifies and supplements the Agreement in certain respects to provide a framework in which the parties may address the special practical and legal issues raised by Transactions in Equity Securities.

These guidance notes briefly summarize the scope and key provisions of Annex VIII and identify certain additional issues which parties entering into Transactions in Equity Securities may wish to address in Schedule VIII.A to the Annex or otherwise. The following discussion should not be relied upon by any party to determine, without appropriate legal, tax, accounting or other relevant professional advice, whether Annex VIII is suitable to its particular circumstances and needs or whether modifications to Annex VIII are required to address adequately issues that may be raised by Transactions in specific Equity Securities. Capitalized terms used but not otherwise defined in these guidance notes have the meanings given to them in the Agreement or Annex VIII.

Background. The National Securities Markets Improvement Act of 1996 (the "1996 Act") removed significant legal obstacles to the development of a U.S. repo market for Equity Securities. In particular, the 1996 Act substantially eliminated prior restrictions under Sections 7 and 8 of the Exchange Act – and the rules of the Board of Governors of the Federal Reserve System (the "Board") thereunder – which generally permitted broker-dealers to obtain credit against listed equity securities only from banks and other broker-dealers and subject to significant minimum margin requirements. Transactions in which a broker-dealer acts as Seller of Equity Securities have traditionally been considered susceptible to characterization as extensions of credit to the broker-dealer for purposes of these former restrictions under the Exchange Act and the Boardís margin rules.

Under the 1996 Act, no federal margin requirements apply to extensions of credit to a member of a national securities exchange or a registered broker-dealer (i) a substantial portion of whose business consists of transactions with persons other than broker-dealers or (ii) to finance the borrowerís activities as a market maker or underwriter. The Board implemented the 1996 Act by, among other things, excluding from the scope of its margin regulations extensions of credit to certain "exempted borrowers" (as defined in the regulations) that qualify for the statutory exemption. Transactions by qualifying broker-dealers acting as Sellers (including Transactions in Equity Securities) are therefore now generally free from regulation under Sections 7 and 8 of the Exchange Act or the Boardís margin rules. Such Transactions remain subject, however, to other securities laws and regulations (including any applicable margin requirements of securities self-regulatory organizations governing Buyers who are broker-dealers).

Scope of Annex VIII and Use of Schedule VIII.A. As indicated above, Annex VIII is intended to provide a framework for Transactions in Equity Securities, including both U.S. and non-U.S. Securities. A form of Schedule VIII.A has been added to the end of the Annex to provide parties with the flexibility to modify the approach taken in the Annex or to supplement the Annex with additional provisions.

Definitions. Paragraph 1 of the Annex provides several additional definitions relevant to Transactions in Equity Securities and modifies certain existing definitions under the Agreement with respect to such Transactions. The new definition of "Equity Security" refers specifically to certain types of securities covered by the Annex and, in addition, explicitly incorporates by reference any other security that is an "equity security" within the meaning of Section 3(a)(11) of the Exchange Act or the rules thereunder. This definition of "Equity Security" is intended to encompass, among other things, ADRs for which the underlying securities are Equity Securities.

The definition of "Purchased Securities" (including "Additional Purchased Securities") under the Agreement has been modified to clarify that if any new or different Securities are exchanged for any Purchased Securities (e.g., through a recapitalization or other corporate action), such new or different Securities shall become Purchased Securities. This approach is consistent with the treatment of such exchanges with respect to loaned securities under Section 26.14 of the Master Securities Loan Agreement.

The definition of "Standard Settlement Date" is based on the standard settlement cycle for the relevant Security. The application of this definition is discussed under "Termination" below.

Termination. Paragraph 2 of the Annex modifies the provisions of Paragraph 3(c) of the Agreement regarding Transactions terminable upon demand. Paragraph 3(c) normally permits such Transactions to be terminated by either party upon the delivery of a notice specifying a termination date, which could be the same or following business day. Paragraph 2 of the Annex requires a Seller providing such termination notice to specify a termination date no earlier than the Standard Settlement Date for the Securities (determined based on the standard settlement cycle for such Securities). This expansion of the notice period required to be provided by Seller is intended to address situations in which Buyer does not have possession of the Securities -- e.g., because it has delivered the Securities to another party in connection with a separate transaction -- and therefore (taking into account the standard settlement cycle for the Securities) requires more than one business day to purchase or otherwise obtain the Securities for delivery to Seller on the termination date.

Under Paragraph 3(c) of the Agreement and Paragraph 2 of the Annex, a demand for termination by Seller must specify a termination date no earlier than the Standard Settlement Date (determined in accordance with SEC Rule 15c6-1, where applicable, or otherwise in accordance with customary market practice) on which Buyer would obtain delivery of the relevant Securities if Buyer were to purchase such Securities at the time of the termination notice. For example, in a Transaction involving Equity Securities traded primarily in the United States, a termination notice delivered to Buyer during New York trading hours may specify as the termination date the Standard Settlement Date for a trade in the relevant Securities entered into in the relevant U.S. market at the time of the notice (i.e., generally the third business day after the date of the contract). If, on the other hand, a Transaction involves Equity Securities having Tokyo as their primary market, the Standard Settlement Date would be determined based on the standard date for settlement of trades entered into in that market at the time of the notice.

The termination date specified by Seller under Paragraph 2 of Annex VIII must be a business day. The parties should note that if Annex VIII is used together with Annex III (for Transactions in "International Securities"), the termination date for Transactions subject to Annex III must be a "business day" as defined in Annex III (which generally includes any date on which the primary market for the applicable Security is open). In addition, the parties should note that the termination procedures in Paragraph 2 of the Annex differ somewhat from the provisions of Section 5 of the Master Securities Loan Agreement, under which (due to certain tax considerations) the termination notice required to be provided by a lender is not automatically adjusted to accommodate any longer settlement cycles that may be applicable to foreign securities.

The parties may wish to consider amending Paragraph 2 of the Annex to require Buyer also to provide more than one business dayís notice upon terminating a Transaction in Equity Securities, in order to allow Seller additional time to arrange alternative funding to replace the terminated Transaction. In addition, Annex VIII provides the parties with the flexibility to modify the definition of Standard Settlement Date. Parties may wish to specify whether any deviation from the standard settlement cycle for the relevant Security may be agreed to orally or whether such agreement must be expressed in writing. For the reasons indicated above, the parties also should consider the extent to which a notice period that is shorter than the standard settlement cycle for a particular Security may limit the ability of Buyer to transfer the Security to a third party (e.g., because Buyer may not be able to obtain the Security in time to return it to Seller on the applicable date).

Margin Maintenance. Under Paragraphs 4(a) and 4(b) of the Agreement, Margin Deficit and Margin Excess are determined with respect to all outstanding Transactions unless, pursuant to Paragraph 4(f), the parties agree that margin rights may be exercised with respect to certain Transactions without regard to any other Transactions under the Agreement. Paragraph 3 of the Annex provides the parties with the additional option of agreeing to permit the exercise of margin rights with respect to certain classes of Transactions (such as Transactions in Equity Securities) without regard to any other classes of Transactions under the Agreement (such as Transactions in non-Equity Securities). This optional provision is intended to provide flexibility for parties which do not have the capability, from an operational perspective, to calculate and monitor their exposures for all Transactions in both Equity Securities and non-Equity Securities on an aggregate basis. Before adopting the approach set forth in Paragraph 3 of the Annex, however, each party should consider the credit issues that may arise if it fails to exercise its rights to make a margin call in respect of a class of Transactions in circumstances where a potentially insolvent counterparty has made a margin call on a separate class of Transactions.

Parties may also wish to consider adopting, in Schedule VIII.A or otherwise, more general "cross-netting" provisions (e.g., providing for cross-default and setoff rights) to cover multiple types of securities transactions with the same counterparty, such as Transactions under the Agreement and securities loans effected under the Master Securities Loan Agreement.

Dividends, Distributions, etc. Paragraph 4 of the Annex confirms that, as currently contemplated under Paragraph 5 of the Agreement, Seller is entitled to receive an amount equal to all Income paid or distributed on or in respect of Purchased Securities not otherwise received by Seller (through The Depository Trust Company ("DTC") or otherwise). Income in the form of cash is treated in accordance with Paragraph 5 of the Agreement. The Annex modifies Paragraph 5, however, with respect to Income in the form of non-cash distributions (e.g., stock dividends or stock split ups) by requiring such non-cash distributions to be added to the Purchased Securities and considered such for all purposes. This modification -- which is consistent with the approach to non-cash distributions under Section 7.2 of the Master Securities Loan Agreement -- is intended to protect the ability of Buyer to use the Purchased Securities to satisfy an outstanding delivery obligation (since Buyerís transfer to Seller of such non-cash distributions might otherwise effectively dilute the amount of Purchased Securities available to Buyer under the relevant Transaction).

Payment and Transfer. Paragraph 5 of the Annex permits transfers of Equity Securities to be effected through DTC. Where parties use this Annex together with Annex III (International Transactions), Paragraph 5(a) of Annex III will require Seller to pay any transfer taxes, stamp taxes and similar costs with respect to the transfer of Securities. Where parties are not using Annex III, they may wish to specify whether Buyer or Seller will be responsible for any transfer costs.

The parties should note that there are a variety of mechanisms pursuant to which transfers of Equity Securities may occur. The parties should consider how any particular transfer mechanism, through DTC or otherwise, will affect their rights, including with respect to the voting of the Purchased Securities, the retransfer of Purchased Securities and the receipt of any Income from the Purchased Securities. The parties should also consider the effect of any transfer option on the characterization of the Transaction for purposes of applicable tax, bankruptcy, securities or other laws and on the priority of Buyerís interest in the Purchased Securities as against third parties under applicable law.

Additional Representations. Unless the parties otherwise agree, each party is required to represent under Paragraph 6 of the Annex that on the date of any transfer of Equity Securities by such party, the Securities are not “control” or “restricted” Securities subject to restrictions on transfer under the Securities Act. This representation is required to be made by the transferor because at the time of the transfer it is in a better position to make the relevant determinations regarding the Securities transferred. Parties may engage in Transactions involving “control” or “restricted” Securities by agreeing that the representations in Paragraph 6 shall not apply and by making such other representations or covenants as may be appropriate.

The parties may also wish to include, in Schedule VIII.A or otherwise, representations regarding the status of any Transactions in Equity Securities under the margin regulations of the Board. For example, as discussed under “Background” above, Transactions in which certain qualifying broker-dealers act as Sellers are exempted under the Exchange Act from any federal margin regulations. A party acting as Buyer in Transactions in which Seller is a broker-dealer obtaining credit in excess of such margin regulations therefore may wish to obtain a representation from such broker-dealer that it qualifies for this exemption. The following is a sample form of such representation:

> “***Additional Representation***. [Broker-dealer] represents and warrants that it is a member of a national securities exchange in the United States or registered as a broker or dealer with the U.S. Securities and Exchange Commission and either (A) a substantial portion of its business consists of transactions with persons other than brokers or dealers or (B) it is entering into each Transaction involving Equity Securities in which it is acting as Seller to finance its activities as a market maker or an underwriter.”
>
> The use of the term “to finance” in clause (B) of this representation, which directly tracks the statutory language of Exchange Act Sections 7(c)(2)(B) and 7(d)(2)(C), is intended to

describe the use of the proceeds of a sale of Securities in a Transaction rather than to characterize the nature of such Transaction. In addition to or in lieu of the foregoing representation, Buyer may wish to obtain a representation from a broker-dealer acting as Seller that it is an “exempted borrower” within the meaning of the Boardís Regulations T and U, as in effect from time to time.

In addition, the parties should consider carefully (and seek appropriate advice from their legal advisors regarding) the potential application of other legal restrictions on ownership or transfer to Transactions in Equity Securities. For example, the Exchange Act contains extensive provisions regarding corporate finance and governance issues and imposes a variety of requirements on transactions by certain holders of Equity Securities. A number of questions may arise as to the application of these provisions of the federal securities laws to Transactions in Equity Securities. In addition, numerous other federal and state statutes, including, for example, the Bank Holding Company Act, the Communications Act and the Public Utility Holding Company Act, regulate the ownership or transfer of particular classes of Equity Securities issued by certain U.S. corporations. Moreover, statutes such as the Hart-Scott-Rodino Antitrust Improvements Act may impose notice or other requirements on, among other things, certain acquisitions of Equity Securities. Parties entering into Transactions involving Equity Securities may wish to consider, on a case-by-case basis, obtaining appropriate representations from their counterparties regarding the application of these and other statutes or regulations to such Transactions.

Rights of Buyer in Purchased Securities. With respect to voting rights, Paragraph 7 of the Annex provides that during the term of a Transaction (i.e., until Buyer is required to return the Purchased Securities), Seller transfers all rights to vote the Purchased Securities to Buyer -- an approach consistent with permitting Buyer to retransfer the Securities in separate transactions. Parties may amend this Paragraph in Schedule VIII.A or otherwise to address particular transactions in which the transfer of voting rights is not possible or desirable. For example, transactions effected through DTCís “Whole Interest Transfer” system may not result in a transfer of voting rights to Buyer. Where the Securities are being held by a third party subject to a tri-party custodial arrangement, moreover, the parties may wish to consider providing that in connection with any votes, consents, or other actions Buyer will use reasonable efforts to act in accordance with such instructions as may be timely provided by Seller. Parties should consider the effect that any such covenants of Buyer regarding the exercise of voting rights with respect to the Purchased Securities may have from a corporate law and governance perspective and on the characterization of the Transaction as a “sale” under applicable law or, if any Transactions are deemed to be loans, on whether Buyer has a perfected security interest in the Purchased Securities under applicable law.

The parties may also wish to consider amending Paragraph 7 to require Buyer to provide Seller with notice of corporate events occurring with respect to any Equity Securities (e.g., a rights offering) and an opportunity to exercise certain rights in connection with such events. Under Paragraph 9(a) of the Agreement, the parties currently have the flexibility to agree to permit Seller to substitute other Securities for any Purchased Securities that may be affected by any corporate events. In connection with certain such events, however, Seller may wish to have the ability to demand a substitution of other Securities for the affected Purchased Securities or to terminate the relevant Transaction (as if it were a demand Transaction). In reviewing any such amendments, Buyer should carefully consider its ability, upon a termination or substitution by

Seller, to recall or find an alternative source for any particular Equity Securities it has transferred to a third party.

The following is a sample form of amendment providing Seller with notice of corporate events and the right to terminate upon such notice:

> "**Notice of Corporate Actions**. In relation to Purchased Securities that are Equity Securities, Buyer shall notify Seller (as soon as possible but in any event within two business days after the day on which a holder of such Purchased Securities would in the normal course have received such notice from the issuer) of any notice issued by the issuer of such Securities to the holders of such Securities relating to any proposed conversion, subdivision, consolidation, takeover, preemption, option or other similar right or event affecting such Securities or of any Income payment declared in respect of such Securities. Whether or not such notice is received from Buyer, upon the issuance of any such notice issued by the issuer Seller may cause the Transaction to be terminated in accordance with Paragraph 3 of the Agreement as if the Transaction were a demand Transaction."

Events of Default. Paragraph 8 of the Annex clarifies that the failure to perform any covenant or obligation under the Annex constitutes an Event of Default under the Agreement. Paragraph 8 also incorporates the notice periods otherwise applicable under Paragraphs 4 or 5 the Agreement (including either the August 1987 or September 1996 versions of the Agreement), to the extent that such Paragraphs are supplemented and amended by Paragraphs 3 or 4, respectively, of the Annex.

Market Value. Paragraph 9 of the Annex specifies the methods for determining the Market Value of any Equity Securities. These provisions, which are based on the methodology for determining market values in Section 15 of the Master Securities Loan Agreement (updated to reflect changes in the over-the-counter markets), permit Equity Securities traded primarily within the United States to be valued based on their last reported sale prices (where available) and Equity Securities principally cleared and settled outside the United States to be valued in accordance with market practice in the principal market for such Securities.

Additional Covenant. Paragraph 10 clarifies the understanding of the parties that Transactions covered by the Annex will not be subject to the provisions of any securities exchange regarding "exchange contracts". This Paragraph is based on a similar covenant in Section 10.5 of the Master Securities Loan Agreement.

Additional Issues.

Transfers of Purchased Securities by Buyer. The Annex does not modify the right of Buyer, under Section 8 of the Agreement, to engage in repurchase transactions with the Purchased Securities or otherwise to sell, transfer, pledge or hypothecate the Purchased Securities. Sellers should consider whether any such restrictions on transfer would be appropriate from a credit perspective or otherwise, and Buyers should consider the relative importance of retaining the flexibility to transfer Purchased Securities (e.g., to satisfy a delivery obligation). In addition, each of the parties should consider the effect that any restrictions on transfer may have on the characterization of a Transaction as a "sale" under applicable law or, if any Transactions are deemed to be loans, the effect of any such restrictions on transfer on whether Buyer has a perfected security interest in the Purchased Securities subject to the Transactions under applicable law. The parties should also consider and consult with their tax advisors regarding the relative advantages and disadvantages for Buyer and Seller from a tax perspective, including with regard to the tax benefits of ownership of the Purchased Securities, of (i) permitting Buyer to transfer or hypothecate the Purchased Securities, including under terms that comply with the requirements of Section 1058(b) of the Internal Revenue Code, (ii) prohibiting Buyer from transferring or hypothecating the Purchased Securities, or (iii) limiting the term of the Transaction so that it terminates some time prior to a dividend record date. Such advantages and disadvantages may include the availability of the dividends-received deduction (to the extent not limited by holding period rules, rules relating to the debt-financing of equity securities or other limitations), the availability of foreign tax credits for withholding taxes on dividends and the effect of treating an equity security as having been disposed of for tax purposes.

Cross-Border Tax Issues. The Annex does not include any provisions specifically addressing cross-border tax issues. Parties should consult with their tax advisors regarding the appropriate tax treatment of Transactions involving Equity Securities and the potential application of withholding tax to payments made thereunder or to dividends received on Purchased Securities, particularly where such Transactions involve non-U.S. Securities or where such parties include non-U.S. persons. Parties may also wish to consider the use of Annex III, which contains provisions applicable to withholding and certain other taxes, for Transactions in Equity Securities that are International Transactions or that involve International Securities, as defined therein.

Periodic Payments of Price Differential. The parties may wish to consider amending the Agreement to provide for periodic payments of the Price Differential by Seller (rather than an aggregate payment by Seller upon termination of the Transaction, as provided under the Agreement). Such periodic payments -- which would be consistent with the periodic payment of loan fees and cash collateral fees in borrowings of Equity Securities under Section 4 of the Master Securities Loan Agreement -- may be attractive to parties who wish to more closely conform certain operational aspects of a Transaction in Equity Securities to current market practice with respect to securities lending transactions involving such Securities.

The following is a sample form of amendment permitting the parties to agree to such periodic payments on a Transaction-by-Transaction basis:

> "**Periodic Payments of Price Differential**. Buyer and Seller may agree that, with respect to any Transaction under the Agreement, Seller shall pay to Buyer: (i) on the [fifteenth day] of the month (or, if such [fifteenth day] is not a business day, on the next business day) following each calendar month during which any part of such Transaction has occurred, the Price Differential determined as of the last day of such preceding calendar month, and (ii) on the termination date of such Transaction, the Price Differential determined as of such termination date. Notwithstanding the foregoing, Seller shall remain obligated to pay Buyer the Repurchase Price with respect to any Transaction (including any unpaid Price Differential, as specified in the Agreement) immediately upon the occurrence of an Event of Default with respect to Seller."