

## Financial Responsibility

### FINRA Requirements for Subordinations; Availability of New Standard Forms

#### Executive Summary

Firms are reminded that, pursuant to new FINRA Rule 4110(e)(1),<sup>1</sup> subordinated loans and notes collateralized by securities (together referred to as subordinations) must be approved by FINRA in order to receive beneficial regulatory capital treatment.<sup>2</sup> This *Notice* explains the requirements for all subordinations for which firms intend to receive beneficial regulatory capital treatment, including certain provisions that all such subordinations, both standard and non-standard,<sup>3</sup> must contain. It also describes the submission and approval process of proposed subordinations.

In addition, the *Notice* provides information about new, standard subordination forms (and a revised Lender's Attestation) that are available at [www.finra.org/subordinations](http://www.finra.org/subordinations).<sup>4</sup> This *Notice* also explains how to obtain approval of proposed amendments to or renewals of previously approved subordinations.

Questions concerning this *Notice* should be directed to:

- Kris Dailey, Vice President, Risk Oversight & Operational Regulation (ROOR), at (646) 315-8434;
- Susan DeMando Scott, Associate Vice President, Financial Operations Department, at (202) 728-8411;
- Joseph Sheirer, Director & Special Counsel, ROOR, at (646) 315-8691; or
- Maria Rabinovich, Principal Counsel, ROOR, at (646) 315-8461.

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#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Legal
- Senior Management

#### Key Topic(s)

- Capital Compliance
- Consolidated Rulebook
- Financial Responsibility
- Subordination Agreements

#### Referenced Rules & Notices

- FINRA Rule 4110(e)(1)
- NYSE Rule 313(d)
- NYSE Rule 420
- NTM 02-32
- Regulatory Notice 09-71
- SEA Rule 15c3-1
- SEA Rule 15c3-1d (Appendix D)
- SEA Rule 17a-4

## Background and Discussion

### A. Regulation of Subordination Agreements

Generally, brokers and dealers use subordinations to borrow funds or securities from investors to increase their regulatory net capital. Under Securities Exchange Act (SEA) Rule 15c3-1, in order to receive beneficial regulatory capital treatment, funds or securities loaned to a broker or dealer must be subordinated to the claims of creditors pursuant to a satisfactory subordination agreement as defined under Appendix D.<sup>5</sup> New FINRA Rule 4110(e)(1) requires that subordinations meet such standards as FINRA may require to ensure the firm's continued financial stability and operational capability, in addition to the standards set forth in Appendix D. Any subordination entered into by a firm where it wishes to receive beneficial regulatory capital treatment must be acceptable to FINRA prior to becoming effective.

### B. Required Provisions

In addition to the requirements set forth in Appendix D, FINRA requires that certain provisions be included in standard and non-standard subordinations.<sup>6</sup> These required provisions are based in large part on requirements and regulatory practices already used by FINRA (f/k/a NASD) and NYSE Regulation. Firms should note that FINRA may require additional terms or modifications based on the circumstances and/or provisions of a particular subordination agreement.

#### 1. Provisions for Approval and Notification; Other Required Representations

All subordinations submitted to FINRA for approval must include provisions for FINRA approval and notification requirements, as well as certain other required representations. Specifically:

- a. the agreement is not effective until approved by FINRA and executed by the parties;
- b. any and all amendments to the agreement require the prior written approval of FINRA;
- c. the rights and obligations of the parties under the agreement may not be transferred, sold, assigned, pledged or otherwise encumbered or disposed of, and no lien, charge or other encumbrance may be created or permitted thereon without the prior written approval of FINRA;
- d. the submitted agreement represents the entire agreement and no other evidence of such agreement has been or will be executed or effective without prior written approval of FINRA;

- e. FINRA will be provided written notice(s) of suspension, acceleration or any notice(s) required pursuant to the agreement or Appendix D;
- f. the lender is not making or entering into the loan based on the firm's standing as a member of FINRA or in reliance on FINRA, nor is FINRA or any director, officer or employee of FINRA liable to the lender with respect to the agreement or any rights or obligations thereunder; and
- g. the parties represent that the executed agreement is a legally valid and binding obligation of the parties that fully conforms to any drafts submitted to and approved by FINRA for execution.

## **2. Obligation of Firm to Reduce Business if in Suspended Repayment**

FINRA requires that all subordinations submitted to FINRA for approval include provisions obligating the firm, if it enters a state of "suspended repayment" (as defined in Appendix D and the FINRA standard forms), to promptly reduce its business, consistent with the protection of its customers, to a condition whereby payments under the subordinations could be made without violating applicable requirements of Appendix D and/or FINRA rules. Firms should be aware that this required provision differs from the optional provision of paragraph (b)(8)(i) of Appendix D, which, if and when incorporated by the parties to a subordination, requires the firm to effect a rapid and orderly liquidation if the firm's obligation to pay is suspended for a period of not less than six months. A firm that is in, or has reason to believe it is about to enter, a state of suspended repayment must immediately notify its Regulatory Coordinator.

## **3. Repayment and Return Provisions**

FINRA requires that any subordination submitted for approval include provisions obligating the lender to repay or return any amounts, collateral and/or notes received from or made by the firm in contravention of the financial requirements contained in Appendix D and/or FINRA rules, provided that the firm must make demand for recovery of such amounts or return of such collateral and/or notes within 120 calendar days from the date such improper payment or return was made. Firms should note that FINRA will not view a firm's demand for recovery (regardless of whether the demand is successful) as a defense in the event of a violation of financial responsibility or other requirements under FINRA or SEC rules.

## C. Process for Submission and Approval of Proposed Subordination Agreements

### 1. Submission of Draft Agreements

All proposed subordination agreements, whether drafted independently by the parties or prepared using FINRA standard forms (which are discussed further in Section D of this *Notice*), must be submitted in draft form (*i.e.*, unexecuted) to the firm's Regulatory Coordinator and Regulatory Specialist, if applicable.<sup>7</sup>

The draft agreement must include the proposed effective date of the agreement, which should generally be at least 10 business days after the date of submission to FINRA if a standard form is used (or longer if a non-standard form is being used).<sup>8</sup> Firms are advised that FINRA may require the parties to cancel—and provide evidence of cancellation with respect to—proposed agreements that are submitted in executed form if FINRA finds the terms of the agreement unacceptable and the parties continue to seek beneficial regulatory capital treatment of the agreement.

### 2. Supporting Documentation Required

A firm seeking approval of a subordination must also submit to FINRA, concurrent with the draft agreement discussed in Section C.1 of this *Notice*, certain additional supporting documentation. Specifically:

- a. a draft of the Lender's Attestation (see Section C.3 of this *Notice*);
- b. if the lender is other than an individual, evidence of the lender's authority to make the loan and evidence of any signatory's authority (*e.g.*, corporate resolutions or analogous documents, trust agreement). Note, however, that where the lender is an unaffiliated bank, a resolution of the lender is generally not required;
- c. documentation evidencing the source of funds that must align with the identity of the proposed lender; and
- d. pro-forma financial statements of the member accounting for the proposed subordination, along with a calculation of the firm's debt-equity ratio, in accordance with paragraph (d) of SEA Rule 15c3-1.

Proposed secured demand note agreements must include details regarding the collateral to be pledged by the lender. Proposed revolving subordinated loan agreements must be accompanied by evidence that the lender meets the definition of a Qualified Lender (as that term is defined in SEC Division of Trading and Markets Interpretation /01 of SEA Rule 15c3-1d(a)(2)(v)(F) (*see Interpretations of Financial and Operational Rules at [www.finra.org/finops](http://www.finra.org/finops)*)).

FINRA reserves the right to request additional documentation based on the type of lender or agreement proposed. Additionally, firms should note that evidence of the completed funding of a subordination agreement is required once agreements are executed.

### **3. Lender's Attestation and Investor Disclosure Document**

All firms seeking approval of a subordination agreement are required to submit Lender's Attestations and Investor Disclosure Documents (IDDs) (both must be signed and submitted to FINRA as part of the final documents—see Section C.5 of this *Notice*).<sup>9</sup> The Lender's Attestation contains several representations required of the lender with regard to information received by the lender from the firm, including certain financial information regarding the firm and a copy of Appendix D.

### **4. Amount of Time for Review**

The amount of time FINRA generally needs to review a proposed subordination and the supporting documentation varies depending on the form and content of the proposed agreement, as well as the completeness of the supporting documentation provided to FINRA. Firms seeking approval for a subordination using standard FINRA forms with little or no modification should submit the draft forms and draft supporting documentation at least 10 business days in advance of the proposed effective date. Agreements prepared by the parties (*i.e.*, non-standard agreements) or agreements prepared using standard FINRA forms that contain additional provisions or substantial modification should be submitted in draft form at least 30 calendar days in advance of the proposed effective date (as such forms require substantially more detailed review by FINRA staff).<sup>10</sup>

### **5. Approval, Execution and Funding; Submission of Final Documents**

Following the submission and review of all pertinent draft documentation, FINRA will advise the firm of the acceptability of the proposed subordination and supporting documentation. The firm and lender may subsequently execute the agreements and related supporting documentation on the proposed effective date stated in the draft documents. The funding of the subordination, other than a revolving subordinated loan agreement not drawn down at execution, must be accomplished on the same day as execution of the final documents. Prior notification to FINRA is required for any drawdown under a revolving subordinated loan agreement. The firm must submit to FINRA proof of funding of the subordination.

The executed documents must conform, in all respects, to any draft documents previously submitted to and approved by FINRA. Upon execution, the firm must submit a copy of the executed agreement and supporting documentation (*e.g.*, resolutions, Lender's Attestation, IDD, proof of funding), either electronically or in paper form, to FINRA, immediately after funding, but in no case later than two business days after funding is completed. Firms are responsible for maintaining original agreements in accordance with applicable recordkeeping requirements.<sup>11</sup> FINRA will provide firms with a written approval letter for the subordination following the receipt of all required executed documents.

#### **6. Amending or Renewing Previously Approved Subordinations**

Any amendment or renewal of a previously approved subordination, including but not limited to an extension of maturity (other than an automatic extension of maturity already included as a provision to an approved subordination), must be reviewed and approved by FINRA prior to becoming effective. FINRA will approve amendments or renewals that are consistent with the requirements of SEA Rule 15c3-1 and Appendix D and satisfy all other requirements of FINRA, as outlined in this *Notice*.

Firms seeking to amend or renew an existing subordination must follow the procedures outlined above in this *Notice* for submitting documents in draft form and submitting supporting documentation. Firms and lenders should be aware that subordination agreements (or provisions in such agreements) that have matured are not eligible for amendment. As with newly proposed subordinations, firms should contact their assigned Regulatory Coordinator and Regulatory Specialist, if applicable (*see* endnote 7), regarding proposed amendments.

## D. FINRA's Standard Forms

### 1. Types of Standard Forms

To ease the preparation and review burdens associated with subordinations, FINRA provides seven standard forms of agreements. Firms may, but are not required to, use these standard forms for proposed subordinations.

The table below provides a summary of the standard forms of subordination agreements and key characteristics of each form. Firms are encouraged to contact their assigned Regulatory Coordinator and Regulatory Specialist, if applicable (*see* endnote 7), regarding questions about which forms they should or can use given their particular circumstances.

FINRA Form	Type of Subordination	SEA Rule 15c3-1(d) Debt-Equity Treatment	Type of Lender	Maturity
SL – 31D	Cash Borrowing	Debt	Generally unrestricted	1 Year Minimum
SL – 31E	Cash Borrowing	Equity	Partner/ Stockholder	3 Year Minimum (Debt treatment in last 12 months)
SL – 31T *	Cash Borrowing	Debt (Temporary)	Generally unrestricted	45 Day <u>Maximum</u>
SDN – 32D	Secured Demand Note Agreement	Debt	Generally unrestricted	1 Year Minimum
SDN – 32E	Secured Demand Note Agreement	Equity	Partner/ Stockholder	3 Year Minimum (Debt treatment in last 12 months)
SDN – 32T *	Secured Demand Note Agreement	Debt (Temporary)	Generally unrestricted	45 Day <u>Maximum</u>
REV – 33R	Revolving Cash Borrowing	Debt	Qualified Lender	1 Year Minimum (from the end of the Credit Period)

\* FINRA Forms SL – 31T and SDN – 32T are Temporary Subordination Agreements permitted under paragraph (c)(5)(i) of Appendix D. No more than three such agreements are permissible in a 12-month period, each with a stated term of no more than 45 days from the date the agreement became effective. Firms should note that such agreements are for the purpose of enabling a broker or dealer, as set forth in paragraph (c)(5)(i) of Appendix D, to participate as an underwriter of securities or for other extraordinary activities in compliance with SEA Rule 15c3-1.

## 2. Certain Optional Provisions in the Standard Forms

The standard forms include references to two types of optional provisions:

(1) provisions that are permitted by Appendix D, but not required thereunder; and  
(2) optional provisions FINRA has included, which are not referenced in—and not precluded by—Appendix D. The optional provisions can be incorporated as part of the agreement if the parties mutually agree to do so.

The optional provisions have been written in a manner that requires the parties, when submitting a proposed subordination for approval, to affirmatively select and clearly indicate any optional provisions they choose to incorporate as part of their agreement. Optional provisions that are not affirmatively included are thereby excluded from the terms of the agreement. Following are examples of the optional provisions available:

- a. For non-equity<sup>12</sup> loans only, a provision allowing the lender, for any reason, to accelerate maturity to a time no earlier than six months from the date of written notice to the firm and FINRA, with such written notice given no earlier than six months from the effective date of the agreement.
- b. For non-equity<sup>13</sup> loans only, a provision allowing the lender to accelerate maturity based on the occurrence of Events of Acceleration or Events of Default. Such events must be clearly stated in the agreement and must be measurable, related to the business of the member, acceptable to FINRA and consistent with Appendix D limitations for such events. Parties wishing to incorporate Events of Acceleration or Events of Default in a subordination may not incorporate the lender's acceleration provision discussed in item a. above.
- c. A provision allowing, subject to prior written approval of FINRA and compliance with the requirements of Appendix D and FINRA rules, the firm, at its option, to make a prepayment of its obligations after one year following the effective date of the agreement. (Note: FINRA Form REV-33R, dealing with revolving cash borrowings, includes this permissive prepayment provision as standard and also allows for permissive prepayment prior to one year from the effective date under certain conditions).
- d. A provision allowing for a rapid and orderly liquidation of the firm if the payment obligations under the agreement are ever suspended for six months or more.
- e. A provision providing for the automatic extension of the maturity date for an additional year if written notice to the contrary is not provided by the lender to the member firm (who must in turn notify FINRA) within certain prescribed time frames.
- f. A provision providing for accrual of eligible interest for the period of the subordination (excluding the last twelve months of the subordination).



### 3. Modifying Standard Forms (Other Options)

Although standardized, FINRA forms may be modified prior to submission for approval. The parties to a proposed subordination may agree to incorporate the “optional rider” provision contained in each standard form. The optional rider provision allows the parties to modify the standard form and/or add any mutually agreed upon term that is not inconsistent with SEA Rule 15c3-1 or Appendix D and is acceptable to FINRA. When incorporating the optional rider provision, the parties must prepare and submit a draft rider containing the proposed terms as part of the proposed draft subordination.

### E. Effect of this *Notice* on Previously Approved Agreements

This *Notice* does not affect subordinations previously approved by FINRA (f/k/a NASD) or NYSE Regulation. Agreements previously deemed to be satisfactory subordinations shall continue to be acceptable until they mature. However, any member firm wishing to amend or renew a previously approved agreement must follow the guidance set forth in this *Notice*.<sup>14</sup>

## Endnotes

- 1 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 member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 FINRA Rule 4110(e)(1), which went into effect on February 8, 2010, as part of the new, consolidated financial responsibility rules, requires that subordinations meet standards set by FINRA in addition to those set forth in SEA Rule 15c3-1d (referred to as Appendix D of SEA Rule 15c3-1, the SEC’s net capital rule). Appendix D authorizes FINRA to establish additional requirements deemed necessary or appropriate. For more information about the new financial responsibility rules, see *Regulatory Notice 09-71* (SEC Approves Consolidated FINRA Rules Governing Financial Responsibility) (December 2009). See also Exchange Act Release No. 60933 (November 4, 2009), 74 FR 58334 (November 12, 2009) (Order Granting Approval to Proposed Rule Change; File No. SR-FINRA-2008-067);

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## Endnotes continued

- Exchange Act Release No. 61408 (January 22, 2010), 75 FR 4596 (January 28, 2010) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2010-004); and Exchange Act Release No. 61513 (February 12, 2010), 75 FR 7532 (February 19, 2010) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2010-008).
- 3 Generally, standard subordinations are those that utilize the standard forms provided by FINRA and/or certain optional provisions as discussed within this *Notice*. Non-standard subordinations are agreements drafted independently by the parties. Firms are not required to use the standard forms.
  - 4 The new forms replace the forms previously made available to FINRA member firms (they were not accessible online).
  - 5 A subordination agreement must be a satisfactory subordination agreement as set forth in Appendix D in order that the respective amounts may be included in the firm's net capital. *See, e.g.*, Rule 15c3-1(c)(2).
  - 6 Firms should note that FINRA will not view the possible unenforceability of an agreement under the laws of any jurisdiction or a contracting party's failure to perform as a defense in the event of a member's violation of financial responsibility or other requirements under FINRA or SEC rules.
  - 7 If a firm is assigned to the Risk Oversight and Operational Regulation (ROOR) Department of FINRA, the documentation and information pertaining to proposed or amended subordination agreements must also be submitted to the firm's assigned Regulatory Specialist in ROOR, in addition to its Regulatory Coordinator. Firms may submit draft agreements and supporting documentation via email to the required staff person(s).
  - 8 In exigent circumstances, FINRA will undertake to expedite the review and approval of proposed subordination agreements.
  - 9 This is new for Dual Members, which, historically, have been required to submit an opinion of counsel pursuant to Incorporated NYSE Rules 420 and 313(d), both of which have been deleted in connection with the adoption of the new, consolidated financial responsibility rules. *See note 2*. For background regarding IDD's, *see Notice to Members 02-32 (Subordinated Loan Agreements) (June 2002)*.
  - 10 *See note 8*.
  - 11 *See, e.g.*, SEA Rule 17a-4.
  - 12 *See paragraph (d) of SEA Rule 15c3-1*.
  - 13 *See note 12*.
  - 14 *See also Section C.6 of this Notice*.