News Bulletin

April 5, 2010

Regulatory Responses to Perceived Issues in the Securities Lending Market

Institutional investors, including pension and mutual funds, have historically viewed securities lending as a relatively low-risk method to increase the returns on their securities portfolios. In a typical securities lending transaction, one party (the securities lender) loans specific securities to the other party (the securities borrower) in exchange for collateral. To the extent that non-cash collateral is used, the securities lender receives a loan fee under the transaction. However, to the extent that cash collateral is used, the securities lender pays a cash collateral fee (also know as a rebate fee) to the securities borrower. Thus, an implicit element of cash collateralized securities loans is the reinvestment of the cash collateral by the securities lender or by an agent of the securities lender.[1]

Many securities lenders that used cash collateral reinvestment programs experienced sizable losses during the recent financial crisis, largely as a result of the declining values of their reinvested collateral. In large measure as a result of those losses, regulators have increased their focus on the securities lending markets.

In September 2009, the Securities and Exchange Commission (the "SEC") hosted a roundtable to discuss various issues relating to securities lending.[2] Key themes that emerged during the roundtable were those of investor protection, better disclosure, and increased transparency. To date, however, the SEC has not proposed any new rules.

In contrast, on January 5, 2010 and as part of its continuing process of developing a consolidated rulebook, the Financial Industry Regulatory Authority, Inc. ("FINRA") published Regulatory Notice 10-03, in which it proposed three rules relating to securities lending. Specifically, the proposed rules: (1) set forth certain requirements for a FINRA member firm (a "Member-Firm") that is a party to an agreement for the loan or borrowing of securities (Rule 4314); (2) govern the borrowing or lending of a customer's margin, fully paid, and excess margin securities (Rule 4330); and (3) establish the obligations of each Member-Firm as to callable securities in its possession or control (Rule 4340).

[1] Instead of earning a return based on a loan fee, securities lenders in cash collateralized securities loans earn their return based on the spread between the return that they receive on the cash collateral and the cash collateral fee.
[2] The roundtable also addressed issues with respect to the related area of short selling. For our alerts on short selling, visit our website at http://www.mofo.com/resources/financial-crisis/#10.

Securities Lending Transactions: Rule 4314

Background

Under current NYSE Rule 296(a), each NYSE member or member organization that is a party to an agreement with another member or member organization providing for the loan and borrowing of securities has the right to liquidate such transaction whenever the other party to such transaction: (1) applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property; (2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due; (3) makes a general assignment for the benefit of its creditors; or (4) files, or has filed against it, a petition under Title 11 of the United States Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA") (collectively, the "liquidation conditions"). Further, NYSE Rule 296(b) provides that no NYSE member may lend or borrow any security to or from any non-NYSE member, except pursuant to a written agreement, permitting the NYSE member the contractual right to liquidate the transaction in the event one of the liquidation conditions has occurred.

Proposed Rule 4314(a)

In 2006, the securities lending industry began to adopt a number of voluntary disclosure practices that were initiated by the SEC's Agency Lending Disclosure Initiative as part of an industry-wide effort to address the issues surrounding agency lending. In part, the initiative called for a party to a securities lending agreement to disclose its capacity as an agent or principal. Consistent with the initiative, Proposed FINRA Rule 4314(a) requires that a Member-Firm that enters into a securities lending agreement as an agent disclose its capacity to the other party to the transaction. Further, in the event the other party is not a Member-Firm, the Member-Firm must determine whether such non-Member-Firm is acting as principal or agent, prior to entering into the securities lending transaction. If the other party is acting as an agent in the transaction, Proposed FINRA Rule 4314(a) requires the Member-Firm to maintain books and records that reflect the details of the transaction with each such agent and identify each principal on whose behalf the agent is acting and the details of each transaction.

Proposed Rule 4314(b)

Consistent with NYSE Rule 296, Proposed FINRA Rule 4314(b) seeks to provide each Member-Firm that is a party to a securities lending agreement with another Member-Firm the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions set forth under the rule.[3]

Proposed Rule 4314(c)

Finally, FINRA is proposing to expand on NYSE Rule 296's written agreement requirement under its Proposed Rule 4314(c). Under the rule, Member-Firms may not lend or borrow securities to or from a non-member-firm of FINRA, except pursuant to a written agreement, which consists of the exchange of contract confirmations, and confers upon the Member-Firm the contractual right to liquidate such transaction, because of a liquidation condition, set forth under the rule.

Permissible Use of Customer Securities: Rule 4330

Background

NYSE Rule 402, NASD Rule 2330, and NASD IM-2330 act as a consumer protection mechanism by setting forth requirements a member must comply with in order to use customers' securities. Specifically, under NYSE Rule

[3] The liquidation conditions set forth under Proposed Rule 4314 are identical to the conditions set forth under NYSE Rule 296.

402 and NASD Rule 2330, a member is prohibited from lending, either to itself or others, securities that are held on margin for a customer and eligible to be pledged or loaned, unless the firm first obtains written authorization from the customer permitting the lending or use of such securities. Note that in order to ease the burden of obtaining consent each time a Member-Firm engages in a securities lending transaction with a customer's securities, the NSYE permits Member-Firms to use a single customer-signed margin agreement/loan consent in lieu of separate written documents.

Proposed Rule 4330(a)

Under Proposed FINRA Rule 4330, FINRA plans to adopt the respective NYSE and NASD rules, subject to certain changes. As such, under Proposed FINRA Rule 4330(a), Member-Firms are still required to meet the written consent authorization requirement by using a single customer-signed margin agreement/loan consent, provided that the agreement contains the following language in bold typeface directly above the signature line:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

Proposed Rule 4330(b)

Proposed FINRA Rule 4330(b) seeks to address the recent increase in the borrowing and lending of customers' fully paid or excess margin securities. Proposed FINRA Rule 4330(b)(1) obligates Member-Firms to notify FINRA at least 30 days before engaging in such borrowing and lending activities. Upon receipt of the notification, FINRA reserves the right to request additional information necessary to evaluate the Member-Firm's compliance with the consumer protection provisions under Securities Exchange Act Rule 15c3-3. Examples of such additional information include: (1) the written agreement authorizing such borrowing of securities, and reflecting the material terms of the arrangement; (2) the types of customers that are parties to such arrangements; (3) the types of accounts used to effect such transactions (whether the subject securities are contained in customers' cash or margin accounts or separate accounts); (4) the types of collateral provided to customers in connection with such transactions, the frequency of marking to market and the custody of such types of collateral; (5) net capital compliance of such transactions; (6) the operational and recordkeeping processes related to such transactions; (7) the rebates paid/received in connection with such transactions and any other compensation arrangements related thereto; (8) the procedures for handling customers' requests to sell the fully paid or excess margin securities subject to such transactions; and (9) any applicable disclosure requirements.

Additionally, Proposed Rule 4330(b)(2) requires a Member-Firm, prior to entering into a securities borrowing transaction with a customer, to provide a written notification to such customer, indicating that the provisions of SIPA may not protect them with respect to such transaction and that the collateral delivered to the customer may constitute the only source of satisfaction of the Member-Firm's obligation in the event of default. The Member-Firm must also advise the customers of the risks associated with such transaction (including potential loss of SIPC protection, loss of voting rights, the type and sufficiency of collateral provided to the customer, any limitations on the customer's ability to sell the loaned securities, the economics of the transaction, including potential tax implications, as applicable, and the Member-Firm's right to liquidate the transaction because of a condition of the kind specified in Proposed Rule 4314(b)) and a determination that such transaction is in fact suitable for the customer.[4]

[4] Supplementary Material .04 of the Proposed FINRA Rule 4330(b)(2) requires that a Member-Firm borrowing a customer's fully paid or excess margin securities is responsible for making the suitability determination regarding the customer. However, according to Supplementary Material .04, the Member-Firm may rely on the representations of another Member-Firm that has a relationship with the customer.

Possession and Control of Callable Securities: Rule 4340

Background

NYSE Rule 402.30 addresses the obligations of Member-Firms with regard to certain partially callable securities.[5] Under the rule, members in possession or control of such partially callable securities are required to identify each security so that its records clearly show in whose account such securities are held. NYSE Rule 402.30 also obligates members to disclose the system and the manner in which such partially callable securities are held and their rights to withdraw uncalled securities and to establish an impartial lottery system as to partially redeemed or called securities, corresponding to the proportional holdings of such securities held in bulk by the members.

Proposed Rule 4340(a)

Proposed FINRA Rule 4340 retains the basic premise of NYSE Rule 402.30 by requiring each Member-Firm that has in its possession or control certain callable securities to establish a procedure by which it will allocate among its customers the securities to be redeemed or selected as called in the event of a partial redemption or call. However, unlike NYSE Rule 402.30, Proposed FINRA Rule 4340(a) applies to any security that may be called or redeemed prior to maturity. Further, Proposed FINRA Rule 4340(a) eliminates the impartial lottery requirements under NYSE Rule 402.30 and permits Member-Firms to establish procedures that require the allocation to be conducted on a fair and impartial basis. The rule clarifies that such procedures may include an impartial lottery system, acting on a pro-rata basis or by any other means which will result in a fair and impartial allocation of such callable securities. However, such allocation procedures must be posted on the Member-Firm's website, and notice must be provided to new customers at the opening of their accounts and at least once a year.

Proposed Rule 4340(b) and 4340(c)

As noted above, NYSE Rule 402.30 prohibits a Member-Firm from allocating securities to any of its accounts or those of its "employees, partners, officers, directors and other approved persons." Proposed FINRA Rule 4340(b) broadens the NYSE's limitation by prohibiting allocations to members and "associated persons,"[6] where the terms of the redemption of callable securities are favorable to the customer. In situations where the redemption of callable securities is unfavorable to the customer, Proposed Rule 4340(c) prohibits a Member-Firm from excluding its accounts and those of its associated person from the pool of securities eligible to be called.

Conclusion

The FINRA rules address some of the perceived shortcomings in the securities lending markets. Whether the SEC will follow suit and propose additional regulations is yet to be seen.

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[5] The following securities are exempt from the requirements under Rule 402.30: (1) certain bonds that have not paid interest for at least two interest periods; (2) Euro dollar bonds deposited in a central clearing facility for such bonds, provided that customers are notified of the deposit into the central clearing facility and also that the member has the right to withdraw uncalled bonds from the facility at any time; and (3) bonds or preferred stocks, provided that the member has satisfied certain requirements, including adopting an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member.

[6] Pursuant to Section 3(a)(18) of the Exchange Act.

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