SULLIVAN & CROMWELL LLP

S&C memo

November 3, 2023

SEC Adopts Rule Mandating Reporting of Securities Loans

Rule 10c-1a Will Require Reporting and Public Disclosure of Securities Lending Transaction Information

SUMMARY

On October 13, 2023, the Securities and Exchange Commission ("SEC") adopted a new rule (the "Final Rule") under the Securities Exchange Act of 1934 ("Exchange Act") requiring the reporting of securities loan information to a registered national securities association ("RNSA")[1] and the subsequent public disclosure by the RNSA of most of that information.[2] Specifically, the Final Rule requires any "covered person" (or a "reporting agent" acting on its behalf) who agrees to a "covered securities loan" on behalf of itself or another person to report to an RNSA, by the end of the same day, that such covered securities loan is effected (or modified), the "Rule 10c-1a information." The RNSA then must disclose publicly most of the Rule 10c-1a information by the morning of the next business day, except for the loan amount, which must be made public after 20 business days, and certain other elements, which are not publicly disclosed but must be made available to the SEC.

The Final Rule will be effective 60 days following the date of publication of the adopting release in the Federal Register (the "Effective Date"). The compliance dates are as follows: (1) an RNSA must propose rules to implement the Final Rule within four months of the Effective Date and those rules must be effective no later than 12 months after the Effective Date; (2) covered persons must start to report information to an RNSA starting on the first business day 24 months after the Effective Date (the "Reporting Date"); and (3) an RNSA must start to make specified information publicly available within 90 calendar days after the Reporting Date.

BACKGROUND

Section 984(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act added section 10(c) to the Exchange Act and directs the SEC to promulgate rules to increase the transparency of information available to brokers, dealers, and investors with respect to securities lending. Pursuant to that mandate and in connection with its concerns that market participants and regulators do not have access to important information on current market conditions, the SEC proposed a securities lending transparency rule (the "Proposed Rule") on November 18, 2021.[3]

The Final Rule is generally consistent with the Proposed Rule, but departs from it in certain important ways, including with respect to the persons required to report, the reportable information, and the reporting timing. That said, the scope of the Final Rule remains broader than many market participants suggested during the comment period. In addition, although the SEC adopted the Final Rule on the same day it adopted rules for reporting of short positions,[4] the SEC did not take the same steps to safeguard against unwarranted public disclosure of short sale activity when it adopted the Final Rule as it did when it adopted its short position reporting rule. In particular, the Final Rule will require loan-level public disclosures on a T+1 basis, including with respect to securities borrowed by customers to deliver into short sales, even though the SEC's parallel short position reporting rule will only involve public disclosure of aggregate short interest levels on a significantly delayed basis.

FINAL RULE

Who Must Report

Any "covered person" who agrees to a covered securities loan on behalf of itself or another person is subject to the Final Rule's reporting obligations. The Final Rule defines "covered person" as:

- any person that agrees to a covered securities loan on behalf of a lender (an "intermediary"), other than a clearing agency when providing only the functions of a central counterparty or a central securities depository pursuant to Rule 17Ad-22 of the Exchange Act;
- any person that agrees to a covered securities loan as a lender when an intermediary is not used, unless the next bullet applies; or
- a broker or dealer when borrowing fully paid or excess margin securities pursuant to Rule 15c3-3(b)(3) of the Exchange Act.

The Final Rule allows a covered person to rely on a "reporting agent" that is a broker, dealer, or registered clearing agency to fulfill its reporting obligations under the Final Rule. In order to use a reporting agent, a covered person must:

- enter into a written agreement with the reporting agent that agrees to provide the "Rule 10c-1a information" (described below) to an RNSA on behalf of such covered person; and
- provide such reporting agent with timely access to the Rule 10c-1a information.

The Final Rule subjects a reporting agent to a number of requirements, including that it:

- provides the Rule 10c-1a information in the format and manner required by the RNSA and within the time periods specified by the Final Rule;
- establishes, maintains and enforces policies and procedures reasonably designed to ensure compliance with the Final Rule;
- enters into a written agreement with an RNSA that permits it to provide Rule 10c-1a information to the RNSA on behalf of the covered person;
- provides the RNSA with a list of each covered person on whose behalf it is acting (and updates such list on a daily basis); and
- preserves for three years (the first two in an easily accessible place) the Rule 10c-1a information obtained from the covered person and the written agreements.

It is important that the definition of covered person does not include persons that lend securities through a broker-dealer, agent lender, or custodian. In those cases, the broker-dealer, agent lender, or custodian is required to provide the Rule 10c-1a information. The SEC notes that in a "fully-paid lending arrangement" with a broker-dealer, the broker-dealer will be the reporting person. On the other hand, if a person directly runs its own securities lending program, then that person would need to report the Rule 10c-1a information to an RNSA, possibly through a reporting agent.

What Securities Loans Must Be Reported

Covered persons are generally required to report information with respect to "covered securities loans." The Final Rule defines covered securities loan to mean a transaction in which any person, on behalf of itself or one or more other persons, lends a "reportable security" to another person, except for:

- a position at a clearing agency that results from central counterparty services or central securities depository services; or
- the use of margin securities by a broker or dealer, unless the broker or dealer lends such margin securities to another person.

The exception for the use of margin securities by a broker-dealer is intended to make clear that, along with the reference in the covered person definition to broker-dealers borrowing fully paid or excess margin securities, when a broker-dealer rehypothecates margin securities from customers in compliance with Rule 15c3-3, the customers are not required to report the Rule 10c-1a information and that, in such a case, the broker-dealer does not have to report the Rule 10c-1a information until it loans the rehypothecated securities. For example, if the broker-dealer pledges those securities under a bank loan or uses those securities to cover a customer fail to deliver, no reporting obligation would apply. Likewise, the SEC makes clear that repurchase transactions typically used for short-term funding are not covered by the Final Rule.

The SEC in the adopting release confirms that a covered securities loan does not include a short sale; rather, the loan used to settle the short sale will be reportable. The SEC acknowledges, however, that there is a linkage between when customers borrow securities and when they use the securities to deliver into

short sales. For example, it is common in arranged financing structures for a broker-dealer to arrange for its customer to borrow securities from an affiliate or other lender in connection with the customer's short sale. The SEC declined commenters' requests to exclude these loans and limit the rule's scope to wholesale lending to broker-dealers; instead the agency sought to address those commenters' concerns about public transparency into short sale activity through the changes to public disclosure aspects of the rule summarized below under "The RNSA's Responsibilities."

The Final Rule defines "reportable security" to mean any security or class of an issuer's securities for which information is reported or required to be reported to the consolidated audit trail as required by Rule 613 of the Exchange Act and the CAT NMS Plan, FINRA's TRACE system, or the MSRB's Real-Time Transaction Reporting System (or any reporting system that replaces one of these systems).

Despite requests by commenters to limit Rule 10c-1 to equity securities, the Final Rule applies to all securities reported to TRACE, including debt and asset-based securities. Similarly, the Final Rule requires reporting of U.S. government securities that are reported pursuant to the MSRB's Real-Time Transaction Repository.

What Information Must Be Reported to an RNSA

Covered persons are required to report three types of information to an RNSA (the "Rule 10c-1a information") with respect to a covered securities loan:

First, covered persons are required to provide "data elements," if applicable, to an RNSA by the end of the day on which a covered securities loan is effected. The data elements are:

- the legal name of the security issuer, and the Legal Entity Identifier ("LEI") of the issuer, if the issuer has a non-lapsed LEI;
- the ticker symbol, International Securities Identification Number ("ISIN"), Committee on Uniform Securities Identification Procedures ("CUSIP"), or Financial Instrument Global Identifier ("FIGI") of the security, or other security identifier;
- the date the covered securities loan was effected;
- the time the covered securities loan was effected;
- the name of the platform or venue where the covered securities loan was effected;
- the amount, such as size, volume, or both, of the reportable securities loaned;
- the type of collateral used to secure the covered securities loan;
- for a covered securities loan collateralized by cash, the rebate rate or any other fee or charges;
- for a covered securities loan not collateralized by cash, the securities lending fee or rate, or any other fee or charges;
- the percentage of collateral to value of reportable securities loaned required to secure such covered securities loan;
- the termination date of the covered securities loan; and

- whether the borrower is a broker or dealer, a customer (if the person lending securities is a broker or dealer), a clearing agency, a bank, a custodian, or other person.

The SEC in the adopting release specifically states that the compensation reporting covers a spread to an identified benchmark or reference rate. The exact method of reporting this type of compensation is left to the RNSA.

The SEC rejected proposals by commenters to permit aggregate reporting of securities loans to RNSAs, and reporting to an RNSA must occur on a loan-by-loan basis. However, as discussed below under "The RNSA's Responsibilities," the RNSA will initially publish loan amounts on an aggregated basis, with the loan amounts for individual loans published with a 20 business-day delay.

Second, covered persons are required to provide certain information on modifications to a covered securities loan to an RNSA by the end of the day on which a covered securities loan is modified, if the modification occurs after other information about the covered securities loan has already been provided to an RNSA, and results in a change to such information. Specifically, if the modification occurs after the data elements for such covered securities loan are provided to an RNSA, and results in a change to information previously required to be provided to an RNSA, the following information must be reported:

- the date and time of the modification;
- the specific modification and the specific data element being modified; and
- the unique identifier assigned to the original covered securities loan.

If the modification is to a covered securities loan for which reporting was not required on the date the loan was agreed to or last modified and results in a change to any of the data elements, then the data elements must be reported as of the date of modification, as well as the date and time of the modification.

Third, covered persons are required to provide certain confidential data elements, if applicable, to an RNSA by the end of the day on which a covered securities loan is effected. These confidential data elements include:

- if known, the legal name of each party to the covered securities loan, other than the customer from whom a broker or dealer borrows fully paid or excess margin securities pursuant to Rule 15c3-3(b)(3) of the Exchange Act, Central Registration Depository or Investment Adviser Registration Depository Number, market participant identification, and the LEI of each party to the covered securities loan, and whether such person is the lender, the borrower, or an intermediary between the lender and the borrower;
- if the person lending securities is a broker or dealer and the borrower is its customer, whether the security is loaned from a broker's or dealer's securities inventory to a customer of such broker or dealer; and
- if known, whether the covered securities loan is being used to close out a fail to deliver pursuant to Rule 204 of Regulation SHO or to close out a fail to deliver outside Regulation SHO.

The confidential data elements are solely for regulatory use and will not be made public. The confidential information may only be shared with another regulator pursuant to an SEC order.

While the name of the lender must be disclosed as part of the confidential information, this does not include the name of customers of broker-dealers borrowing fully paid or excess margin securities from customer accounts. Thus, lenders to a broker-dealer in a fully paid lending arrangement would not be disclosed.

There was considerable comment on whether securities loans in effect prior to the Effective Date of the Final Rule would need to be reported. The SEC determined not to require the reporting of outstanding securities loans, but if such a securities loan is modified, as indicated above, all the relevant information must be reported.

The RNSA's Responsibilities

An RNSA has several important obligations under the Final Rule. First, an RNSA must implement rules regarding the format and manner of its collection of information required to be reported under the Final Rule. These rules will be subject to SEC review and approval as well as a notice and comment period.

Second, an RNSA is required to make publicly available certain of the Rule 10c-1a information, as follows:

- not later than the morning of the business day after the covered securities loan is effected:
  - the unique identifier assigned by an RNSA to the covered securities loan;
  - the data elements, except for the loan amount; and
  - the LEI, ISIN, CUSIP, FIGI, or other security identifier(s) that an RSNA determines is appropriate to identify the relevant reportable security, as well as information pertaining to the aggregate transaction activity and distribution of loan rates for each reportable security and those security identifier(s).
- on the 20th business day after the covered securities loan is effected, the loan amount.
- not later than the morning of the business day after the covered securities loan is modified, any modification to the data elements, except for the loan amount (any modification to the loan amount must be disclosed on the 20th business day after the covered securities loan is modified).

Aggregate transaction activity refers to the absolute value of transactions so that net position changes will not be discernable. This aggregation is intended to address concerns by commenters that proprietary information could be disclosed in the new reports. However, an RSNA would still be required to publicly disseminate other data elements on a T+1 basis and disclose actual loan amounts after 20 business days.

Third, an RNSA must keep the confidential data elements confidential, in accordance with applicable law and the Final Rule's requirements regarding data retention and availability. In this regard, the RNSA must establish, maintain, and enforce reasonably designed policies and procedures to maintain the security and confidentiality of the data received by it.

Finally, the Final Rule also provides that an RNSA may establish and collect reasonable fees in connection with its activities. In an important change from the Proposed Rule, the Final Rule provides the RNSA with discretion to charge fees to persons other than covered persons. Thus, it is possible that covered persons will not alone bear the costs of the RNSA.

Cross-Border Application

In response to comments, the SEC provided additional guidance on the cross-border application of the Final Rule. Consistent with the "territorial approach" taken by the SEC with respect to other rules under the Exchange Act, the SEC determined that its authority under Section 10(c) of the Exchange Act extends to "conduct within the U.S. that comprises (in whole or in part) effecting, accepting, or facilitating of a borrowing or lending transaction." Applying this standard, the SEC indicates that the Final Rule's reporting requirements "will generally be triggered" whenever a covered person effects, accepts, or facilitates (in whole or in part) in the U.S. a lending or borrowing transaction. The SEC declined to adopt any of the exclusions proposed by commenters, including proposed modifications that would exclude transactions by non-U.S. persons, limit the application of the Final Rule to loans of U.S. exchange traded securities offered by a U.S. lender or take into account reporting under other non-U.S. reporting regimes.

* * *

ENDNOTES

1 An RNSA is an association of brokers and dealers that is registered as a national securities association pursuant to Section 15A of the Exchange Act. The only current RNSA is the Financial Industry Regulatory Authority.

2 Reporting of Securities Loans. SEC Release No. 34-98737; File No. S7-18-21 (Oct. 13, 2023) (the "Adopting Release").

3 Reporting of Securities Loans. SEC Release No. 34-93613; File No. S7-18-21 (Nov. 18, 2021) (the "Proposing Release"). *See also* SEC Fact Sheet: Securities Lending Transparency (Nov. 18, 2021), *available at* https://www.sec.gov/files/rules/proposed/2021/34-93613-fact-sheet.pdf.

4 Short Position and Short Activity Reporting by Institutional Investment Managers. SEC Release No. 34-98738; File No. S7-08-22 (Oct. 13, 2023).

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.