Best Practices for Recalls and Buy-Ins

A Best Practices Document from the RMA Securities Lending Council and
Securities Lending Operations and Technology Committee

Note:
This document is not intended to replace any existing contractual agreement between counterparties/market participants, including deadlines, unless otherwise provided in the contractual agreement itself. This document aims to describe established market and best practices to ensure a well-functioning market and help mitigate the potential for increased fails due a truncated settlement timeframe.

Market Participants

Seller: In a securities lending context, the Seller represents the beneficial owner of the securities that are being sold. The Seller is typically referred to as the "principal" or "client."

Buyer: The "Buyer" is the outside party to whom the securities are owed. The "Buyer" is responsible to initiate the buy-in process with a notification of intent to buy-in, to execute, and to provide notice of execution. The "Buyer" can either execute on its own once its purchase fails or as required by a market rule.

Lender: Party either making the loan of securities to the Borrower or intermediating between the party making the loan and the Borrower. The "Lender" can either act as principal or "Agent" (principal or client). The lending agent is typically responsible for managing the recall process including issuing recalls to a borrower.

Borrower: The "Borrower" is the party borrowing the securities from a "Lender." Market sells failing due to securities on loan is typically a result of a Borrower not returning the securities to the Lender by intended settlement date of the sale of the securities. When a buy-in is executed, the liability is typically passed to the borrower.

Custody Bank: A Bank engaged by a Lender to hold and manage its securities portfolio. In typical lending relationships, securities are delivered and received directly to and from the lending fund's Custody account to facilitate a sale settlement. The Custody Bank's settlement teams are important to the process as they are responsible for managing the settlement of market sells. Timely turnaround to ensure securities are available for a client on settlement date requires coordination between Lenders, borrowers, and the Custody Bank settlement process.

Regulatory Environment

SEC Rule 204: Rule 204 was implemented by the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934 as amended 2009 to address abusive "naked" short selling. A broker-dealers must purchase or borrow securities to close out its pending buys once failing assuming the Buyer has a net liability. For long sells, a broker-dealer must close out its fail by no later than the beginning of trading on S+3 (typically T+5), or S+1 (typically T+3) for short sells. The Rule 204 buy-in requirement has become the most common for stock loan buy-ins since its inception. For purposes of Rule 204, sells failing due to securities on loan are considered "long sells".

On May 28th, 2024, the US Market will transition to a T+1 settlement cycle. On and after May 28th, 2024, the Rule 204 close-out requirement will remain at S+3 (T+4 modified from T+5).

Regulation SHO: Regulation SHO was adopted by the SEC to establish a regulatory framework governing short sales, specifically targeting abusive "naked" short selling. Reg SHO limits the amount of time a broker-dealer can allow a failure to deliver to continue. The rule created a "Threshold Security List" which reports any stock with more than 0.5% of its outstanding securities failing for five consecutive business days. Securities included on this Threshold Security List cannot be short-sold as the likelihood of a buy-in is heightened. Rule 204 supersedes this rule as it is stricter in its definition.

SEC Rule 15c3: This SEC rule sets minimum net capital requirements for Broker-dealers. Firms are required to have liquid assets equal to or greater than a certain percentage of total liabilities. In a securities lending scenario, a broker dealer may be required to execute a buy-in to close out a pending liability to comply with its acceptable asset/liability ratio. These buy-ins are typically executed in the afternoon around T+10 if a rule 204 buy-in has not already been executed.

Continuous Net Settlement ("CNS"): "CNS" is a service provided through DTCC where the long and short positions of each participant are netted to one long or short position. Within the service, National Securities Clearing Corporation ("NSCC") becomes the counterparty to each side of the trade and guarantees each participant's transactions where availability exists within the depository. If one participant is owed securities from CNS, that participant, i.e., the receiving party, has the option to submit a buy-in notice. The buy-in will be allocated depending on the age and size of another participant's net short position.

Industry Best Practices Defined (With Established Market Practices)

Recall Notification

1. Lenders or Lending Agents should issue recall notices to borrowers in a manner consistent with the relevant Securities Lending Agreement ("SLA") between Lender and Borrower.
2. Recall notices should contain the following information: Issue Date, Borrower, Security Name, Security Identifier, quantity of securities recalled, "part-of" quantity, original loan date, rebate/loan rate, Borrowers/Lenders account, recall due date, and any special return instructions. Relevant corporate action information can also be included, such as if the securities are being recalled CUM (with) or EX (without) Dividend.
3. Recalls are typically sent to Borrowers via third-party vendors. Sending and receiving recalls in an automated fashion is preferred industry-wide as it provides systemic notifications between counterparties which can be leveraged to initiate timely inventory management protocols to maintain efficient settlement discipline. Absent an automated method of transmitting recalls, email will be the method of last resort.
4. Regardless of the method of transmission, all parties, (Borrower, Lender and/or Lending Agent) should have a way of producing the notice(s) at least three months after notification to settle any potential disputes over recall timing.
5. Should a recall notice need amendment or cancellation, the amendment notice should be sent in writing or using the same method as the original recall notice. Ideally, a courtesy phone call should follow.
6. If the Borrower disagrees with the terms of a recall notice (securities, part of lot, due date, account, etc.), the Borrower should immediately contact the Lending Agent/Lender in writing and explain its disagreement (responding to the actual notice, preferably). The Lending Agent/Lender should then clarify all points to the borrower's satisfaction. If a borrower does not object, it is understood the recall is agreed. In the interest of satisfying recalls in a timely manner, borrowers should refrain from "DK'ing" or canceling recalls where there is minor discrepancy in the recall details (due date, etc.) and apply the recall to their system for securities allocation. These minor discrepancies can be addressed with the lender afterward.
7. Recall notices should be sent to the borrowers as soon as possible to give the borrower time on day-one of the recall to manage inventory requirements. For the avoidance of doubt, it is advised to issue recall notices by 7:00pm Eastern Time as a best practice, with the understanding that recalls can be issued up to 11:59pm Eastern Time with the expectation that the borrower will utilize commercially reasonable efforts to attempt to return securities the next business day. The spirit of this practice is to ensure the market achieves an efficient settlement discipline and reduced settlement risk by providing notification to Borrowers, allowing inventory management protocols to be initiated to ensure timely return(s) and to avoid increased market fails.

8. Securities are typically recalled from borrowers with the same settlement cycle as the market in which the securities are being recalled, i.e., US Equity T+1. If a "Seller" or "client" sells securities with a shortened settlement cycle (T+0), the Lender can either recall the securities on the same cycle or recall the securities with a standard cycle. This will depend on agreements in place with Lender/client, and Lender/borrower.
9. Issuing the recall in a timely manner is the Lender's responsibility, with the risk of recalling late borne by the Lender. Returning securities by recall due date is the borrower's responsibility, and the borrower is responsible for managing its recalls and recall due dates, provided a valid recall notice was sent. Borrower should assume that any recall outstanding beyond recall due date is subject to a buy-in without further notice.

Established Market Practice

The recall notice issued by the Lender or Lending Agent to the Borrower serves as the definitive tool that states what security and quantity is being recalled and the date by which the securities must be returned to avoid liability. Recalls are permitted to be issued until 11:59pm Eastern Time. The Lending Agent/Lenders will seek to send recall notices throughout the day and endeavor to issue no later than 7:00pm Eastern Time to assist the market inventory management process, to maintain settlement efficiency and to reduce settlement risk. Unless otherwise provided in the existing contractual agreement between counterparties/market participants, recalls issued prior to the cutoff time provided for in that agreement will have a due/liability date of the following business day. An additional day will be added to the due/liability date for recalls issued between the cutoff time and 11:59pm Eastern Time (including for buy-in execution). The expectation is that diligent effort will be made to satisfy the recall the following business day if the recall is issued prior to 11:59pm Eastern Time.

Basic Definition of a Buy-In

"Buying-in" a security is a process that is initiated when the delivering party (e.g., the Borrower or the Seller) of a security fails to deliver to the eligible receiving party (e.g., the Lender or the Buyer.) The receiving party will purchase (buy-in) the same securities from a third party to close out its pending receive and pass the cost of the additional purchase to the delivering party. Once the buy-in is executed, the delivering party will receive its originally agreed upon sell proceeds and the original order will be closed.

In the context of securities lending, a buy-in typically occurs when a Seller's delivery fails due to its securities being on loan over the intended Settlement Date and the Buyer either chooses to close out its receive once the sell fails or is required to do so by a market rule. Buy-ins may also occur if the delivering party fails to deliver a recalled security in sufficient time to satisfy the receiver requirement for the securities (e.g., Proxy or ESG)

Buy-In Notification

Buyer/Seller Relationship

1. Once a sale is failing in the market and it is apparent a buy-in could be imminent, the Buyer should provide the Seller with a formal notice of its intent to buy-in the securities if the sale does not settle by a certain date (and time). The notice should include the buying firm's letterhead, security name, security ID, trade reference, number of securities needed, date by which they need to settle, and contact information at the buying broker.
2. The notice should be sent from the Buyer to the Seller 48 hours prior to execution, but no less than 24 hours prior.

Seller/Lender Relationship

1. The Seller/Client should provide the Lender with prompt notification of its receipt of a potential and/or formal buy-in (a buy-in threat), so the Lender may notify the Borrower and manage the recall, return and/or liability associated with the buy-in.
2. The Seller should promptly provide the Lender with any additional information received in respect of the buy-in.

Lender/Borrower Relationship

1. Once the recall due date passes, the Lender and the Borrower should be in daily contact to gauge the urgency of the recall and likelihood of a buy-in, with ultimate responsibility to return the securities being borne by the Borrower. Any confusion as to the due date or the receipt of the recall notice should be settled at this time.
2. If the Lender has not been made aware of any specific threat from a buying broker, it is recommended to relay that message but reiterate there could potentially be a threat the Lender is not aware of.
3. If the Lender receives a specific threat from a buying broker, the Lender should contact all relevant Borrowers as soon as possible to advise them of who the threat is coming from, the quantity of securities needed, date of the execution, and if it is a regulatory buy-in for the morning or an afternoon threat.
4. The Lender should readily provide the most accurate information it has in the spirit of helping avoid the execution of a buy-in, however with the exception of the formal written recall and/or buy-in notice, communication from the Lender regarding expected buy-in dates, number of securities needed to cover the buy-in, etc., should be considered informational only with the expectation the Lender is providing the most accurate information possible to avoid a buy-in execution.

Established Market Practice

1. Best practices are such that participants should provide as much information as they have available to avoid buy-ins, but notifying participants of specific threats is not a requirement.
2. Buy-Ins can be executed on S+1 at the Buyer's discretion regardless of whether a regulatory requirement exists to do so. Since the Buyer is not "required" to notify the Seller, the Lender is not formally required to notify the Borrower. If a buy-in occurs and the chain of notification is not complete, the recall due date determines liability.

Returns of Securities Subject to Securities Loan Transaction to satisfy Buy-Ins (timing)

With the increased number of regulatory buy-ins at market open due to SEC Rule 204, there has been an increase in instances where Borrowers will return securities prior to market open to satisfy or reduce the buy-in at market open. The same practice is possible for afternoon buy-ins however the occurrence is less common. Lending Agents should be willing to accept returns prior to executed buy-ins.

1. Any return that settles during the day, prior to the buy-in, should be accepted and applied to the sale which is being bought in.
2. Securities that are returned prior to market open on buy-in date should also be accepted on a reasonable-efforts basis. While there is no definitive amount of time needed for securities to be applied, 45 minutes prior to market open should provide enough time for a Seller/Custody Bank to deliver securities to the Buying Broker. The amount of time needed to apply returned securities to a sell prior to buy-in execution depends on several factors such as participant time zones, Custody Bank efficiency, and Seller/Buyer willingness to take securities so close to the deadline or to accept partial settlement.
3. Borrowers should always notify the Lender of returns or "calling them in." If securities are not called in, but rather "dumped" (the Lender is not notified of return), the securities will most likely not be applied. Applying the securities would truly be "reasonable efforts" in this case.
4. Sellers/Custody Banks should make every effort to partially settle any sale coming up for a buy-in with available securities in Custody. If a buy-in is executed, the only price that is passed should be applicable to the securities still on loan, returned after notification of the buy-in execution to the Borrower or as bilaterally agreed between the Lender and the Borrower.
5. The Sellers/Lenders should be in contact with the Buyers prior to buy-in execution to gauge exactly what the Buyer needs to fulfill its requirement. It is possible a Buyer has multiple receives pending prior to open and may only need a small number of securities to avoid a buy-in.

Established Market Practice

1. Best practices are such that Lenders/Sellers/Custody Banks should be as accommodating as possible when trying to apply returned securities as close to the buy-in deadline as possible; however, if the securities cannot be applied to the sell in time, the securities will be returned to the borrower and the buy-in price will be passed. The same rule applies to partial deliveries.
2. There is no definitive time frame in which a borrower can return securities prior to the deadline where the securities are guaranteed to be applied. Any return delivered after recall due date is considered late, and application of those securities is considered "reasonable efforts."

Buy-In Execution

1. When a buy-in is executed, the Buyer should notify the Seller and the Lender (if they have been in contact) as soon as possible after execution. The Buyer needs to communicate the quantity of securities purchased as well as the price per share. The Seller/Lender will need to onward deliver the securities/price information to the Borrower assuming the Lender has a Borrower they can pass the liability to.
2. If a stock is thinly traded, the Buyer may execute a "VWAP" order (Volume-Weighted Average Price). The Buyer will execute in this manner so as not to artificially inflate the price and overly burden the Seller. If the Buyer does execute in this manner, the Buyer will not be able to provide a price for the Seller/Lender until the end of the trading day. The Lender will need to communicate this to the Borrower who will be eagerly looking for the price. Once a VWAP order is executed, the Lender will not take additional returns until the quantity purchased is confirmed.
3. Once a buy-in has been executed, the Lender can either take the loan down off its books or leave it on until buy-in settlement date. The contract should be deemed "non-markable" as collateral calls will no longer be necessary. On settlement date of the buy-in, the cash will move, and the loan will be taken down by the Borrower and the Lender if it has not been already.

Passing Prices

1. Once a buy-in has been executed, the details should be passed to the Lender and onward to the Borrower as soon as possible. A verbal confirmation should be passed no later than 30 minutes after receipt of the notification of the execution, and the written or electronic confirmation with all the details should be sent no later than 60 minutes after receipt of notification of the execution. This typically correlates to 10:00am Eastern Time for orders completed at the open, and 4:30pm Eastern Time for orders that were VWAP'd or executed in the afternoon.

2. If an order was booked as a VWAP order, the Lender should notify the Borrower not to expect a price no earlier than 4:00pm Eastern Time.
3. Passing a price in a timely manner is important because the party receiving the price will need to close out its exposure by passing the price to another counterpart, close a short, or sell its securities to re-coup its expense. The sooner the party receiving the price is notified, the sooner it can close its position, minimizing its price exposure.
4. If the price passed is exceeds the current day's trading range, the buying broker should be able to defend the price they are passing. Using available pricing feeds like Bloomberg, the price being passed should be transparent. The same goes for a Borrower who is passed a price well below the day's trading range. The Borrower should identify the discrepancy and ask for clarification.
5. In the event of a small price discrepancy being passed to a Borrower through the communication chain, the Borrower should be accommodating and take the amended price as long as the discrepancy is discovered between trade and settle date of the buy-in trade and the dollar value is not significant.

Established Market Practice

1. The formal written buy-in notification must be passed from the Buyer to the Seller, the Seller to the Lender, and the Lender to the Borrower within the same day on which the Buy-In takes place.
2. If more than a day passes before a Seller is notified by a Buyer that a buy-in took place, the Seller may be overly exposed to price fluctuations and may not accept the price.