

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49081; File No. SR-NASD-2004-05)

January 14, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Amend NASD Rule 2370 Relating to Certain Lending Arrangements Between Registered Persons and Customers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 9, 2004, the National Association of Securities Dealers, Inc. (“NASD” or “Association”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.<sup>3</sup>

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD proposes to amend NASD Rule 2370 to exempt certain types of permissible lending arrangements from the rule’s notice and approval requirements and also to indicate that the scope of the rule is limited to lending arrangements between registered persons and their customers, rather than any customer of the firm. The text of the proposed rule change appears below. New text is in italics. Deleted text is on brackets.

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**2370. Borrowing From or Lending to Customers**

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act to approve the proposed rule change prior to the 30th day after its publication in the Federal Register. 15 U.S.C. 78s(b)(2).

(a) No person associated with a member in any registered capacity may borrow money from or lend money to any customer of [the member] such person unless: (1) the member has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member; and (2) the lending or borrowing arrangement meets one of the following conditions: (A) the customer is a member of such person's immediate family; (B) the customer is a financial institution regularly engaged in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in the ordinary course of business; (C) the customer and the registered person are both registered persons of the same member firm; (D) the lending arrangement is based on a personal relationship with the customer, such that the loan would not have been solicited, offered, or given had the customer and the associated person not maintained a relationship outside of the broker/customer relationship; or (E) the lending arrangement is based on a business relationship outside of the broker-customer relationship[;and (3) the m].

(b) Procedures

(1) Members [has] must pre-approve[d ] in writing the lending or borrowing arrangements described in subparagraphs (a)(2)(C), (D), and (E) above.

(2) With respect to the lending or borrowing arrangements described in subparagraph (a)(2)(A) above, a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval either prior to or subsequent to entering into such lending or borrowing arrangements.

(3) With respect to the lending or borrowing arrangements described in subparagraph (a)(2)(B) above, a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval

either prior to or subsequent to entering into such lending or borrowing arrangements, provided that, the loan has been made on commercial terms that the customer generally makes available to members of the general public similarly situated as to need, purpose and creditworthiness. For purposes of this subparagraph, the member may rely on the registered person's representation that the terms of the loan meet the above-described standards.

[(b)] (c) No change in text.

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## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### (1) Purpose

Current NASD Rule 2370 prohibits registered persons from borrowing money from or lending money to a customer (collectively referred to herein as "lending arrangements") unless the member has written procedures allowing such lending arrangements consistent with the rule, and the loan falls within one of five permissible types of lending arrangements. The five types of permissible lending arrangements are: the customer is a member of the registered person's immediate family (as defined in the rule); the customer is in the business of lending money; the

customer and the registered person are both registered persons of the same firm; the lending arrangement is based on a personal relationship outside of the broker-customer relationship; or the lending arrangement is based on a business relationship outside of the broker-customer relationship. In addition, NASD Rule 2370 requires members to pre-approve each loan in writing. This regulatory framework gives members greater control over, and more specific supervisory responsibilities for, lending arrangements between registered persons and their customers. Members that choose to permit their registered persons to borrow from or lend to customers consistent with the requirements of the rule must evaluate, before granting approval, whether the lending arrangement falls within one of the five types of permissible arrangements.

In adopting NASD Rule 2370, NASD considered the potential for misconduct when registered persons and customers enter into lending arrangements.<sup>4</sup> NASD has brought disciplinary action against registered persons who have violated just and equitable principles of trade by taking unfair advantage of their customers by inducing them to lend money in disregard of the customers' best interests, or by borrowing funds from, but not repaying, customers. The potential for misconduct also exists when a registered person lends money to a customer.

Since NASD Rule 2370 became effective on November 10, 2003,<sup>5</sup> it has become apparent to both members and NASD staff that the notice and approval requirements with respect to lending arrangements between family members and lending arrangements between registered persons and a financial institution regularly engaged in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in

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<sup>4</sup> See Securities Exchange Act Release No. 48242 (August 29, 2003), 68 FR 52806 (September 5, 2003) (Order approving SR-NASD-2003-92).

<sup>5</sup> See NASD Notice to Members 03-62 (October 8, 2003).

the ordinary course of business place onerous recordkeeping requirements on firms and also may invade the legitimate privacy interests of customers and registered persons. NASD, therefore, proposes that NASD Rule 2370 be amended to exempt these two categories of lending arrangements from the notice and approval requirement of NASD Rule 2370, provided that the lending arrangement between a registered person and a financial institution loan has been made on commercial terms that the customer generally makes available to members of the general public similarly situated as to need, purpose and creditworthiness.

NASD believes that the potential for misconduct is greatly reduced, or eliminated, when loans occur between family members. Therefore, NASD proposes to amend NASD Rule 2370 to exempt certain types of permissible lending arrangements from the rule's notice and approval requirements. With respect to lending arrangements between family members, as described in subparagraph (a)(2)(A) to NASD Rule 2370, NASD is of the view that it would be sufficient for purposes of compliance with NASD Rule 2370 if a member's written procedures indicate that the member permits such lending arrangements and that registered persons need not notify the member or receive member approval either prior to or subsequent to such lending arrangements.

In addition, NASD believes that the potential for misconduct is greatly reduced, or eliminated, when registered persons borrow from banks or other financial institutions in the business of lending money, provided the terms of the lending arrangement are those that would also be available to the general public doing business with those institutions who are similarly situated as to need, purpose and creditworthiness. Such transactions would include, but not be limited to, mortgages, personal loans, home equity lines of credit, and credit card accounts, and would also include lending arrangements with an affiliate of the customer. Thus, with respect to lending arrangements described in subparagraph (a)(2)(B) to NASD Rule 2370, NASD is of the

view that a member's written procedures may indicate that registered persons are permitted to enter into such lending arrangements and are not required to notify the member or receive member approval either prior to or subsequent to entering into such lending arrangements, provided that the loan has been made on commercial terms that the customer generally makes available to members of the general public similarly situated as to need, purpose and creditworthiness. For purposes of this subparagraph, the member may rely on the registered person's representation that the terms of the loan meet the above-described standards. The fact that a registered person can negotiate a better rate or terms for a loan that is not the product of the broker-customer relationship would not vitiate the idea that the loan occurred on terms generally offered to the public.

NASD has also concluded that the potential for misconduct is most significant when a registered person enters into a lending arrangement with his or her own customer. Moreover, the NASD states that its members, especially those members with a significant number of institutional customers, have pointed out that individual registered persons may not even know nor, for privacy reasons, should know, the name of every customer. Thus, in some firms, registered persons would be put in the position of reporting, and getting approval for, every credit card, every mortgage, and every home equity line of credit, in case the banking institution was a firm customer. NASD states that this was not the intent of the rule. Thus, NASD proposes to amend NASD Rule 2370 to indicate that the scope of the rule is limited to lending arrangements between registered persons and their customers, rather than any customer of the firm. It is the member's responsibility to determine whether a particular individual represents or services a customer.

NASD would also like to make clear that the purpose of NASD Rule 2370 is to give members the opportunity to evaluate the appropriateness of particular lending arrangements between their registered persons and customers and the potential for unnecessary and ill-advised conflicts of interests between both the registered person and his customer and the registered person and the member with which he is associated. NASD Rule 2370 does not require that members necessarily have oversight of the terms of the loan, or its execution or administration. However, the absence of such requirements in the rule does not signify the conclusion of NASD that, under certain circumstances, such action by members may be appropriate and necessary in accordance with the member's supervisory obligations. It continues to be the prerogative of member firms to exclude any or all lending arrangements between registered persons and their customers.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>6</sup> which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is designed to accomplish these ends by (1) continuing to prohibit registered persons from borrowing money from or lending money to a customer unless the member has written procedures allowing such lending arrangements consistent with the rule, and the loan falls within one of five permissible types of lending arrangements and (2) maintaining the notice and approval requirement except where the lending arrangement is between: (a) registered persons and family members; or (b) between registered persons and lending

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<sup>6</sup> 15 U.S.C. 78o-3(b)(6).

institutions, provided the terms of such arrangements are those that the customer would also generally make available to members of the general public similarly situated as to need, purpose and creditworthiness.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which NASD consents, the Commission will:

(A) by order approve such proposed rule change; or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All

comment letters should refer to File No. SR-NASD-2004-05. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filings will also be available for inspection and copying at the principal office of the Association. All submissions should refer to File No. SR-NASD-2004-05 and should be submitted by [insert 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>7</sup> 17 CFR 200.30-3(a)(12).