CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

ISSUE BRIEF

California Debt and Investment Advisory Commission May 2005

SECURITIES LENDING AGREEMENTS

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I. DEFINITION

A securities lending agreement is an agreement between a lender (e.g., a local agency) and a counterparty/borrower (e.g., a financial institution), in which the lender agrees to loan its securities to a borrower in exchange for collateral (e.g., cash, securities, or a letter of credit). Once the agreement has been fulfilled, the securities, which are held by a third party, are returned to the lender and the collateral is returned to the borrower[1].

Securities lending agreements are very similar to reverse repurchase agreements (also called reverse repos). In short, a reverse repurchase agreement is used to solve cash flow concerns, whereas a securities lending agreement is used to earn additional income. With a reverse repurchase agreement, there is an agreement that one party will actually buy securities from another party. At a specified date, the first party that purchased the securities will resell the securities to the original owner. Conversely, in a securities lending agreement, the securities are loaned from one party to another and the securities are collateralized.

Figure 1 (page 2) summarizes the requirements specified in California Government Code Section 53601(ii) for local agencies to participate in securities lending agreements. The first requirement is that before a local agency (the lender) can loan its securities, the securities must have been owned and fully paid by the local agency for a minimum of 30 days before the securities lending agreement can be executed.
Secondly, the total of all reverse repurchase agreements and securities lending agreements on investments owned by the local agency cannot exceed 20 percent of the base value of the portfolio. This requirement ensures greater diversification of instruments held in the portfolio.

Another stipulation to participate in a securities lending agreement is that the agreement does not exceed a term of 92 days; however, if the agreement includes a written codicil (a supplement to the agreement) that guarantees a minimum earning or spread for the entire period between the loan of a security using a securities lending agreement and the final maturity date of the same security, the term can exceed 92 days.

The final requirement is that funds obtained or funds within the pool of an equivalent amount to that obtained from loaning a security to a borrower through a securities lending agreement shall not be used to purchase another security with a maturity longer than 92 days from the initial settlement date of the securities lending agreement, unless the securities lending agreement includes a written codicil which guarantees a minimum earning or spread for the entire period between the loan of a security using a securities lending agreement and the

[1] An incentive for a borrower to participate in a securities lending agreement is that the loaned securities can be used as collateral for the borrower's own investment transactions, which is more economical than owning securities.

final maturity date of the same security. This requirement is to prevent local agencies from using short-term borrowing to invest in long-term instruments, which potentially can lead to a liquidity problem.

Figure 1

Securities Lending Agreement Requirements Pursuant to Government Code 53601
Security must be owned and fully paid a minimum of 30 days prior to sale.[1]
Total of all reverse repurchase agreements and securities lending agreements cannot exceed 20 percent of the portfolio's base value.
Term of the securities lending agreement is not to exceed 92 days.[2]
Funds obtained through a securities lending agreement shall not be used to purchase another security with a maturity longer than 92 days from the initial settlement date of the securities lending agreement.[3]

[1]This code section applies to both reverse repurchase agreements and securities lending agreements.

[2, 3]Term limitation will not be applied if the agreement has a written codicil that guarantees a minimum earning or spread for the entire period between the sale of a security and the final maturity date of the same security.

Securities lending agreements can be profitable transactions for larger agencies in that local agencies with at least $200 million in government securities can gain incremental income from loaning their securities[2]. In addition, even though the ownership of loaned securities is legally transferred to the borrower, the local agency is still entitled to all dividends, distributions, and interest. However, local agencies should be informed of the risks associated with investment in securities lending agreements, including credit risk, collateral risk, and operational risk.

This issue brief will explain the process of investing in securities lending agreements, discuss the different types of collateral used, and the benefits and risks, which are primarily related to reinvestment, associated with participating in a securities lending agreement. A glossary of key terms is included at the end of the document.

II. Securities Lending Agreement Process

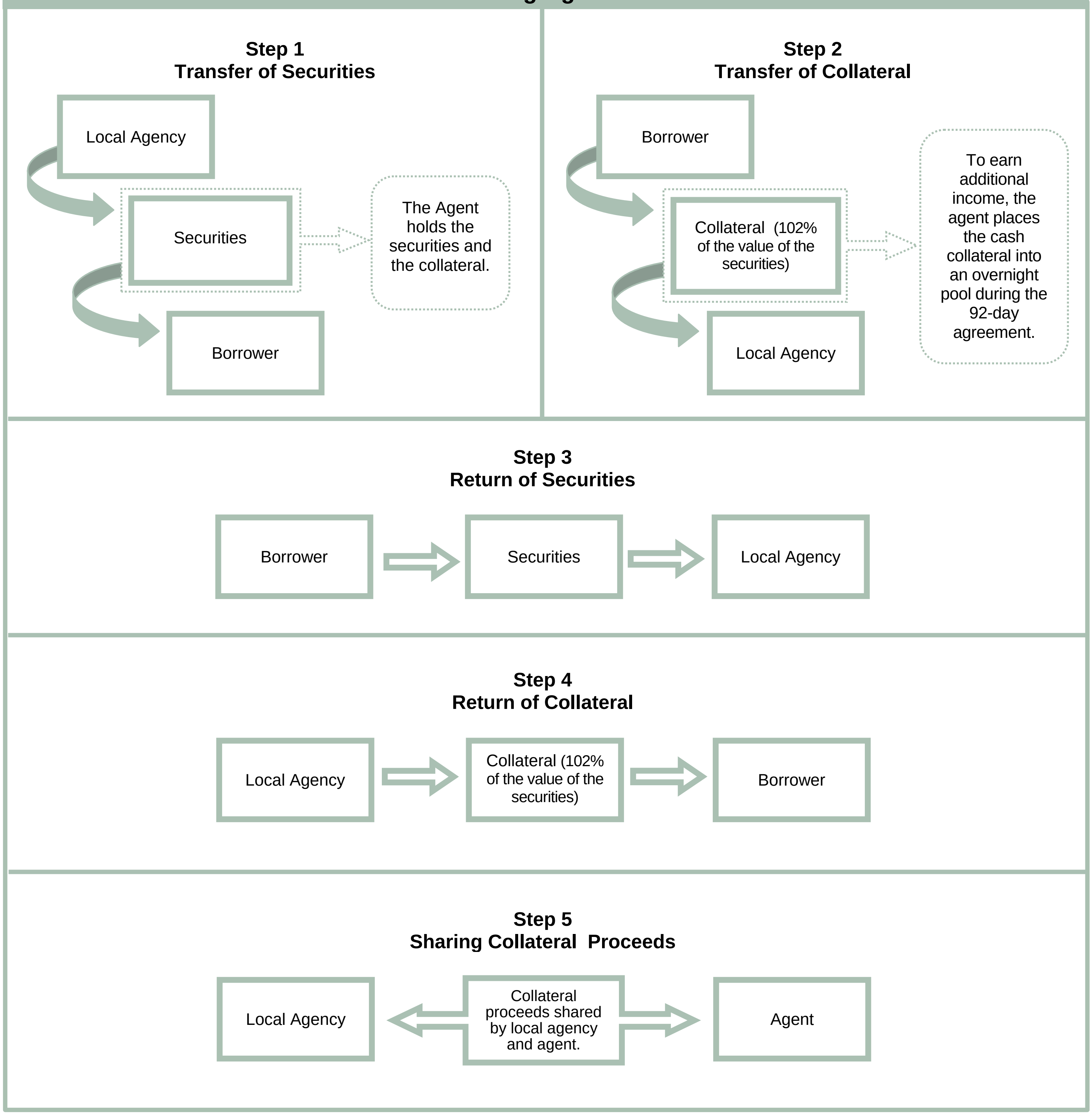
Typical stages involved in the securities lending agreement process are as follows:

1. The lender (local agency) should obtain approval from its legislative body to participate in a securities lending agreement. Once the local agency receives approval from its legislative body, the authorization to participate in securities lending agreements should be included in the investment policy.
2. The local agency and the agent then agree on the terms of the contract, such as what securities will be loaned, the length of the loan, the type of collateral (typically cash) to be used for the loan of the securities, and the interest rate (which is based on the borrower's needs) and terms.
3. The agent matches the local agency's securities with a borrower's needs. Most borrowers prefer U.S. Treasuries because they are AAA rated and they are easily marked-to-market.
4. Through the agent, the local agency loans securities to a borrower in exchange for collateral, typically 102 percent of the market value if cash is used. A letter of credit or U.S. government securities can also be used as collateral. When either of those is accepted, then the local agency and the borrower agree on a fee that the local agency pays.
5. At the conclusion of the agreement, the securities are returned to the local agency and the borrower receives its collateral.

Figure 2 (page 3) further shows the securities lending agreement process beginning with the transfer of securities.

[2] The State Treasurer's Office Local Agency Investment Fund/ Pool Money Investment Account (LAIF/PMIA) occasionally participate in securities lending agreements, but this type of investment transaction is not a regular part of their investment practices.

Figure 2
Securities Lending Agreement Process



III. TYPES OF COLLATERAL

The use of collateral in a securities lending agreement reduces risk in this type of transaction. As previously stated, the local agency receives collateral from the borrower in exchange for the use of the local agency's securities. Cash is the safest collateral to accept due to its flexibility. Although non-cash collateral is acceptable, transactions that include letters of credit or U.S. government securities are more complicated to monitor and difficult to convert if the agreement needs to be cancelled. While cash is the safest and best collateral to accept, letters of credit and U.S. government securities will also be discussed in this issue brief.

Cash

Cash collateral can range from 100 percent to 105 percent of the market value of the borrowed securities (typically, 102 percent is used). Once the agent has obtained the cash collateral, the collateral generally is placed in an overnight pool for investing. To ensure the safety of the local agency's investment, the pool should be valued in the tens of billions. In the event that a pool experiences a loss in value, the loss in a large pool (one comprised of many participants) is shared among the participants, which lowers each participant's overall loss. Therefore, the lender would still likely have sufficient funds to cover the collateral in any one agreement. On the other hand, if there is a loss in a small pool, each participant would be exposed to a greater share of that loss.

The lender must pay the borrower interest on cash collateral received in exchange for securities. Although interest on cash collateral is typically one percent, the interest rate is determined by the borrower's needs (i.e., the greater the need, the lower the rate of interest the borrower is willing to accept). Also, if a lender has a bond issue that is in high demand (also referred to as a special), then the interest rate could be discounted.

The lender reinvests the cash collateral, and ideally profits from the difference between the return on the reinvestment and the amount paid in interest to the borrower. The earnings from the collateral reinvestment are shared between the lender and the agent. Although the actual percentage that the lender receives is determined during the initial contract process, a typical distribution of the earnings is generally 60/40: 60 percent for the lender and 40 percent for the agent.

Letters of Credit and U.S. Government Securities

Instead of paying interest when letters of credit or U.S. government or federal securities[3] are used for collateral, the lender and borrower agree on a fee that the lender pays. When securities are used as collateral, the collateral is given a predetermined margin. If the market value of the collateral falls below an acceptable level during the term of the securities lending agreement, the local agency's agent can make a "margin call" (i.e., a demand for additional collateral). If, however, the collateral appreciates or the loaned securities depreciate in value, causing the loaned securities to be over-collateralized, the borrower may request the return of any excessive margin.

IV. BENEFITS

The benefits for the local agency of participating in a securities lending agreement are having the loaned securities collateralized, receiving additional incremental income, while retaining full rights to all dividends, distributions, and interest from loaned securities.

[3] Should be valued at 102 percent of the loaned securities.

Collateralized Securities

As previously discussed, the securities that are lent to the borrower are protected by collateral. Therefore, if the loaned securities are jeopardized in any way, the collateral provides a measure of safety by allowing the local agency to retain the cash collateral provided by the borrower or to make a margin call if securities were used as collateral.

Incremental Income

If cash is used as collateral, the agent will invest the collateral in an overnight pool, within the guidelines established by the lender. Investment in an overnight pool can provide additional income to the lender.

Earnings Entitlements

During a securities lending agreement, the borrower has legal ownership of the loaned securities; however, the lender still receives any dividends, distributions, and interest the securities earned.

V. RISKS

Although securities lending agreements are relatively safe, especially if cash collateral is used, there are some risks. Those risks include collateral risk, credit risk, and operational risk.

Collateral Risk

There are two types of collateral risk:

- reinvestment of collateral, and
- accepting collateral other than cash, such as another security, for the loan of securities.

Reinvesting Collateral. Perhaps the largest risk in securities lending agreements is the reinvestment of collateral, due to the possibility that a pool could experience a loss. This risk can be mitigated in a securities lending agreement by choosing a large bank with a large pool and by investing collateral in high quality, short-term instruments, such as a money market mutual fund.

Security Collateral. This type of collateral risk occurs when the market value of a security used as collateral does not cover the loan in a securities lending agreement. If the borrower provides securities instead of cash for collateral, then the collateral must be marked-to-market (i.e., current replacement cost) on a daily basis for the duration of the securities lending agreement. Additionally, the agent must always confirm that the collateral is never less than the loaned securities. Therefore, to lower collateral risk, it is essential that the securities lending agreement include a condition that if the securities on loan increase, the borrower must provide additional collateral.

Credit Risk

Credit risk is associated with the concern that a borrower with a poor credit rating will not be able to meet its obligations such as returning the loaned securities. Although receiving cash collateral lowers this risk, to be protected further against credit risk, the local agency's investment policy should include credit standards for firms borrowing its securities. The local agency should provide their agent with a copy of their investment policy, as it is the agent's responsibility to ensure that credit standards of the borrower are maintained.

Operational Risk

Operational risk is the risk of processing errors due to ineffective internal processes, individuals, and systems, or from external events. Since the agent is responsible for managing all transactions in a securities lending agreement and is held accountable for the financial results, it is necessary to choose an agent experienced in securities lending agreements, preferably one from a large financial institution. An agent experienced in handling large volumes of securities lending agreements is less likely to be subjected to failed internal processes, which is a result of an employee's willful violation against internal policies, or inadequate or non-existent procedures. The agent is also responsible for providing detailed reports on all lending activity.

Figure 3 summarizes some of the benefits and risks of participating in a securities lending agreement.

Figure 3

Benefits and Risks of Securities Lending Agreements
BENEFITS
Securities are fully collateralized.
Additional income can be derived from investment of collateral.
Local agency is entitled to all dividends, distributions, and interest from loaned securities.
RISKS
Credit Risk – Borrower receiving securities could be financially unstable and borrower could default.
Collateral Risk – non-cash collateral could fall below the value of the loaned securities.
Reinvesting Collateral Risk – Investment pool where cash collateral is reinvested could experience a loss.
Operational Risk – Failed internal processes.

VI. RECOMMENDATIONS

If a local agency has an active investment strategy and has sufficient availability of investments to loan, then participating in a securities lending agreement is another investment option that the local agency may consider.

The following should be kept in mind when engaged in a securities lending agreement:

- To assist the legislative body in making a decision, it would be beneficial to have an expert in the field explain what a securities lending agreement is. A representative from a leading financial institution should be invited to explain the process, benefits, and risks.
- Before participating in a securities lending agreement, make certain that the securities used will not be needed in the near term for cash flow purposes. Even if cash is received as collateral for loaned securities, that money is not available for cash flow needs because it is in the custody of the third-party agent. If securities are needed for cash flow purposes, then a securities lending agreement is not practical.
- Identify an agent experienced in securities lending agreements. Preferably, the agent should be a large bank that does billions of dollars of transactions in security lending agreements. Since one of the agent's responsibilities is to reinvest the collateral in a pool, it also is advisable to look at the bank's reinvestment pool size (i.e., the number of participants in a pool) before deciding to use that bank as an agent. Choose an agent whose reinvestment pool has a large participant base because that indicates a diversified pool.
- Provide the agent with a copy of the local agency's investment policy, which the agent should sign, so that the agent is aware of the local agency's credit guidelines for the borrowers.
- Include stipulations in the contract that will allow flexibility, such as being able to terminate the agreement early or with short-notice.
- Cash collateral is the safest type of collateral to accept because cash can be reinvested (unlike a letter of credit or U.S. government securities) if any adverse events occur during the agreement. Therefore, accepting cash collateral is strongly encouraged.

- When choosing an agent, choose a large bank experienced in securities lending. Although large financial institutions may be more expensive, it is most likely the safest option because they can provide indemnification against borrower default and they have the ability to obtain better earnings.
- Since a securities lending agreement is open-ended, securities on loan can vary from day to day. Communicate with the agent each day to know what securities are out on loan to avoid trading a loaned security.
- Make the agent a fiduciary in the agreement so that it will be the agent's responsibility to make sure that the borrower is reliable.
- Insist on knowing to whom the securities are being lent because it is important to know that the borrower is financially stable.
- Request a list of companies/borrowers that are in the investment pool.
- Monitor the portfolio daily and ask for a report. The agent must have a recordkeeping system that produces daily reports that should include, but not limited to, a list of securities that are currently on loan, outstanding loans by borrower, and returns of loaned securities.
- Negotiate with the agent regarding the distributions of earnings from an investment pool that will be shared between the agent and the local agency.
- Include in the agreement that the agent mark-to-market the loaned securities each day.

ACKNOWLEDGMENT

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GLOSSARY

Agent
The bank that arranges the securities lending agreement and holds in custody the securities and collateral. The agent provides transaction instructions, monitors credit-worthiness, marks-to-market investments, and invests cash collateral.

Codicil
A written supplement or addendum to the securities lending agreement, which modifies the term limitation beyond the 92-day limit imposed on securities lending agreements.

Collateral
The cash or securities provided as a guarantee for securities that are borrowed by the counterparty.

Counterparty
The borrower or broker/dealer that receives the securities from the lender.

Fiduciary
A legally appointed party that manages or acts as custodian of money or property for another and must exercise a high standard of care imposed by law or contract.

Lender
The party (local agency) that agrees to loan its securities in exchange for collateral.

Mark-to-Market
To value securities at current market prices. Marking to market is the only way to monitor risk and profit and loss effectively.

Overnight Pool
An investment means that allows multiple investors to combine their funds to invest in short-term instruments.

Reverse Repurchase Agreement (Reverse Repo)
An agreement of one party (e.g., a financial institution) to purchase securities at a specified price from a second party (such as a public agency) and a simultaneous agreement by the first party to resell the securities at a specified price to the second party on demand or at a specified date.

Special
A preferred bond issue or issues that have a particular Committee on Uniform Securities Identification Procedures (CUSIP) number.

SAMPLE SECURITIES LENDING AGREEMENT

The Bond Market Association provides a sample agreement and notes entitled "2000 Master Securities Loan Agreement" and "2000 Master Securities Loan Agreement Guidance Notes." These two documents can be found at the following link: **http://www.bondmarkets.com/ story.asp?id=838.**

Although individual agreements may include items specific to each lender's and borrower's requirements, the following are summaries of all 26 sections, Annexes I through III, and Schedules A and B that are included in the sample Master Securities Loan Agreement.

1. **Applicability:** Describes that a lender and borrower can enter into a securities lending agreement. Also states that the transaction will be referred to as a loan and that the transaction will be governed by the securities lending agreement.

2. **Loans of Securities:** This section addresses the terms of the securities loaned, which include the amount of securities, the basis of compensation, and the amount of collateral.

3. **Transfer of Loaned Securities:** This section describes a schedule when the securities to be loaned will be transferred.

4. **Collateral:** States when collateral should be provided, the specifications of the different types of collateral, substitution of collateral for collateral, addresses consequences for not delivering securities once collateral is received, and how to handle the expiration of a letter of credit.

5. **Fees for Loans:** This sections states that the fees that both the borrower and lender have to pay. If the borrower uses a collateral other than cash, then the borrower has to pay a fee to the lender and if the lender received cash collateral, the lender needs to pay a fee to the borrower.

6. **Termination of the Loan:** Section 6 discusses when a loan can be terminated based on the termination date determined at the beginning of the loan. Also, this section states that the "borrower may terminate a loan on any business day by giving notice to lender and transferring the loaned securities to lender before the cutoff time on such business day if (i) the collateral for such loan consists of cash or government securities or (ii) lender is not permitted, pursuant to section 4.2, to retransfer collateral."

7. **Rights in Respect of the Loaned Securities and Collateral:** This section states that during the term of the loan, the borrower has the right to transfer the loaned securities to others and lender waives the right to vote, provide consent, or take any similar action concerning the loaned securities if "the record date or deadline for such action falls during the term of the loan." Correspondingly, if the lender has the right to retransfer the collateral under the Agreement, the borrower waives all rights to vote, provide consent, or take any similar action concerning the collateral until the lender is required to return the collateral.

8. **Distributions:** The lender and borrower are each entitled to receive all distributions on the loaned securities and collateral, respectively, to the same extent as if the loan had not been made. If the other party is not in default, each party is must transfer to the other party cash in the amount of any cash distribution on the loaned securities or collateral, which the other party is entitled to receive.

9. **Mark to Market:** This section refers to the Exchange Act Rule 15c3-3(b)(3)(iii), which states that if a broker-dealer is borrowing securities from a customer, the broker-dealer must daily mark each loan to market and maintain collateral with a market value equal to at least 100% of the value of the loaned securities.

10. **Representations:** This section contains several representations and warranties that are made by both parties, such as transferring collateral, not relying on the other party for tax or accounting advice during the loan agreement, etc.

11. **Covenants:** Principal/agent liability, as it relates to Section 10 and Annex I, is the focus of this section.

12. **Events of Default:** This section states that if there is a default, the non-defaulting party can immediately terminate the loan provided that it notifies the defaulting party.

13. **Remedies:** In the event there is a default, Section 13 allows the non-defaulting party the right to do the following: purchase a similar amount of Replacement Securities or Replacement Collateral to replace the Loaned Securities or Collateral it has transferred to a defaulting party; take the necessary actions to sell any Collateral or a like amount of Loaned Securities it may hold; and apply and set off Collateral or Loaned Securities, and any proceeds thereof (including amounts drawn under a letter of credit supporting any Loan), against the cost of such Replacement Securities or Replacement Collateral and any other obligation of the defaulting party under the Agreement. The defaulting party remains liable to the non-defaulting party for the difference, with interest thereon, between the cost of the Replacement Securities or Replacement Collateral (plus any other amounts due to the non-defaulting party) and the sales price received (or deemed received) by the non-defaulting party for the Collateral or Loaned Securities. As security for the defaulting party's obligation to pay such difference, the Agreement provides the non-defaulting party with a security interest in any property of the defaulting party then held by or for the non-defaulting party and a right of setoff with respect to such property and any other amounts payable by the non-defaulting party. At its discretion, the non-defaulting party may elect, in lieu of purchasing all or a portion of the Replacement Securities or Replacement Collateral or selling all or a portion of the Collateral or Loaned Securities, to be deemed to have made such purchase or sale on the terms specified in the Agreement. Section 13 also contains "an express acknowledgment that, unless otherwise agreed by the parties, the assets subject to any Loan under the Agreement are instruments traded in a 'recognized market.'"

14. **Transfer Taxes:** Under this section, the borrower must pay any transfer taxes connected to the transfer of loaned securities or collateral.

15. **Transfers:** This section explains the requirements for the transfer of cash, letters of credit and securities.

16. **Contractual Currency:** Section 16 describes which payments are to be made. As summarized in the Bond Market 2000 Master Securities Loan Agreement Guidance Notes, "the party entitled to receive a payment may, at its option, accept payment in a currency other than the Contractual Currency, in which case Section 16 seeks to minimize the exchange risks to which the party receiving payment is subject. Payments made in any currency other than the Contractual Currency discharge the payor's payment obligation only to the extent of the amount of the Contractual Currency the recipient is able to purchase with the amount tendered in the other currency. Except in the event of a Default by the payee, the party making payment remains liable for any shortfalls in amounts due in the Contractual Currency, including shortfalls after any judgments or orders against that party in another currency have been converted to the Contractual Currency. If the amount in the Contractual Currency received upon conversion of the tendered currency exceeds the amount due, the recipient, except in the event of a Default by the payor, must refund the difference. The enforceability of these provisions will be subject to applicable law and judicial practice."

17. **Employee Retirement Income Security Act of 1974 (ERISA):** This section identifies requirements and transactions raising potential ERISA concerns, to comply with Prohibited Transaction Exemption (PTE) 81-6 if any loan involves ERISA Plan assets, and it provides other requirements appropriate to securities lending transactions involving ERISA plan assets.

18. **Single Agreement:** As stated in the Bond Market 2000 Master Securities Loan Agreement Guidance Notes, "all loans made under the agreement are part of the same contractual arrangement and that payments and transfers under all loans may be netted. In addition, default in the performance of any obligation under any loan constitutes default under all loans under the agreement, and the non-defaulting party may set off claims and apply property held by it in respect of any loan against obligations owed to it in respect of any other loan with the defaulting party."

19. **Applicable Law:** The Bond Market 2000 Master Securities Loan Agreement states the following: "This agreement shall be governed and construed in accordance with the laws of the State of New York without giving effect to the conflict of law principles thereof." New York is used because the greatest number of securities lending agreements occurs in the State of New York. Therefore, for participants in a securities lending agreement in California, the laws of the State of California should be applied.

20. **Waiver:** As stated in the Bond Market 2000 Master Securities Loan Agreement, "The failure of a party to this Agreement to insist upon strict adherence to any term of this Agreement on any occasion shall not be considered a waiver or deprive that party of the right thereafter to insist upon strict adherence to that term or any other term of this Agreement. All waivers in respect of a Default must be in writing."

21. **Survival of Remedies:** Section 21 addresses the survival of remedies in regards to the termination of the loan and the return of loaned securities or collateral.

22. **Notices and Other Communications:** This section specifies the types of communication that can be used between the parties in the securities lending agreement.

23. **Submission to Jurisdiction; Waiver of Jury Trial:** As summarized in the Bond Market 2000 Master Securities Loan Agreement Guidance Notes, " Submission to the jurisdiction of state and federal courts located in New York City, as provided in Section 23, is designed to address in particular the possibility that foreign parties using the Agreement might not otherwise be subject to such jurisdiction. The submission to jurisdiction is non-exclusive, so that a party may initiate proceeding in any other court of competent jurisdiction."

24. **Miscellaneous:** Section 24 contains a variety of provisions usually found in this type of agreement, such as setting a margin percentage, assignment, and agreement termination.

25. **Definitions:** A list of 47 terms are defined.

Sections 26 and 27, and Annexes I through III are taken directly from the Bond Market's 2000 Master Security Loan Agreement Guidance Notes.

26. **Intent:** Sections 26.1 to 26.5 seek to assist the parties in obtaining the benefits of certain Bankruptcy Code and Federal Deposit Insurance Act ("FDIA") protections applicable to participants in securities lending transactions. Parties entering into the Agreement with an insured depository institution should be aware of the written agreement and related requirements under sections 11(d)(9), 11(n)(4)(1), and 13(e) of the FDIA that may apply in the event that the Federal Deposit Insurance Corporation (the "FDIC") or the Resolution Trust Corporation (the "RTC") is appointed conservator or receiver. In this regard, the FDIC and the RTC have issued policy statements under which a "qualified financial contract" (such as a loan of securities) will be deemed to satisfy the FDIA's written agreement and related requirements if (i) it is evidenced by a writing that is sent reasonably contemporaneously with the parties' agreement to enter into the transaction, (ii) the counterparty relies in good faith on evidence of the insured institutions' corporate authority to enter into the transactions, which evidence may consist of a written representation in a master agreement by a vice president or more senior officer of the institution, and (iii) the counterparty maintains copies of records establishing the existence of the writing and the evidence of authority. See FDIC and RTC, "Statements of Policy on Qualified Financial Contracts" (Dec. 12, 1989). In view of these policy statements, it would be appropriate at a minimum for a party to require, when using the Agreement with a federally insured depository institution, that the Agreement be executed by an officer who is at least a full vice president of that institution. In light of the expanded scope of the assets that may be covered by the Agreement, technical changes been made in revised Section 26 to provide that a Loan is not intended to fall within the Bankruptcy Code definition of a "securities contract," or the FDIA definition of a "securities contract" or "qualified financial contract," if the assets subject to such Loan would render such definitions inapplicable.

Under Section 26.6, the parties agree that Loans are not "exchange contracts" and are not governed by buy-in or similar rules of any self-regulatory organization.

27. **Disclosure Relating to Certain Federal Protections:** Section 27.1 provides the notice required by Exchange Act Rule 15c3-3(b)(3)(iv), governing Borrowers who are broker-dealers, stating that the provisions of the Securities Investor Protection Act of 1974 may not protect Lender with respect to Loaned Securities. Section 27.2 provides express notice, as required by a 1989 SEC no-action letter, that the Collateral for a Loan may include, as permitted by applicable law, some Government Securities that are not backed by the full faith and credit of the U.S. Government (for example, securities issued or guaranteed by the Federal Home Loan Mortgage Corporation (Freddie Mac) or the Federal National Mortgage Association (Fannie Mae)). See Public Securities Association (available March 2, 1989). See also Exchange Act Release No. 26,608 (Mar. 8, 1989) (proposed amendment to Exchange Act Rule 15c3-3(b)(3)(iii) specifically permitting the use of certain agency securities as collateral).

Annex I : Annex I addresses a number of practical and legal issues in the context of a securities loan relationship with a party acting as Agent for one or more Principals. For example, a bank may be a party to the Agreement as agent lender, or a broker-dealer may be a party to the Agreement as agent borrower for one or more customers (e.g., in a prime brokerage arrangement). In light of the potential ambiguity regarding when an Agent is liable for its Principals' obligations, the central objective of Annex I is to assist parties entering into securities loan transactions in determining who, as between the Agent and its Principals, is liable for performance under the Agreement.

Annex I, as originally published in May 1993, was prepared in consultation with a number of Agent banks and representatives of Robert Morris Associates, but no endorsement of Annex I by any of these entities is implied.

Annex II: Annex II establishes the procedures for determining the Market Value (as defined in the Agreement) of exchange-traded, over-the-counter, and Foreign Securities for all purposes under the Agreement (except the provisions governing Default). Unless otherwise agreed, the Market Value of a letter of credit is the undrawn amount thereof.

Annex II provides that the Market Value of fixed-income Securities (including Government Securities) traded in the over-the-counter market shall be determined in accordance with market practice, based on a price or quotation obtained from a generally recognized source agreed to by the parties. The parties are encouraged to agree upon appropriate procedures for determining the Market Value of such Securities prior to the commencement of the Loan.

All determinations of Market Value for purposes of Annex II include accrued interest (other than interest previously transferred to the other party) except in those limited cases where there is a contrary market practice. Determinations of Market Value under Annex II are generally made on the basis of the last sale, quotation, or bid (or other specified criteria) on the preceding Business Day.

Annex III: Annex III establishes special terms and conditions for certain Term Loans, in which the parties agree that Lender will lend to Borrower a specific amount of Loaned Securities against a pledge of cash Collateral by Borrower until a scheduled Termination Date. The provisions of Annex III are designed to permit the parties to obtain the economic benefits of entering into Loans for a scheduled term. While the Annex preserves each party's right to terminate a Loan within the standard timeframes established by the Agreement, each party should consult with its own tax, legal and other advisors to ascertain whether use of the Annex may result in adverse tax and accounting consequences under the Internal Revenue Code and U.S. GAAP (as well as under ERISA, where applicable).

Schedules A: Names and Addresses for Communications

Schedules B: Defined Terms and Supplemental Provisions

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