

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70958; File No. SR-FINRA-2013-035)

November 27, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; 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

On August 14, 2013, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”),¹ a proposed rule change to adopt financial and operational rules relating to securities loans and borrowings, permissible use of customers’ securities, and callable securities as FINRA Rules in the consolidated FINRA rulebook. The proposed rule was published for comment in the Federal Register on September 3, 2013.² The Commission received two comment letters on the proposed rule change.³ On November 22, 2013, FINRA responded to the comments and filed Partial Amendment No. 1 to the proposed rule change.⁴ On November 25, 2013 FINRA filed Partial Amendment No. 2 to the proposed rule change. The text of the proposed rule change, as modified by Partial Amendments No. 1 and No. 2, is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, on the Commission’s website at <http://www.sec.gov>, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² Exchange Act Release No. 70272 (Aug. 27, 2013); 78 FR 54350 (Sep. 3, 2013).

³ Letter from Kyle Brandon, Managing Director, SIFMA to Elizabeth Murphy, Secretary, Securities and Exchange Commission, dated Sep. 24, 2013 (“SIFMA Letter”); Letter from William A. Jacobson, Esq. and Hyesoo Jang, Cornell University Law School to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated Sep. 24, 2013 (“Cornell Letter”).

⁴ Letter from Kosha K. Dalal, FINRA to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated Nov. 22, 2013 (“FINRA Response Letter”).

This order approves the proposed rule change, as modified by Partial Amendments No. 1 and No. 2.

I. Description of the Proposal

As part of the process of developing a new consolidated rulebook,⁵ FINRA has proposed to amend and adopt the following as FINRA Rules: (1) NYSE Rule 296 (Liquidation of Securities Loans and Borrowings)⁶ and Supplementary Material paragraphs .10 and .20 as FINRA Rule 4314 (Securities Loans and Borrowings); (2) NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities) as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers’ Securities); and (3) NYSE Rule 402.30 (Securities Callable in Part) as FINRA Rule 4340 (Callable Securities).

A. FINRA Rule 4314 (Securities Loans and Borrowings)

FINRA is proposing new FINRA Rule 4314, which provides clarity as to whether parties are acting as principals or agents when entering into an agreement to loan or borrow securities by requiring a member that acts as agent in a securities loan or borrow transaction to disclose its capacity as agent. In cases where the member lends securities to or borrows securities from a counterparty that is acting in an agency capacity, proposed FINRA Rule 4314 would require that the member maintain books and records to reflect the details of the transaction with the agent and each principal on whose behalf the agent is acting and the details of each transaction.

⁵ The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE. The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice March 12, 2008 (Rulebook Consolidation Process).

⁶ For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

Specifically, proposed FINRA Rule 4314(a) would require a member that lends or borrows securities in the capacity of agent to disclose such capacity to the other party or parties to the transaction. The provision would further require a member, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction. When the other party (who may or may not be a member) is acting as agent in the transaction, the member would be required to maintain books and records that reflect: (A) the details of the transaction with the agent; and (B) each principal on whose behalf the agent is acting and the details of each transaction. In addition, proposed FINRA Rule 4314(a) would establish a uniform books and records requirement.

Proposed FINRA Rule 4314(b), based on NYSE Rule 296(a), provides that each member that is a party to an agreement for the loan and borrowing of securities with another member has the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions specified in the rule. In addition, proposed FINRA Rule 4314(c) would require that no member shall lend or borrow any security to or from any person that is not a member of FINRA, including any customer, except pursuant to a written agreement. Under the proposed rule, the written agreement may consist of the exchange of contract confirmations that confers upon such member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in proposed FINRA Rule 4314(b).

FINRA is proposing to add new Supplementary Material .01 through .05 to the proposed FINRA rule to provide clarity and guidance by describing how a member firm can meet its disclosure obligations under the proposed rule, and clarifying the proposed rule's books and

records requirements. First, FINRA is proposing to transfer NYSE Rule 296.10, which defines the term “agreement for the loan and borrowing of securities,” as proposed Supplementary Material .01, without substantive change. Proposed Supplementary Material .02 clarifies that a member may satisfy its disclosure obligation in proposed FINRA Rule 4314(a) by, among other things, providing specific disclosure of its capacity as agent in the written agreement between the parties or in the individual confirmations of each security exchanged between the parties for each loan and borrow transaction. Proposed Supplementary Material .03 clarifies the books and records requirements imposed by proposed FINRA Rule 4314(a) by requiring members to create and maintain records for each securities loan or borrow transaction in accordance with Exchange Act Rules 17a-3 and 17a-4. It also provides that when a member enters into a securities loan or borrow transaction with a party that is acting as agent on behalf of another principal, the member must maintain a record of the details of the transaction with the agent that includes certain specified information.

Proposed Supplementary Material .04 reminds members of their obligations under proposed FINRA Rule 4330(b) (discussed below) to provide written disclosures to customers regarding the risks and financial impact associated with the customer’s loan of securities, and requires that members disclose in such written notice their right to liquidate the borrow transactions with customers under the conditions specified in proposed FINRA Rule 4314(b). Proposed Supplementary Material .05 would require, for purposes of proposed FINRA Rule 4314(c), that each member subject to the provisions of Exchange Act Rule 15c3-3 that borrows fully paid or excess margin securities from a customer must comply with the provisions of Exchange Act Rule 15c3-3 relating to the requirements for a written agreement between the borrowing member and the lending customer.

B. FINRA Rule 4330 (Customer Protection – Permissible Use of Customers’ Securities)

FINRA is proposing new FINRA Rule 4330, which prohibits a member from lending, either to itself or others, securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless the firm first obtains a written authorization from the customer permitting the lending of the customer’s securities. The proposed rule adds new disclosure requirements and establishes the need for members to conduct appropriateness determinations before engaging in the borrowing and lending of customers’ fully paid and excess margin securities.

Specifically, proposed FINRA Rule 4330(a) would require a member to obtain a customer’s written authorization prior to lending securities that are held on margin for the customer and that are eligible to be pledged or loaned. Proposed FINRA Rule 4330(a) would provide that “[n]o member shall lend securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless such member shall first have obtained a written authorization from such customer permitting the lending of such securities.”

FINRA has proposed two supplementary provisions related to proposed FINRA Rule 4330(a). Proposed Supplementary Material .01 would provide, consistent with NYSE Rule 402(a) and NASD Rule 2330(b), that the definitions contained in Exchange Act Rule 15c3-3 would apply to proposed FINRA Rule 4330. However, the proposed supplementary material does not include the requirement contained in both the NYSE and NASD rules for members to maintain cash reserves as prescribed by Exchange Act Rule 15c3-3 because members continue to be subject to Exchange Act Rule 15c3-3.

Proposed Supplementary Material .02, which was modified by Partial Amendment No. 1, deletes the specific legend requirement contained in NYSE Rule Interpretation 402(b)/01 that

was required to be placed in customer margin agreements. Instead, proposed Supplementary Material .02 requires that the customer account agreement/margin agreement/loan consent include a clear and prominent disclosure that the broker-dealer may lend, either to itself or others, any securities held in a customer's margin account.

In addition, FINRA proposed new requirements in proposed FINRA Rule 4330(b) to address the borrowing and lending of customers' fully paid or excess margin securities. Specifically, proposed FINRA Rule 4330(b)(1) would require a member that borrows fully paid or excess margin securities carried for the account of any customer to: (A) comply with the requirements of Exchange Act Rule 15c3-3; (B) comply with the requirements of Section 15(e) of the Exchange Act to provide notices to customers regarding securities lending; and (C) notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to first engaging in such securities borrows.

Proposed Supplementary Material .03 would provide that upon FINRA's receipt of such written notification required under proposed FINRA Rule 4330(b)(1)(C), FINRA may request such additional information as it may deem necessary to evaluate compliance with Exchange Act Rule 15c3-3, Section 15(e) of the Exchange Act and other applicable FINRA rules or federal securities laws or rules. Proposed Supplementary Material .03 gives examples of the additional information that FINRA may request, such as the member's operational and recordkeeping processes related to the securities borrows.

Proposed FINRA Rule 4330(b)(2) would impose two new requirements that a member must satisfy prior to first entering into a securities borrow transaction with a customer. First, proposed FINRA Rule 4330(b)(2)(A) would require that a member have reasonable grounds for believing that the customer's loan of securities is appropriate for the customer. In making this

determination, the member would be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including, but not limited to, the customer's financial situation and needs, tax status, investment objectives, investment time horizon, liquidity needs, risk tolerance and any other information the customer may disclose to the member or associated person in connection with entering such securities loan transaction. Accordingly, where a member has a securities borrow program, the member would be required to determine the appropriateness of such activity for the customer prior to the customer entering into the first securities borrow. Proposed Supplementary Material .04 clarifies that the member borrowing a customer's fully paid or excess margin securities is responsible for making the determination under proposed FINRA Rule 4330(b)(2)(A), regarding the appropriateness of such borrow from a customer. The proposed supplementary material would provide that when the member has entered into a carrying agreement with an introducing member pursuant to FINRA Rule 4311, the member may rely on the representations of the introducing member that has a customer relationship with the lender in making the determination.

In Partial Amendment No. 1, FINRA proposed adding proposed Supplementary Material .05 that would allow a member to determine that a customer's loan of securities is appropriate for the customer by complying with FINRA Rule 2111(b) if the customer is an institutional account.⁷ FINRA stated in its response to comments that members with documentation that they have used to evaluate institutional accounts under FINRA Rule 2111(b) should review that documentation to ensure that it complies with the requirements of proposed FINRA Rule 4330.⁸

⁷ FINRA Rule 2111 is FINRA's suitability rule. Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions listed in that paragraph are satisfied.

⁸ FINRA Response Letter, at 5

Second, proposed FINRA Rule 4330(b)(2)(B) would require a member, prior to first entering into securities borrows with a customer, to provide the customer, in writing (which may be electronic), with a clear and prominent notice stating that the provisions of the Securities Investor Protection Act of 1970 may not protect the customer with respect to the customer's securities loan transaction and that the collateral delivered to the customer may constitute the only source of satisfaction of the member's obligation in the event the member fails to return the securities. In addition, proposed FINRA Rule 4330(b)(2)(B) would require a member to provide the customer with certain disclosures regarding the customer's rights with respect to the loaned securities, and the risks and financial impact associated with the customer's loan of securities. Proposed FINRA Rule 4330(b)(3) would require that a member create and maintain books and records evidencing compliance with proposed FINRA Rule 4330(b)(2). Such records must be maintained in accordance with the requirements of Exchange Act Rule 17a-4(a).

Proposed Supplementary Material .06 would require members that have any existing fully paid or excess margin securities borrows with customers as of the effective date of proposed Rule 4330 to notify FINRA in writing of such borrows within 30 days from the effective date of the rule. FINRA will specify the manner and format of such notification in a Regulatory Notice announcing the effectiveness of the rule. In addition, in Partial Amendment No. 2 FINRA proposed extending the amount of time that members would have to provide customers with the disclosures required by proposed FINRA Rule 4330(b)(2)(B) from 90 days to 180 days from the effective date of the rule.

C. FINRA Rule 4340 (Callable Securities)

FINRA is proposing new FINRA Rule 4340 to provide clarity to customers about the procedure used by a member when a security is called or redeemed prior to maturity. Proposed

FINRA Rule 4340(a) requires each member that has in its possession or under its control any security that by its terms may be called or redeemed prior to maturity to identify such securities and establish an impartial lottery system by which it will allocate among its customers the securities to be redeemed or selected as called in the event of a partial redemption or call. The proposed rule change is based on NYSE Rule 402.30, but would eliminate the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member. Instead, proposed FINRA Rule 4340(a)(1) would adopt a more flexible approach that would allow a member to establish, and make available on the member's website, procedures by which it will allocate among its customers, on a fair and impartial basis, the securities to be redeemed or selected as called in the event of a partial redemption or call. Proposed Supplementary Material .02 would clarify that such procedures may include the use of an impartial lottery system, acting on a pro-rata basis, or such other means as will achieve a fair and impartial allocation of the partially redeemed or called securities.

Proposed FINRA Rule 4340(a)(2) would require the member to provide written notice, which may be electronic, to new customers at the opening of an account, and to all customers at least once every calendar year, of the manner in which they may access the allocation procedures on the member's website and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

Proposed FINRA Rule 4340(b) would prohibit a member from allocating securities to any of its accounts or those of its "associated persons" in a redemption offered on terms favorable to the called parties until all other customers' positions have been satisfied. Proposed

FINRA Rule 4340(b) would apply the restriction to a member and its “associated persons,” rather than to a member’s “employees, partners, officers, directors, and approved persons,” which was the language in NYSE Rule 402.30. Accordingly, the proposed rule would provide that, where redemption of callable securities is made on terms favorable to the called parties, a member shall not allocate the securities to any account in which it or its associated persons have an interest until all other customers’ positions in such securities have been satisfied.

Proposed Supplementary Material .01 would clarify that the term “associated person” as used in the proposed rule would have the meaning provided in Section 3(a)(18) of the Exchange Act, which expressly excludes, for certain purposes, any persons associated with the member whose functions are solely clerical or ministerial (referred to as “clerical and ministerial associated persons”). The proposed supplementary material also would make clear that, in the event of a redemption made on terms favorable to the called parties, a member may include the accounts of clerical and ministerial associated persons in the pool of securities eligible to be called.

Where the redemption of callable securities is made on terms unfavorable to the called parties, proposed FINRA Rule 4340(c) and proposed Supplementary Material .03 would make clear that a member cannot exclude its positions or those of its associated persons, including the accounts of clerical and ministerial associated persons, from the pool of securities eligible to be called. FINRA believes that requiring a firm to include the positions of the firm and all its associated persons (including those engaged in clerical and ministerial functions) when a redemption is on terms unfavorable to the called parties is reasonable because the provision ensures that all parties are on parity. In addition, proposed Supplementary Material .03 would codify that where an introducing member is a party to a carrying agreement with another

member that is conducting an allocation pursuant to proposed FINRA Rule 4340(a), any accounts in which the introducing member or its associated persons have an interest shall be subject to the provisions regarding participation in favorable and unfavorable calls or redemptions. Furthermore, the introducing member must identify such accounts to the member conducting the allocation.

III. Summary of Comments and FINRA's Response

As noted above, the Commission received two comment letters in response to the proposed amendments. Both comments expressed support for the proposed rule change. The comment letters, and FINRA's response to comments, are summarized below.

A. Proposed FINRA Rule 4314

The Commission received one comment in response to proposed FINRA Rule 4314. The commenter requested that proposed FINRA Rule 4314 cross-reference the Agency Lending Disclosure Initiative ("ALD Initiative").⁹ The commenter also requested that the Commission staff finalize a draft no-action request with respect to agency lending ("ALD No-Action Letter").¹⁰ In its response letter to the Commission, FINRA acknowledged the ALD Initiative and the ALD No-Action Letter. FINRA stated, however, that notwithstanding the ALD Initiative and ALD No-Action Letter it "believes that proposed Rule 4314 addresses the need for transparency and disclosure under securities lending arrangements" and should be adopted.¹¹ FINRA further stated that once the ALD No-Action Letter is finalized, it will review the

⁹ SIFMA Letter, at 4. In 2006, the industry began to adopt voluntary books and records and disclosure practices relating to securities lending as a result of an industry-wide initiative to address the risks associated with agency lending, which became known as the ALD Initiative.

¹⁰ Id.

¹¹ FINRA Response Letter, at 2.

requirements of FINRA Rule 4314 to address any inconsistencies between the rule and the no-action letter.¹²

B. Proposed FINRA Rule 4330

The Commission received two comments in response to proposed FINRA Rule 4330. One commenter supported the written authorization requirement in proposed FINRA Rule 4330(a) “because it will alert customers about use of their margin securities and pertinent risks.”¹³ One commenter stated that language used as a safe harbor in proposed Supplementary Material .02 should apply only to customer margin agreements entered into after the effective date of proposed FINRA Rule 4330.¹⁴ The commenter further asked that FINRA clarify the exact language that would comply with the rule as well as where the language should be placed relative to the signature line.¹⁵ In response to these comments, FINRA amended the language in proposed Supplementary Material .02 to delete the specific language that had been included as a safe harbor. Although the language in proposed Supplementary Material .02 was identical to the language in NYSE Rule Interpretation 402(b)/01, some FINRA members had not previously been subject to the requirements of NYSE Rule Interpretation 402(b)/01. FINRA recognized that for those members that had not previously been subject to proposed Supplementary Material .02 the costs to “re-paper” customer margin agreements could be burdensome. Thus, FINRA removed the safe harbor language in proposed Supplementary Material .02 and added language stating that the customer account agreement/margin agreement/loan consent must include “clear

¹² Id.

¹³ Cornell Letter, at 2.

¹⁴ SIFMA Letter, at 5.

¹⁵ Id., at 4-5.

and prominent disclosure that the firm may lend either to itself or others any securities held by the customer in its margin account.”¹⁶

Proposed FINRA Rule 4330(b)(2)(A) would require a member to have reasonable grounds to believe that the customer’s loan of securities is appropriate. One commenter supported the proposed amendments stating that it will provide additional protection to customers.¹⁷ Another commenter supported the provision but suggested that FINRA adopt an institutional safe harbor similar to FINRA Rule 2111(b).¹⁸ In response to these comments, FINRA added new proposed Supplementary Material .05, which states that “a member may fulfill the obligation set forth in paragraph (b)(2)(A) above for an institutional account . . . by complying with the requirements of Rule 2111(b).” FINRA further stated that firms with existing institutional customers under FINRA Rule 2111(b) should evaluate those customers to ensure they comply with the requirements of proposed FINRA Rule 4330. Thus, any institutional customer, regardless of whether the customer meets the requirements of FINRA Rule 2111(b), would need to also satisfy the requirements in FINRA Rule 4330.

Proposed FINRA Rule 4330(b)(2)(B) requires members to provide customers with certain disclosures relating to a customer’s securities loan transactions. One commenter supported this disclosure requirement believing it will help customers “assess the risks and financial impact associated with securities lending transactions.”¹⁹ One commenter suggested developing an industry standard risk disclosure form.²⁰ FINRA stated that it recognizes the

¹⁶ FINRA Response Letter, at 4.

¹⁷ Cornell Letter, at 2.

¹⁸ SIFMA Letter, at 5.

¹⁹ Cornell Letter, at 2.

²⁰ SIFMA Letter, at 6.

benefits of a standard disclosure form and understood that creating such a form may take longer than FINRA's proposed effective date for the rule.²¹ Thus, FINRA agreed to extend the compliance date for providing disclosures to customers to 180 days following the effective date of the proposed rule change. FINRA notes that while it will work with industry groups to develop such a template, a standard template would not guarantee compliance with FINRA rules. Further, FINRA stated that members should tailor their disclosures to fit their particular situation.

C. Proposed FINRA Rule 4340

The Commission received no comments on proposed FINRA Rule 4340.

IV. Discussion and Commission's Findings

After careful review of the proposed rule change, the comments received, and FINRA's Response Letter, the Commission finds that the proposed rule change, as modified by Partial Amendments No. 1 and No. 2, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.²² In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act, which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.²³

²¹ FINRA Response Letter, at 5-6.

²² In approving this rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²³ 15 U.S.C. 78o-3(b)(6).

More specifically, the Commission believes the proposed new rules provide important protections for customers who engage in securities lending transactions. The proposed new rules will provide consistency throughout the industry with respect to securities lending transactions. The proposed new rules protect customers by promoting transparency, establishing uniform books and records requirements, providing customers with additional disclosures, and providing redemptions that are free from conflicts of interests.

The Commission believes that FINRA has adequately responded to the concerns raised by commenters by adding further explanation in the Supplementary Material for proposed FINRA Rule 4330 and by extending the compliance date for FINRA Rule 4330(b)(2)(B). These changes were made in Partial Amendments No. 1 and No. 2, which the Commission believes adds clarity to the new rules.

For the reasons stated above, the Commission finds that the rule change is consistent with the Exchange Act and the rules and regulations thereunder.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,²⁴ that the proposed rule change (SR-FINRA-2013-035), as modified by Partial Amendments No. 1 and No. 2, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Kevin M. O'Neill
Deputy Secretary

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).