ALERTS

SEC Issues Guidance Regarding Fully Paid Securities Lending Collateral Arrangements

October 27, 2020

On Oct. 22, 2020, the staff of the U.S. Securities and Exchange Commission's ("SEC" or "Commission") Division of Trading and Markets ("Division staff"), in a letter to the Financial Industry Regulatory Authority ("FPSL Collateral Guidance"), issued no-action relief to broker-dealers operating fully paid and excess margin securities lending programs (such programs, "FPSL programs") that employ certain cash collateral arrangements. While characterized as no-action relief, the FPSL Collateral Guidance states that the identified collateral arrangements are prohibited under rule 15c3-3(b) of the Securities Exchange Act of 1934, as amended ("Exchange Act"). The FPSL Collateral Guidance allows broker-dealers that currently employ such cash collateral arrangements to continue to do so, but only until April 22, 2021. Given this relatively short "compliance" window, broker-dealers currently operating FPSL programs will want to determine whether any changes to their programs are necessary.

Background and Current Regulatory Framework

Rule 15c3-3(b)(1) of the Exchange Act provides that broker-dealers must obtain and maintain possession or control of all fully paid and excess margin securities carried for the accounts of customers. Exchange Act rule 15c3-3(b)(3) provides that, notwithstanding the possession or control requirements of Exchange Act rule 15c3-3(b)(1), a broker-dealer may

borrow customer fully paid and excess margin securities,[1] but only where the broker-dealer "provides" its customer with "collateral, which fully secures the loan of securities" by the close of business on the day of any such loan.[2]

Exchange Act rule 15c3-3(b)(3)'s collateralization requirement is designed to protect the securities lender in the event of the broker-dealer's insolvency.[3] Importantly, while the text of Exchange Act rule 15c3-3(b)(3) merely refers to *providing* collateral to the customer, the Commission, when adopting the requirements of Exchange Act rule 15c3-3(b)(3), stated that the rule would "compel the firm to turn over the collateral physically to the lender."[4]

Notwithstanding the intent of the Commission in adopting Exchange Act rule 15c3-3(b)(3),[5] the Division staff notes that a number of "broker-dealers operating [FPSL] Programs have *not* turned over the collateral physically to the lender and therefore retain control over the collateral that is used to secure their borrowings of fully paid and excess margin securities."[6] The FPSL Collateral Guidance expressly identifies collateral arrangements whereby "collateral [is] deposited into the [customer's] securities account at the broker-dealer or an omnibus account at a bank in the name of the broker-dealer [borrower]" as non-compliant under Exchange Act rule 15c3-3(b)(3), noting that under such arrangements the broker-dealer, and not the customer, has exclusive control over the transfer and liquidation of the collateral.[7]

Analysis

The FPSL Collateral Guidance states that the collateral arrangements identified in the letter do not comply with the requirements of Exchange Act rule 15c3-3(b)(3) and must be terminated by no later than April 22, 2021. Further, a joint statement by SEC Commissioners Lee and Crenshaw makes clear that this is a critical issue and that failure to comply with the requirements of Exchange Act rule 15c3-3(b)(3) following expiration of the no-action relief will not be tolerated.[8]

Notwithstanding the letter's clarity regarding the FPSL collateral arrangements identified therein, the FPSL Collateral Guidance does not note whether other collateral arrangements employed in FPSL programs (that is, collateral arrangements other than those specifically identified in the letter) are similarly deficient and, perhaps most importantly, does not

specify which collateral arrangements *would* comply with Exchange Act rule 15c3-3(b)(3). The lack of additional guidance regarding *compliant* arrangements may prove burdensome for broker-dealers currently operating non-compliant FPSL Programs, particularly given the relatively short no-action window.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] At which point, the broker-dealer will no longer be deemed to have possession or control of such securities.

[2] *See* Exchange Act rule 15c3-3(b)(3).

[3] Importantly, in a FSPL Program, the customer acts as lender (that is, it lends its fully paid and excess margin securities to its broker-dealer, which acts as borrower). Typically, the broker-dealer operating a FPSL will rehypothecate any fully paid and excess margin securities it borrows from its customers.

[4] *See* Exchange Act Release No. 34-18737 (May 13, 1982), 47 Fed. Reg. 21759 at 21768 (May 20, 1982).

[5] *Id.*

[6] *See* the FPSL Collateral Guidance (emphasis added).

[7] For instance, in such arrangements, the bank carrying the collateral would be wholly unaware of the identity of the broker-dealer's customer.

[8] *See Joint Statement on No-Action Relief for Non-Compliance with the Customer Protection Rule*, available at https://www.sec.gov/news/public-statement/lee-crenshaw-customer-protection-2020-10-23#_ftnref7 (last accessed Oct. 24, 2020).

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