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Guidance Notes to the Amendment to the Master Securities Loan Agreement

The Bond Market Association (the "Association") has prepared an Amendment (the "Amendment") to the Master Securities Loan Agreement (the "MSLA") designed to implement a number of statutory and regulatory developments, including the recent expansion of the scope of permitted securities lending transactions, and to provide a framework for discussing the special practical and legal issues raised thereby.

These guidance notes briefly summarize the scope and key provisions of the Amendment and identify certain additional issues which parties to an MSLA or other securities loan agreement may wish to address in light of such developments. *The following discussion should not be relied upon by any party to determine, without appropriate legal, tax, accounting or other relevant professional advice, whether the Amendment is suitable to its particular circumstances and needs or whether modifications to the Amendment or the MSLA are required to address adequately issues that may be raised by specific transactions.* Capitalized terms used but not otherwise defined in these guidance notes have the meanings given to them in the Amendment or the MSLA.

I. Statutory and Regulatory Developments

Recent Amendments to Regulation T. Recent amendments to Regulation T of the Board of Governors of the Federal Reserve System (the "Board") have significantly liberalized the regulatory restrictions applicable to the securities borrowing and lending activities of broker-dealers. These amendments, effective on April 1, 1998, not only implement the amendments to the Securities Exchange Act of 1934 (the "Exchange Act") effected by the National Securities Markets Improvement Act of 1996 ("NSMIA"), but also include a number of modifications to Regulation T adopted by the Board in connection with its periodic review of its margin regulations.

Among the significant implications of NSMIA and the Board's amendments for securities lending activities are:

- Elimination of restrictions regarding the amount and type of Collateral required under Regulation T for securities borrowing and lending transactions (although the collateral requirements of Rule 15c3-3 under the Exchange Act and comparable Treasury regulations under Section 15C of the Exchange Act continue to apply);

- Elimination of the permitted purpose requirement under Regulation T for Loans of securities by "exempted borrowers" — i.e., registered broker-dealers with a substantial non-broker-dealer business — as well as registered broker-dealers entering into Loans to finance their market making or underwriting activities (although broker-dealers qualifying for such treatment may not borrow securities from a Lender other than another qualifying broker-dealer without a permitted purpose);

- Elimination of the permitted purpose requirement with respect to all Loans involving securities other than Equity Securities; and

- Expansion of the foreign securities exception in Regulation T to permit all broker-dealers to lend (or to borrow for the purpose of relending) any foreign securities to a foreign person for any purpose lawful in the country in which they are to be used.

Revised Article 8 of the Uniform Commercial Code. Revised Article 8 of the Uniform Commercial Code (the "UCC") is the result of an effort to overhaul current commercial law rules for investment securities to reflect the realities of modern securities holding practices, and in particular, for securities held indirectly by one or more securities intermediaries. Revised Article 8 has been enacted in over forty jurisdictions, including New York. In addition, Revised Article 8 governs most transfers of interests in securities issued by the U.S. Treasury and certain government sponsored entities that are maintained in book-entry form through the Federal Reserve Bank system.

II. Specific Provisions

Scope. Although the Amendment generally has been prepared for use in connection with the MSLA, its specific provisions have been drafted in a sufficiently generic fashion (e.g., without reference to particular section numbers or provisions of the MSLA) to facilitate its use with any form of master securities lending agreement that may be in place between the parties (a "Master Agreement"). Accordingly, specific references to sections of the MSLA in these guidance notes are for illustrative purposes only.

Parties using the Amendment should determine whether any modifications are required to conform its provisions to their particular documentation.

A. Collateral and Mark to Market.

Section 1 of the Amendment allows parties to agree to eliminate the requirement (in Sections 3.1 and 8.1 of the MSLA) that Borrower transfer upon commencement of a Loan and subsequently maintain, as of the close of each Business Day during the term of a Loan, Collateral with a market value equal to at least 100% of the market value of the Loaned Securities. Pursuant to Section 1, the parties may agree that the margin percentage shall be less than 100% with respect to any Loan. Such an agreement may, in accordance with Section 11.2, be made in writing or orally (if confirmed promptly thereafter in writing or through a system such as Loanet that compares such transactions if Borrower and Lender are participants therein), or in any other manner agreed upon by the parties in writing. Such an agreement may cover a single Loan or an entire class of Loans between the parties. In the absence of any such agreement, however, the margin percentage with respect to any Loan shall not be less than 100%.

In the event that the parties agree that the margin percentage may be less than 100% with respect to one or more Loans, but fail to set out in a confirmation or other writing the margin percentage with respect to any specific Loan, Section 1 of the Amendment provides that the applicable margin percentage with respect to such Loan shall not be less than the ratio of the market value of Collateral required to be transferred by Borrower at the commencement of the Loan to the market value of Loaned Securities required to be transferred by Lender at the commencement of the Loan. Section 1 thus establishes a minimum "floor" above which Collateral must subsequently be maintained throughout the term of the Loan if the 100% minimum collateral requirement is eliminated and a specific margin percentage is not agreed upon. This provision is similar to the provisions used to determine the "Buyer's Margin Percentage" and "Seller's Margin Percentage" under the Master Repurchase Agreement in the absence of any express agreement by the parties.

Although Regulation T no longer imposes any collateral requirements on the borrowing and lending of securities, minimum collateralization requirements may still apply in a number of contexts, depending upon the status of Borrower and Lender and the nature of their relationship. For example, SEC Rule 15c3-3 generally requires a broker-dealer that borrows securities from a customer to enter into a written agreement that at a minimum provides, among other terms, that the broker-dealer will deliver and subsequently maintain collateral with a market value equal to at least 100% of the market value of all outstanding securities loaned. Similarly, Loans by ERISA Plans in reliance on Prohibited Transaction Exemption 81-6 ("PTE 81-6") are subject, among other conditions, to a 100% collateralization requirement. The Amendment accordingly does not eliminate the 100% collateralization requirement for Loans where Lender is a Customer of a Borrower that is a broker-dealer or where the Loans are effected in reliance upon PTE 81-6.

Moreover, for parties that are required to prepare financial reports in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), Loans that are collateralized at less than 100% of the market value of the Loaned Securities may be subject to a different accounting treatment than traditional securities loans (especially if such Loans are effected without a permitted purpose). Furthermore, depending upon the status of the parties (e.g., tax-exempt organizations), such Loans may have certain tax consequences under the Internal Revenue Code.

Parties using the Amendment should determine whether any Loans contemplated thereunder are subject to a minimum collateralization requirement or any other restrictions on the type or quantity of Collateral acceptable under any applicable laws, rules or regulations. Parties using the Amendment should also consult with their accounting advisors to determine the accounting treatment of Loans involving less than 100% Collateral, as well as with their legal advisors to determine the tax consequences of such Loans (especially if they involve tax-exempt organizations).

Before agreeing to accept Collateral in an amount less than the market value of the Loaned Securities, Lender should consider carefully the credit, insolvency, liquidity, regulatory capital and other implications of such a determination.

B. Permitted Purpose.

Equity Securities. Section 2.1 of the Amendment provides the parties with the flexibility to agree, in connection with any Loan involving an Equity Security, that the Borrower shall not be deemed to represent that it is borrowing the securities for a "permitted purpose," provided that the Lender represents that it qualifies for an exemption from the margin requirements under NSMIA and the Board's margin regulations.

Section 2.1 supersedes, in cases where the parties so agree, the standard representation contained in virtually all securities lending agreements — for example, in Section 9.5(b) of the MSLA — that Borrower is borrowing the Loaned Securities for the purpose of making delivery in the case of short sales, fails to receive securities or similar circumstances (as described in Section 220.10 of Regulation T). The standard permitted purpose representation will continue to apply in those cases where the parties do not expressly agree to the contrary, although it is expected that the parties will identify whether individual Loans are or are not for a permitted purpose as a matter of practice. To assist the parties in maintaining adequate records to identify whether Loans are or are not for a permitted purpose, the

Amendment provides that any agreement by the parties to eliminate the permitted purpose representation with respect to a Loan may, in accordance with Section 11.2, only be made in writing, orally (if confirmed promptly in writing or through a system such as Loanet), or in such other manner as may be agreed by the parties in writing.

To preserve the reciprocal nature of the MSLA without requiring each party to represent that it qualifies for an exemption from the margin rules, Section 2.1 of the Amendment provides that the party acting as Lender shall make such a representation only with respect to Loans in which the parties have agreed that the Borrower need not have a permitted purpose. In lieu of this approach, the parties may prefer to include an explicit representation by each party that will be acting as Lender (in a schedule to the Amendment or otherwise) that it qualifies for the statutory 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 Loan involving an Equity Security in which it is acting as Lender to finance its activities as a market maker or an underwriter."

In addition to or in lieu of the foregoing representation, Borrower may wish to obtain a representation from a broker-dealer acting as Lender that it is an "exempted borrower" within the meaning of Regulation T.

Lenders who wish to use the Amendment should note that, notwithstanding the exemptions afforded by NSMIA, in certain circumstances it may still be prudent to obtain a permitted purpose representation from a Borrower to whom it on-lends Equity Securities. For example, a Lender that borrows securities from a party other than a broker-dealer (such as a bank or insurance company) may wish to obtain a permitted purpose representation from the party to whom it relends such securities (including another broker-dealer) as a means of assuring the existence, where necessary, of a permitted purpose for the original borrowing. Lenders who engage in Loans without a permitted purpose, as well as Lenders who engage in conduit lending of customer securities, may wish to consider developing procedures that would identify those Loans for which they require a permitted purpose and that would ensure that any necessary representations are received from the Borrower in connection with such Loans.

Neither the MSLA nor the Amendment specifically addresses the applicability of the permitted purpose requirement in the context of a Loan involving two parties neither of which is subject to Regulation T (e.g., a bank or foreign broker-dealer borrowing securities from a non-broker-dealer U.S. customer). The parties may wish to consider adopting additional provisions to accommodate such situations, especially in circumstances where a foreign broker-dealer is involved.

Neither the MSLA nor the Amendment expressly reflects the exception in Section 220.10(b) of Regulation T permitting a broker-dealer to relend any Loaned Security that is a foreign security to a foreign person for any purpose lawful in the country in which it is to be used, although it is contemplated that such transactions are included among the transactions "otherwise permitted pursuant to Regulation T" within the meaning of Section 9.5(b) of the MSLA. Parties that intend to enter into such transactions may wish to ensure that such transactions are permissible under the terms of their securities lending documentation.

Non-Equity Securities. Section 2.2 of the Amendment provides that Borrower shall not be deemed to represent that it is borrowing Loaned Securities other than Equity Securities for a permitted purpose. Because the permitted purpose requirement of Regulation T no longer applies to Loans of securities that are not Equity Securities, such a representation has no continuing regulatory significance.

C. Termination and Voting Rights in Respect of Collateral.

Section 3 of the Amendment modifies the provisions of Section 5(a) of the MSLA and adopts provisions that mirror Section 6 of the MSLA to reflect the expansion of the permissible categories of Collateral, in cases where Lender is permitted to retransfer Collateral under the terms of the Master Agreement.

Termination. Clause (a) of Section 3 requires Borrower, if it wishes to terminate a Loan the Collateral for which includes securities other than Government Securities, to provide a termination notice to Lender and to specify a termination date in such notice no earlier than the standard settlement date for such Collateral. The notice period required to be provided by Borrower, which mirrors the notice period required to be provided by Lender, is intended to address situations in which Lender does not have possession of the Collateral - e.g., because it has delivered the Collateral to another party in connection with a separate transaction - and therefore (taking into account the standard settlement cycle for the Collateral) requires more than one Business Day to purchase or otherwise obtain the Collateral for delivery to Borrower on the termination date. Borrower's right to terminate a Loan backed solely by Government Securities, cash, letters of credit, money market instruments or other non-securities assets would continue to be governed by the existing provisions of the Master Agreement.

The parties should note that, unless otherwise agreed, the standard settlement date for Collateral consisting of securities other than Government Securities is the third Business Day following the termination notice. Although the parties may wish to extend the notification period with respect to certain types of securities with a longer settlement cycle (e.g., foreign securities), because of certain tax considerations under the Internal Revenue Code and accounting considerations under U.S. GAAP (as well as ERISA considerations, where applicable) each party may wish to retain the right to terminate any Loan within five Business Days. For this reason, neither the MSLA nor the Amendment provides that Borrower's or Lender's notification period shall automatically be adjusted to accommodate any longer settlement cycle that may be applicable to a foreign security.

The parties should carefully consider the implications of any delays necessitated by the use of different types of Collateral in connection with Loans where Borrower is borrowing the Loaned Securities for a permitted purpose, especially in circumstances where Lender is engaged in conduit lending of customer securities.

Voting Rights in Respect of Collateral. Clause (b) of Section 3 provides that until Lender is required to return the Collateral (e.g., upon termination of a Loan or pursuant to any substitution, mark-to-market or similar provisions in the MSLA), Borrower waives all rights to vote the Collateral - an approach consistent with permitting Lender to retransfer the Collateral in separate transactions. Parties may wish to amend this Section to address particular transactions in which the transfer of voting rights is not possible or desirable and should consider the effect that any covenants of Lender the parties may wish to adopt regarding the exercise of voting rights with respect to the Collateral may have from a corporate law and governance perspective and on whether Lender has a perfected security interest in the Collateral under applicable law.

Substitution of Collateral. The Amendment does not specifically address the impact of the expansion of the types of Collateral permitted in securities lending transactions on Borrower's right to substitute Collateral pursuant to Section 3.5 of the MSLA. Section 3.5 of the MSLA provides that Borrower may, upon reasonable notice to Lender (taking into account all relevant factors, including industry practice, the type of Collateral substituted and the applicable method of transfer) substitute Collateral for Collateral securing any Loan or Loans. As noted in "Termination" above, if Lender has the right to retransfer Collateral under the Master Agreement, Lender may require more than one Business Day to purchase or otherwise obtain Collateral for delivery to Borrower in the event Borrower requests substitution.

Borrower and Lender should carefully consider the tax treatment under the Internal Revenue Code and accounting treatment under U.S. GAAP of Loans with respect to which Borrower does not have an unrestricted right to substitute Collateral, especially if such Loans are not made for a permitted purpose and are not terminable upon five Business Days' notice. Borrower and Lender should also be mindful of the period of time required to retransfer Collateral in the event that Borrower wishes to substitute Collateral for the purpose of exercising its rights with respect to certain corporate events (see "Voting Rights in Respect of Collateral" above).

Parties using the Amendment should consult their legal and accounting advisors to determine the tax and accounting consequences of eliminating or restricting Borrower's right of substitution in connection with any Loan, and particularly in connection with term Loans for which Borrower does not have a permitted purpose. Parties using the Amendment in connection with any other securities lending documentation should also ensure that Lender is given sufficient notice and opportunity to purchase or otherwise obtain Collateral for delivery to Borrower in the event Borrower requests substitution.

D. Dividends, Distributions, etc.

Section 4.1 of the Amendment is intended to update Section 7.3 of the MSLA to reflect the fact that, since there are no longer any limitations imposed on the types of Collateral that may be transferred in connection with a Loan under Regulation T, distributions on Collateral may consist of stock dividends, rights to purchase additional securities and other non-cash collateral in addition to cash distributions.

Section 4.2 of the Amendment confirms that, as currently contemplated under Section 7.3 of the MSLA, Borrower is entitled to receive an amount equal to all cash to be paid

or distributed on or in respect of Collateral not otherwise received by Borrower (through The Depository Trust Company ("DTC") or otherwise). Distributions in the form of cash are treated in accordance with the provisions of the Master Agreement. Section 4.2 of the Amendment establishes additional provisions, however, with respect to distributions in the form of non-cash distributions (e.g., stock dividends or stock split ups) that require such non-cash distributions to be added to the Collateral and considered such for all purposes. These provisions - which are consistent with the approach to non-cash distributions with respect to Loaned Securities under Section 7.2 of the MSLA - are intended to protect Lender's ability to use the Collateral to satisfy an outstanding delivery obligation (since Lender's transfer to Borrower of such non-cash distributions might otherwise effectively dilute the amount of Collateral available to Lender under the relevant Loan).

E. Transfer.

Section 5 of the Amendment is intended to update the transfer provisions of Section 16.1 of the MSLA to reflect the new terminology of Revised Article 8 of the UCC, without effecting any substantive changes to the method for transferring securities and other assets thereunder. Specifically, Section 5 provides that all transfers of Loaned Securities or Collateral consisting of "financial assets" may be transferred by, in addition to any other means agreed upon by Borrower and Lender, (a) physical delivery (as currently provided in subsection (a) of Section 16.1), (b) registration of an uncertificated security in the transferee's name by the issuer of such uncertificated security, or (c) the crediting of such financial assets to the "securities account" of a "securities intermediary" (the Revised Article 8 equivalent of subsection (b) of Section 16.1 respecting transfers on the books of a Clearing Organization).

Because a transferee on whose behalf securities are credited in a securities account by a securities intermediary no longer has an interest in the underlying security, but only a "security entitlement" with respect to the security, Section 5 clarifies, for the avoidance of doubt, that references to "securities" throughout the Master Agreement include any "security entitlements" with respect thereto. Likewise, Section 5 provides that the terms "financial intermediary" and "clearing corporation", if used in the Master Agreement, refer to the Revised Article 8 term "securities intermediary".

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 Collateral, the retransfer of Collateral and the receipt of any distributions on the Collateral. The parties should also consider the effect of any transfer option on the characterization of the Loan for purposes of applicable tax, bankruptcy, securities or other laws and on the priority of Lender's interest in the Collateral as against third parties under applicable law.

F. Representations and Warranties.

Section 6 of the Amendment contains a number of general representations and warranties to be made by each party regarding its authority to enter into the Amendment.

G. ERISA.

Section 7 of the Amendment is intended to ensure that nothing in the Amendment will be construed to limit Borrower's obligations under PTE 81-6 if Borrower is borrowing securities from a Plan and Borrower and Lender intend to conduct the Loan in accordance with its requirements. PTE 81-6, among other requirements, requires Borrower to transfer and maintain at all times Collateral with a market value equal to 100% of the market value of the Loaned Securities and generally restricts the types of Collateral that Borrower may transfer with respect to any Loan to cash, securities issued or guaranteed by the United States government or its agencies or instrumentalities, and certain irrevocable bank letters of credit.

H. Events of Default.

Section 8 of the Amendment clarifies that it shall be an event of default under the Master Agreement if either party fails to perform any covenant or obligation under the Amendment or if any representation made by either party in the Amendment shall be incorrect or untrue in any material respect. Section 8 also incorporates the notice periods otherwise applicable under the Master Agreement with respect to any failure on Lender's part to transfer distributions on Collateral to Borrower (for example, in Section 11(d) of the MSLA), to the extent that any such provisions are amended and supplemented by Sections 4.1 and 4.2 of the Amendment.

I. Transfer Taxes.

Section 9 of the Amendment provides that, unless otherwise agreed by the parties, Borrower shall pay any transfer taxes, stamp taxes and similar costs with respect to the transfer of Collateral, either upon termination of the Loan or pursuant to any substitution, mark-to-market or similar provision of the Master Agreement.

J. Definitions.

The Amendment does not define certain basic terms that appear in virtually all securities lending agreements the meaning of which has not changed as a result of recent statutory and regulatory developments (e.g., "Loan", "Lender", "Borrower", "Loaned Securities"). Section 11 of the Amendment, however, defines several terms which may or may not be commonly defined in securities lending documentation (e.g., "Customer", "Plan") or which are unique to the transactions contemplated by the Amendment (e.g., "Equity Security").

In addition, Section 11 modifies the definition of "Collateral" to accommodate Collateral consisting of securities other than traditional securities loan collateral (i.e., in general, U.S. Treasuries and certain other U.S. government obligations, certain foreign securities and money market instruments and letters of credit from qualifying banks). As noted above, a Loan that is not subject to Rule 15c3-3 and that is not conducted in accordance with PTE 81-6 may generally be secured with Collateral that does not fall within the specific categories enumerated in each of those rules (e.g., Equity Securities). The definition of "Collateral" under the Agreement has therefore been expanded to include any new or different securities exchanged for any securities that are Collateral (e.g., through a recapitalization or other corporate action). This approach is consistent with the treatment of such exchanges with respect to Loaned Securities under Section 26.14 of the MSLA.

No provisions have been drafted to address the acceptability of such additional types of Collateral, since most parties identify the categories of eligible Collateral in a non-standard schedule or otherwise outside the provisions in the main body of the Master Agreement. *Nevertheless, parties seeking, in appropriate circumstances, to use Collateral of a type other than those previously required by Regulation T should consider whether any modifications to their documentation are needed to address this possibility.*

Before agreeing to accept Collateral that does not fall within the categories previously enumerated in Regulation T, Lenders should consider carefully the credit, insolvency, liquidity, regulatory capital and other implications of such a determination.

III. Additional Issues.

Stock-for-Stock Loans. Parties contemplating Loans involving the borrowing of Equity Securities collateralized by Equity Securities should consider carefully (and seek appropriate advice from their legal advisors regarding) the implications of such Loans under the SEC's Net Capital Rule and Customer Protection Rule, Rules 15c3-1 and 15c3-3 under the Exchange Act respectively.

Cross-Border Tax Issues. The Amendment does not include any provisions specifically addressing cross-border tax issues. Parties should consult with their tax advisors regarding the appropriate tax treatment of Loans involving Collateral other than traditional securities loan collateral and the potential application of withholding tax to payments made thereunder or to dividends received on Collateral, particularly where the related Loans involve non-U.S. securities or where such parties include non-U.S. persons.

Other Issues. In addition, the parties should consider carefully (and seek appropriate advice from their legal advisors regarding) any additional regulatory issues that may arise in connection with Loans in which Borrower does not have a permitted purpose and transfers to Lender Collateral consisting of Equity Securities, especially where Lender does not retransfer the Collateral.

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