SIDLEY

SIDLEY AUSTIN LLP
1501 K STREET, N.W.
WASHINGTON, D.C. 20005
+1 202 736 8000
+1 202 736 8711 FAX

AMERICA • ASIA PACIFIC • EUROPE

January 14, 2021

**By Email and FedEx**

Elizabeth H. Baird
Michael A. Macchiaroli
Thomas K. McGowan
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

**Re: October 22, 2020 No-Action Letter Regarding Broker-Dealers Borrowing Fully Paid and Excess Margin Securities from Customers**

On behalf of the Securities Industry and Financial Markets Association ("SIFMA"),[1] we respectfully submit for your consideration this response to the October 22, 2020 letter from the U.S. Securities and Exchange Commission, Division of Trading and Markets (the "Division") to the Financial Industry Regulatory Authority, Inc. ("FINRA") regarding broker-dealers' borrowing of fully paid and excess margin securities from customers (the "No-Action Letter") under paragraph (b)(3) of SEC Rule 15c3-3 ("Rule 15c3-3").[2]

As described further herein, it is SIFMA's position that, in addition to collateral arrangements involving the physical delivery of collateral to a customer, there are also collateral arrangements currently used by member firms that comply with paragraph (b)(3) because they are also consistent with the customer protection principles reflected in Rule 15c3-3. Specifically, while under such collateral arrangements currently used by member firms, customers may not be granted immediate access to, or the ability to reuse, the collateral (as can be the case in arrangements involving the physical delivery of collateral), these arrangements nevertheless are

[1] SIFMA brings together the shared interests of hundreds of broker-dealers, investment banks, and asset managers. On behalf of the industry's nearly one million employees, SIFMA advocates on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. SIFMA serves as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. SIFMA also provides a forum for industry policy and professional development. With offices in New York and Washington, DC, SIFMA is the U.S. regional member of the Global Financial Markets Association.

[2] 17 CFR § 240.15c3-3.

designed to ensure that in the event of an insolvency default by the borrowing broker-dealer, the customer will have direct access to and rights in (*i.e.*, "control" of) the pledged collateral without the need for the broker-dealer's involvement or consent.[3] As such, the collateral should not become general property of the borrowing broker-dealer's insolvency estate under the Securities Investor Protection Act of 1970[4] and, consequently, its customers should not have to rely on an unsecured general creditor claim under SIPA.

## I. Background and Benefits of Fully Paid Lending

The U.S. Securities and Exchange Commission ("SEC") added paragraph (b)(3) to Rule 15c3-3 in 1982 to provide an exception from the general requirement that a broker-dealer maintain physical possession or control of a customer's fully paid or excess margin securities that are carried by the broker-dealer, thereby allowing broker-dealers to establish programs to borrow such securities from their customers and on-lend these securities ("FPL Programs"). As a condition thereto, subparagraph (b)(3)(iii)(A) of the rule requires a broker-dealer to "provide to the lender . . . collateral, which fully secures the loan of securities". As the Division noted in the No-Action Letter, the Adopting Release relating to paragraph (b)(3) states that "[t]he rule will still compel the firm to turn over the collateral physically to the lender and mark to the market."[5] Subparagraph (b)(3)(iv) further requires that a broker-dealer provide prominent notice that the provisions of SIPA may not protect the lender customer with respect to the borrowed securities and, therefore, the collateral provided by the borrowing broker-dealer may constitute the customer's only source of satisfaction if the broker-dealer becomes insolvent and fails to return the borrowed securities.[6]

At the time that Rule 15c3-3(b)(3) was adopted, lenders participating in broker-dealers' FPL Programs were typically sophisticated institutions such as mutual funds, pension funds, and insurance companies. However, many broker-dealers' FPL Programs that were established in the years following its adoption began offering their programs to retail brokerage customers. With the SEC's approval of FINRA Rule 4330, which went into effect in May 2014,[7] retail

[3] Such collateral arrangements also ensure that in the case of a *non*-insolvency default by the broker-dealer, the customer will have direct access to and rights in the pledged collateral without the need for the broker-dealer's involvement or consent.

[4] 15 U.S.C. §§ 78aaa *et seq*. ("SIPA").

[5] *See Net Capital Requirements for Brokers and Dealers*, Exchange Act Release No. 34-18737 (May 13, 1982), 47 FR 21759, 21768 (May 20, 1982) (the "Adopting Release").

[6] Rule 15c3-3(b)(3) requires this notice because the Securities Investor Protection Corporation ("SIPC") takes the position that, as a result of certain amendments to SIPA in 1978 and related court cases, a brokerage customer that lends securities to a broker-dealer and receives collateral is not a "customer" of the broker-dealer under SIPA. *See Borrowing and Lending of Securities by Brokers and Dealers and Related Requirements*, Exchange Act Release No. 34-18420 (Jan. 13, 1982), 47 FR 3531, 3532, n. 10 (Jan. 25, 1982).

[7] *See Order Approving Proposed Rule Change to Adopt FINRA Rules 4314 (Securities Loans and Borrowings), 4330 (Customer Protection-Permissible Use of Customers' Securities) and 4340 (Callable Securities) in the Consolidated FINRA Rulebook, as Modified by Partial Amendments No. 1 and No. 2*, Exchange Act Release No. 70958 (Nov. 27, 2013), 78 FR 72951 (Dec. 4, 2013); *see also* FINRA, Regulatory Notice 14-05 (Feb. 2014).

lending became an integral part of many firms' fully paid lending business, and customers have come to view these programs as benefits incident to their normal brokerage account relationship. This expansion of FPL Programs has yielded a number of significant benefits. For example, FPL Programs offer customers – both retail and institutional – the opportunity to earn income on their securities positions without having to sell their securities. They also help to alleviate fails to deliver, particularly in more illiquid (*i.e.*, "hard to borrow") securities, and facilitate market efficiency by increasing overall liquidity.

## II. The SEC Should View as Acceptable Collateral Arrangements that are Consistent with the Principles of Rule 15c3-3(b)(3)

SIFMA has members with FPL Programs for institutional customers that provide for physical delivery of the collateral to the customer in the manner described in the Adopting Release, although these programs may vary as to whether institutional customers are required to segregate the collateral after delivery or permitted to reuse it at their own risk.

SIFMA also has members with FPL Programs that utilize other collateral arrangements which provide customers with protection in the event of the member's default or insolvency that is the functional equivalent of physically delivering the collateral to their customers because actual physical delivery may be neither practicable nor desirable. With respect to such FPL Programs, SIFMA members prefer to deliver collateral to the customer in a way that (i) ensures during the securities loan that the collateral is safeguarded and available to satisfy the borrowing broker-dealer's obligations to the customer in the event of a broker-dealer default/insolvency, and (ii) alleviates the administrative burden to the customer of maintaining the collateral with their own custodian, and potentially needing to engage the services of that custodian to perform the administrative tasks of returning the collateral as may be required for daily mark-to-market movements and upon the termination of the loan.

In this regard, many retail and institutional FPL Programs maintain the collateral in a manner that not only protects the customer's rights in the collateral in the event of the broker-dealer's default/insolvency, but also limits the broker-dealer's access to the collateral during the term of the loan.[8] While some aspects of these collateral arrangements may vary, they all reflect

FINRA Rule 4330(b)(2)(A) permits a broker-dealer to borrow securities from a brokerage customer, provided the broker-dealer has reasonable grounds for believing that the loan(s) of securities are appropriate for the customer (and provided the broker-dealer fulfills the other requirements set forth in FINRA Rule 4330).

[8] In order to fulfill its responsibilities under the FPL Program, including its obligation under Rule 15c3-3(b)(3)(iii)(B) to daily mark to market all loans, in an efficient and cost-effective manner, the broker-dealer is often granted the ability to deposit and withdraw collateral in the customer's collateral account. When this is granted, the broker-dealer remains obligated under Rule 15c3-3(b)(3)(iii) and the terms of its lending agreement with the customer to maintain collateral that is not less than 100 percent of the market value of all outstanding loans of securities. Under the Uniform Commercial Code of the State of New York ("UCC"), the customer may retain a perfected security interest in the collateral even if the broker-dealer retains some rights over the collateral.

three key elements that establish the customer's control[9] over the collateral: **(i) the collateral is delivered away from the borrowing broker-dealer, (ii) the customer has a perfected security interest in the collateral, and (iii) the customer can directly obtain the collateral without the involvement or consent of the broker-dealer, in the event of the insolvency of the broker-dealer.** In the event of a broker-dealer insolvency, collateral held pursuant to such a collateral arrangement would be expected to pass to the customer and not be treated as part of the broker-dealer's insolvency estate by a SIPC trustee.

It is SIFMA's view that such collateral arrangements with these three key elements should be deemed to comply in all material respects with Rule 15c3-3(b)(3) and should be viewed as the functional equivalent of the physical delivery arrangement described in the Adopting Release.

## III. The SEC Should Consider Additional Acceptable Delivery Options for Institutional Lenders

In addition to, but separately from, the collateral arrangements described in the preceding section of this letter, SIFMA respectfully requests the opportunity to speak with the SEC Staff regarding other acceptable collateral arrangements with institutional customers in FPL Programs.

* * *

On behalf of SIFMA, we appreciate the opportunity to respond to the No-Action Letter and also your consideration in these matters. In this regard, as SIFMA member firms are mindful of the April 22, 2021 deadline set forth in the No-Action Letter, they are eager to engage in a dialogue with the SEC Staff on an expedited basis if there are any questions regarding the positions outlined herein. If you have any questions or require additional information, please do not hesitate to contact us by calling Kevin Campion at (202) 736-8084, David Katz at (212) 839-7386, or Erin Kauffman at (202) 736-8310, or to contact SIFMA by calling Rob Toomey at (212) 313-1124 or Joe Corcoran at (202) 962-7383.

Sincerely,

/s/ Kevin J. Campion
/s/ David M. Katz
/s/ Erin N. Kauffman

Cc: Securities Industry and Financial Markets Association

[9] Under the UCC, a security interest may be perfected by giving the secured party (*i.e.*, the customer of the broker-dealer or such customer's agent) "control" over the collateral. This control may be achieved through delivery of the collateral to the secured party, as well as through the granting of a security entitlement.