SEC,Finra Mull New Regulations On Securities Lending Practices

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By Sarah N. Lynch

Of DOW JONES NEWSWIRES WASHINGTON (Dow Jones)--Some panelists at a roundtable on securities lending Tuesday told the U.S. Securities and Exchange Commission they should consider new rules governing the securities lending market to protect institutional investors from major losses and promote more market transparency.

Meanwhile, the self-regulatory group for the brokerage industry announced it is strongly leaning toward proposing new rules this year that would offer greater protections to smaller retail investors who are increasingly being approached by firms to see if they would be willing to lend out their shares.

"We did not expect the kind of disaster in the securities lending program that we experienced [last year]," said Jerry Davis of the New Orleans Municipal Employees' Retirement System during a roundtable hosted by the SEC. "This was sold to us as an idea some 20 years ago. It was going to be free money from your idle assets. That was a very seductive concept. Then Lehman failed," he added.

The multitrillion-dollar securities lending market has helped big Wall Street firms and institutional investors like pension and mutual funds make money for decades. But the credit crisis last year exposed the risks it can entail and many now see greater need for new regulations to shed more sunshine on the opaque market.

Securities lending allows pension funds and other investors to make some money off otherwise idle assets by lending out their securities to borrowers who put up cash collateral in exchange for shares. It is an important practice for short-sellers, who sell the borrowed shares in a bet the stock will decline and later buy them back at a lower price before returning them to the lender.

The SEC has said it is looking into possible new rules on securities lending practices to address issues like the lack of a central public marketplace that displays quotes and also potential conflicts. The bulk of the roundtable on Tuesday focused on institutional lending, which comprises the majority of the market.

But regulators at the Financial Industry Regulatory Authority said brokerage firms are starting to turn more and more to retail investors to locate shares now that the crisis has hindered institutional lending, and they want to be sure smaller investors know what they are getting into first.

"We're looking hard at rules that basically ensure that broker-dealers allow customers to fully understand all the risks involved," Finra Chief Executive Richard Ketchum said, noting that the rules will likely focus on disclosing things from potential conflicts to restrictions firms may have on liquidating securities.

As for institutional investors, some panelists said Tuesday their concerns lie around the practices surrounding the re-investment of cash collateral. Securities lenders work through agents such as banks, which act as middlemen between lenders and borrowers. Those agents in turn invest lenders' cash collateral.

After suffering losses from cash collateral programs, however, some say there needs to be greater disclosures to lenders by agents about the risks this may entail and how the money can be invested.

"I absolutely think there should be more disclosure and a more precise commitment from lending agents in terms of what they will do under what circumstances," Davis said, noting that the agreements the New Orleans pension fund had with its agents were "marvels of simplicity."

Some said Tuesday that alternatives to using cash as collateral could help the U.S. market.

"By encouraging cash as collateral, the U.S. regulators have inadvertently encouraged many practitioners to build cash balances, which in turn have driven earnings in the good times and losses in the bad times," said Mark Faulkner, the founder of Data Explorers which has a global database of over-the-counter stock loan data.

In a speech last week, SEC Chairman Mary Schapiro said the SEC is doing a "wholesale review" of the securities lending market and looking at everything from potential conflicts to transparency issues. The roundtable Tuesday served as a way to help the SEC get a better idea of how to better protect lenders

The SEC is also looking into a series of potential new rules on short-selling, which will be discussed at a second roundtable Wednesday. That roundtable will center on possible "pre-borrow requirements" which would require short-sellers to have agreements to borrow stocks from specific brokers before placing an order.

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