

Notice to Members

MARCH 2004

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Registered Representatives
Senior Management

KEY TOPICS

Borrowing From and Lending to
Customers
Rule 2370

INFORMATIONAL

Borrowing From and Lending to Customers

SEC Approves Amendments to Rule Governing Lending
Between Registered Persons and Customers; **Effective
date: February 18, 2004**

Executive Summary

On August 29, 2003, the Securities and Exchange Commission (SEC) approved the adoption of NASD Rule 2370, prohibiting registered persons from borrowing money from or lending money to a customer unless (1) the member has written procedures allowing such lending arrangements consistent with the rule; (2) the loan falls within one of five prescribed permissible types of lending arrangements set forth in the rule; and (3) the member pre-approves the loan in writing.¹

The amendments to Rule 2370, as approved by the SEC on February 18, 2004, exempt from the rule's notice and approval requirements lending arrangements involving a registered person and a customer that is: (1) a member of his or her immediate family (as defined in the rule); or (2) 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), provided 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. The amendments to Rule 2370 also limit the scope of the rule to lending arrangements between registered persons and their customers, rather than any customer of the firm.

Questions/Further Information

Questions concerning this *Notice* may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8844.

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Background

The purpose of Rule 2370 is to prohibit registered persons from borrowing money from or lending money to a customer (collectively referred to as “lending arrangements”) unless certain conditions are met. Under Rule 2370, no person associated with a member in any registered capacity may borrow money from or lend money to any customer unless the firm has written procedures allowing such lending arrangements and (1) the customer is a member of the registered person’s immediate family (as defined in the rule); (2) the customer is in the business of lending money; (3) the customer and the registered person are both registered persons of the same firm; (4) the lending arrangement is based on a personal relationship outside of the broker-customer relationship; or (5) the lending arrangement is based on a business relationship outside of the broker-customer relationship. As initially adopted by NASD on August 29, 2003, Rule 2370 also required members to pre-approve each lending arrangement in writing.

Since Rule 2370 became effective on November 10, 2003, it became apparent both to members and NASD staff that the pre-approval requirement with respect to lending arrangements between registered persons and financial institutions raised recordkeeping and privacy issues. Members with institutional customers advised NASD of the difficulties registered persons could encounter in determining whether a particular financial institution was a firm customer if that institution was not the representative’s customer. Members advised NASD that individual registered persons may not know nor, for privacy reasons, should know, the name of every firm customer. Thus, registered persons employed by members with institutional customers could be in a position of being required to report and get firm approval for, among other things, every credit card application, mortgage, bank loan, and home equity line of credit. This was not the intent of the rule.

Thus, with respect to lending arrangements with financial institutions 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, Rule 2370 has been amended to provide 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 lending arrangement 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.² Such transactions include, but are not limited to, mortgages, personal loans, home equity lines of credit, and credit card accounts, and also include lending arrangements with an affiliate of the customer.

NASD further concluded that the potential for misconduct is most significant when a registered person enters into a lending arrangement with his or her own customer. NASD has, therefore, amended 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 firm's responsibility to determine whether a particular individual represents or services a customer.

Additionally, NASD concluded that the potential for misconduct is greatly reduced, or eliminated, when loans occur between family members. As a result, NASD has amended Rule 2370 to allow a member's written procedures to indicate that a registered person is not required to obtain a member's approval, either prior to or subsequent to, entering into a lending arrangement between the registered person and a customer that is a member of his or her immediate family (as defined in the rule).

In sum, NASD has amended Rule 2370 as follows:

- ▶ With respect to lending arrangements between family members, as described in paragraph (a)(2)(A), a member's written procedures may 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.
- ▶ With respect to lending arrangements between registered persons and financial institutions, as described in paragraph (a)(2)(B), 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 arrangements, 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. The member need not investigate such lending arrangements, but may rely on the registered person's representation that the terms of the loan meet these 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.
- ▶ The scope of the rule is limited to lending arrangements between registered persons and their customers, rather than any customer of the firm.

In making these changes, NASD has considered that the purpose of 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 or her customer and the registered person and the member with which he or she is associated. 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.

Effective Date

These amendments became effective on February 18, 2004.

Endnotes

- 1 See Release No. 34-48242 (Aug. 29, 2003), 68 FR 52806 (Sept. 5, 2003) (File No. SR-NASD-2003-92).
- 2 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.

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ATTACHMENT A

Proposed additions are underlined; proposed deletions are in brackets.

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2370. Borrowing From or Lending to Customers

(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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