**SEC Securities Lending and Short Sale Roundtable**

**Panel 4: <u>The Future of Securities Lending and Potential Regulatory Solutions: Market Evolution; SEC's Role; Assessing any Regulatory Gaps</u>**

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## The Evolution of Securities Lending

The evolution of the securities lending market in the US in the near term is likely to be most influenced by a combination of recent market events and regulatory changes that may occur in the future.

With regard to market factors, two that affected securities lending over the course of the recent financial crisis are likely to be the most impactful. The first of these was the serious impairment of some of the cash collateral pools in which securities lending cash collateral was invested. The second issue related to the degradation in the financial condition of several broker-dealers, most notably Bear Stearns and then the failure of Lehman Brothers, which raised counterparty concerns.

With respect to impaired cash collateral pools, the valuations of some of the fixed income instruments in these collateral pools were negatively impacted by a combination of credit and liquidity issues. These conditions highlighted the following:

1. Lending large quantities of easy-to-borrow securities was not a risk free way to generate returns.
2. The impairment of the collateral pools affected the ability of some lenders to reduce their lending balances or exit lending programs, since it was important for the cash collateral managers to not be forced to sell securities that would result in realized losses. In some cases, lenders who wanted to reduce balances or exit lending programs were compelled by their lending agents or cash collateral managers to take in-kind distributions of the collateral pool investments.
3. The significant mismatch between the weighted average maturities of these collateral pools and the overnight nature of virtually all securities loans exacerbated the situation.
4. In order to maintain the stability of cash collateral pools, lenders (or their agents) had to compete for borrow balances by raising rebate rates on loans of easy-to-borrow securities.

These cash collateral investment issues have raised several potential securities lending market changes. Among these are the following:

1. Increased interest in lending securities versus non-cash collateral which eliminates collateral reinvestment. This is the predominant form of lending in Europe where lending regulations permit a broad range of securities, including equities, to be provided as collateral for securities loans.
2. A focus on intrinsic value lending, that is, shifting the goal of lending programs from generating large amounts of cash collateral to lending securities that command higher fees in the lending marketplace.
3. Improved risk controls in cash collateral investment pools, including tighter investment guidelines and more attention focused on the asset/liability (i.e., duration) mismatch.
4. A more conservative cash collateral investment profile.

The second market factor, the increase in the concern that lenders had regarding broker-dealer counterparties, has already impacted the securities lending market, as follows:

1. Lenders scrutinized borrowers' financial condition more thoroughly.
2. In response to credit concerns, lenders were more focused on diversifying their balances.
3. Lenders altered their limits with broker-dealer borrowers, shifting balances as necessary.
4. Lenders were more focused on the borrower indemnification provided by lending agents and understanding the specifics of the indemnity and the entity providing it.

## Factors Influencing the Growth or Contraction of Securities Lending

Securities lending is principally demand driven. Therefore, contraction or growth of securities lending will be influenced directly by the volume of trading that has a short sale component. There is a fundamental misunderstanding regarding the transactions that drive demand, with an impression that directional short selling is either the only, or the principle, source of demand. While directional short selling is a factor, much of the demand for borrowing results from short selling related to a whole host of other trading strategies including:

Convertible arbitrage
Warrant arbitrage
Risk arbitrage
Options trading
Long/short strategies

Since these trading strategies are largely undertaken by hedge funds, the borrowing marketplace will only be as robust as the hedge funds that generate demand and their gross short exposures. This is the primary factor that will influence the growth or contraction of securities lending. Borrow balances today are lower than they were a year ago and significantly below their highs. This is directly related to the changes in hedge fund behavior in the wake of the financial crisis.

A second factor that can impact the size of the securities lending market is the depth and breadth of supply. Given that much of the demand for securities lending is for hedging, the interaction between supply and demand as reflected in borrowing fees, can influence whether a trading strategy will work. To the extent that supply tightens, rates could make certain trades uneconomic. Regulatory or other factors that would make it undesirable for institutions to lend would therefore affect the size of the market. While the supply side of the market experienced some turbulence during the financial crisis, institutions largely remained in the market. Some of the institutions that did curtail their lending activity have returned and others are expected to return as markets improve.

A third factor that has the ability to impact the size of the securities lending market is unpredictable regulatory action. This was the case last summer in the wake of emergency orders which first required preborrows for 19 financial stocks and then prevented short selling altogether in the shares of financial companies. These orders contributed to short covering, but not to stability, as the "rules of the road" changed quickly and unpredictably.

**Regulation of the Securities Lending Market**

The securities lending market in the US is highly regulated and has been for many years. Among the regulations that directly relate to securities lending are the following:

> Regulation T of the Board of Governors of the Federal Reserve System which specifies the conditions under which a US broker-dealer may engage in securities lending transactions. This rule establishes what is known as "the permitted purpose requirement" for borrowing securities – (i.e., that a broker dealer may generally borrow or lend U.S. securities from or to a customer (non broker-dealer) solely "for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations.").
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> Rule 15c3-3 under the Securities Exchange Act of 1934, which contains the requirements for how a US broker-dealer documents and collateralizes securities borrows from customers (i.e., the types of acceptable collateral and the amount of collateral that must be provided). 15c3-3 promulgates extensive requirements related to borrowing from customers including the requirement that a broker provide the customer with:

a. a written agreement setting forth the rights and liabilities of the parties;
b. a schedule of compensation;
c. a schedule of the securities to be borrowed;
d. specified forms of collateral;
e. a minimum 100% collateral requirement;
f. daily marking-to-market; and
g. notice that SIPA may not protect the lender.

Exchange Act Rule 15c3-1, which has provisions that relate to how a US broker-dealer must adjust the minimum net capital it is required to maintain based on its securities borrowing and lending activities.

There are also other regulations that have an indirect, but nonetheless substantial, impact on securities lending, such as Rule 204 and the other rules under Regulation SHO. While these primarily have a direct affect on the demand side of the market, there are also regulations, such as the Investment Company Act of 1940 and ERISA, which directly impact the supply side by setting conditions on securities lending for investment fiduciaries.

**Jurisdiction over Securities Lending**

As the principal regulator for broker-dealers in the US, the SEC has oversight of the securities borrowing and lending activities of these entities. The SEC, through its own activities and those of FINRA and other self-regulatory organizations, has been very active in conducting both regulatory examinations and sweeps that have focused on a broad range of securities lending-related activities, including compliance with Rule 15c3-3 as well as targeted examinations of compliance with Reg SHO, including Rule 204.

The SEC does not directly regulate the non-broker-dealer entities that participate in securities lending. Other significant non-broker dealer participants in the securities lending markets include entities operating under direct regulation from one or more regulators. For example, the custodians and non-custodial agent lenders, are typically banks regulated by the Federal Reserve and other banking regulators, such as state banking departments, while investment companies and mutual funds are regulated by the SEC.

**Regulatory Reform**

An arena where the SEC could pursue regulatory reform that would impact securities lending practices relates to prime brokerage, where action is pending to replace the 1994 Prime Brokerage No-Action Letter with one that has been modified to take into consideration client compliance with Reg SHO in a prime brokerage setting. Specifically, the new no-action letter would require that prime brokers report to executing brokers client behavior at it relates to incorrect order marking (long versus short and vice

versa) and non-compliance with locate requirements in order to assist the executing broker in determining whether it is reasonable to rely on the client with respect to order marking or locate compliance.

The monitoring and procedures required in the new letter are targeted at detecting clients that are "bad actors" with respect to the requirements of order marking and short sale and locate compliance. These would be effective in detecting and curtailing naked short selling in ways that are superior to the proposals circulating in the market relating to pre-borrows and the so-called "hard locate" concept. For example, the proposed no action letter is designed to limit the risk that an executing broker would rely upon a bad actor misrepresenting a short sale as a long sale. This risk would not be addressed by imposing a pre-borrow or hard locate, because the bad actor could still make this misrepresentation to the executing broker. Furthermore, we think the pre-borrow or hard locate would have adverse unintended consequences to the securities lending market, such as locking up securities inventory far in excess of the amount reasonably expected to be required to settle actual short sales (which number of shares typically represent but a small fraction of the number of shares subject to locate requests).

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