FINRA
Financial Industry Regulatory Authority

November 22, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2013-035 – Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing,[1] a proposed rule change to adopt the consolidated FINRA financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities, and callable securities. The Commission received two comment letters in response to the Proposing Release.[2]

The proposed rule change would adopt new FINRA Rule 4314 (Securities Loans and Borrowings), FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities), and FINRA Rule 4340 (Callable Securities). The proposed rule change would also delete NASD Rule 2330 (Customers' Securities or Funds), NASD IM-2330 (Segregation of Customers' Securities), Incorporated NYSE Rule 296 (Liquidation of Securities Loans and Borrowings), including Supplementary Material .10 and .20, Incorporated NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities), including Supplementary Material .30, and NYSE Rule Interpretations 296(b)/01 and 402(b)/01 as they are, in main part, either duplicative of, or do not align with, the proposed requirements.

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1 *See* Securities Exchange Act Release No. 70272 (August 27, 2013), 78 FR 54350 (September 3, 2013) (Notice of Filing File No. SR-FINRA-2013-035) (the "Proposing Release").

2 Letters from Kyle Brandon, Managing Director, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated September 24, 2013 ("SIFMA"); and William A. Jacobson, Esq., Clinical Professor of Law, Director, Securities Law Clinic, and Jyesoo Jang, Cornell University Law School, to Elizabeth M. Murphy, Secretary, SEC, dated September 24, 2013 ("Cornell Law Clinic").

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The comments received by the Commission on the consolidated rule proposal and FINRA's responses to the comments are discussed in detail below.

A. General Support

Cornell Law Clinic and SIFMA expressed overall support for the proposed rule change. SIFMA noted that it understands that the proposed rules are designed to enhance and formalize the current safeguards in the securities lending market. In addition, SIFMA noted that FINRA acknowledged and incorporated many of the suggestions from an earlier letter submitted by SIFMA in response to *Regulatory Notice* 10-03.[3]

B. Proposed FINRA Rule 4314

1. Finalize ALD Initiative and Codify SEC Guidance in the Proposed Rule

SIFMA reiterated a comment offered in response to *Regulatory Notice* 10-03 and recommended that FINRA work with the SEC staff to finalize the relief to be provided under the draft Agency Lending Disclosure ("ALD") no-action letter request submitted to the SEC in October 2006, which proposed procedures for disclosures with respect to agency lending, prior to or simultaneous with the adoption of proposed FINRA Rule 4314, and then expressly cross-reference the ALD Initiative in proposed Rule 4314. SIFMA expressed concern that there is no explicit reference to the ALD Initiative in the text of the proposed rule because, although the ALD no-action request letter remains in draft form, it believes that broker-dealers engaging in securities lending activities are currently examined by the SEC and FINRA for compliance with the terms of the ALD no-action request letter.

As stated in the Proposing Release, FINRA acknowledges the draft ALD no-action letter request and the work of SIFMA, industry participants, the SEC, and other regulators, including FINRA, in developing the ALD Initiative. However, FINRA cannot adopt and codify draft guidance pending at the SEC. In addition, given the passage of time, FINRA strongly believes that proposed Rule 4314 addresses the need for transparency and disclosure under securities lending arrangements. FINRA remains committed to working with the industry and the SEC to finalize the ALD no-action letter request and reaffirms its commitment to reviewing the requirements of FINRA Rule 4314 (if approved) to address any inconsistencies that may result following the issuance of any final guidance by the SEC.

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3 *See Regulatory Notice* 10-03 (January 2010) and comment letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 8, 2010.

C. Proposed FINRA Rule 4330

1. Support for Additional Disclosure Requirement

Cornell Law Clinic supported the requirement in proposed Rule 4330, and specifically Rule 4330(b)(2)(B), which requires firms to disclose in writing information regarding the rights, risks and financial impact associated with securities lending transactions prior to entering into such transactions. Cornell Law Clinic further noted that it "believe[s] that this rule will aid individual customers in making more informed investment decisions."

2. Clarify Requirement for Text and Placement of Legend in Customer Margin Agreement

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 are eligible to be pledged or loaned, thereby adopting the requirement in Incorporated NYSE Rule 402(b). Proposed Supplementary Material .02 would permit a member to satisfy this written authorization requirement by using a single customer signed margin agreement/loan consent, provided it contains a legend in bold type face directly above the signature line substantially stating the following:

BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS.

Cornell Law Clinic supported the continuation of the written authorization requirement because "it will alert customers about use of their margin securities and pertinent risks."

SIFMA stated that firms have developed independently a variety of approaches as to the manner in which they document their customers' written authorization to loan such customers' securities. In addition, SIFMA stated that "members have indicated that their customer margin account agreements contain a disclosure similar to the language proposed in Supplementary Material .02, although the exact language and placement may differ." Moreover, SIFMA stated its belief the placement requirement may conflict with the required placement of other disclosures (e.g., FINRA Rule 2268). SIFMA noted that some members have indicted their belief that their chosen approaches are equally effective at ensuring that their customers are aware and acknowledge that their securities may be loaned out to the member or others. In addition, SIFMA requested that FINRA clarify that placing the legend near and preceding the signature line, but not necessarily above the signature line, would be deemed compliant with the placement requirement in Supplementary Material .02. SIFMA requested, given the prevalence of these alternative documentary approaches within the industry, and to avoid the costs and administrative burden of having to "re-paper" a firm's entire margin customer base, that FINRA apply

Supplementary Material .02 solely to customer margin agreements entered into after the effective date of the proposed rule change.

FINRA notes that the requirement in proposed Supplementary Material .02 is not new, but is identical to that in Incorporated NYSE Rule Interpretation 402(b)/01. However, members that were not previously subject to the requirements of NYSE Rule Interpretation 402(b)/01 may not have agreements in place that comply with its requirements. Therefore, in light of the comments and noting the potential burden on members not previously subject to the requirements of NYSE Rule Interpretation 402(b)/01, FINRA is proposing to amend Supplementary Material .02 to delete the specific legend requirement and revise proposed Supplementary Material .02 as follows:

.02 Authorization to Lend Customers' Margin Securities. For purposes of paragraph (a) of this Rule, members may use a single customer account agreement/margin agreement/loan consent signed by a customer as written authorization to permit the lending of a customer's margin eligible securities in lieu of obtaining a separate written authorization; provided such customer account agreement/margin agreement/loan consent includes clear and prominent disclosure that the firm may lend either to itself or others any securities held by the customer in its margin account.

While FINRA is proposing the amendment to accommodate the continued use of the existing customer account agreements/margin agreements/loan consents, members would remain responsible for ensuring that existing agreements contain necessary provisions to comply with the intent and purpose of proposed Supplementary Material .02.

3. Establish Institutional Customer Exception for Appropriateness Review

Proposed FINRA Rule 4330(b)(2)(A) would require a member to have reasonable grounds for believing that a customer's loan of securities are appropriate. Cornell Law Clinic supported the proposed appropriateness requirement and stated that the "heightened risks call for greater attention to the issue of suitability and also justify putting the burden to determine suitability on brokerage firms."

SIFMA noted its appreciation that FINRA clarified in the Proposing Release that the appropriateness determination would be required to be performed prior to the member first entering into securities borrows with a customer, and would apply with respect to a customer's overall participation in a fully paid securities lending program; i.e., the appropriateness determination would not be required to be made on a transaction-by-transaction basis. SIFMA stated its belief that this is the correct approach with respect to the securities lending market.

SIFMA also requested that FINRA adopt an institutional safe harbor under proposed FINRA Rule 4330(b) that provides that a member firm that has satisfied the requirements of FINRA Rule 2111(b) with respect to an institutional account shall be automatically deemed to have satisfied the appropriateness obligation in proposed FINRA

Rule 4330 with respect to the institutional account. SIFMA stated that "if a member firm reasonably determines that an institutional customer is capable of evaluating the risks of engaging in a securities loan transaction, and the institutional customer has indicated that it exercises independent judgment, such customer should require no greater protection with respect to a securities lending transaction than a recommended transaction or investment strategy involving a security." Further, SIFMA stated it believes that the safe harbor should be equally applicable to an agent of a customer, similar to FINRA Rule 2111(b).

In light of these comments, FINRA is proposing to add new Supplementary Material .05 (Appropriateness Determination for Institutional Customers) to establish an institutional customer exception similar to that in FINRA Rule 2111(b). Specifically, FINRA is proposing to add the following Supplementary Material:

> **.05 Appropriateness Determination for Institutional Customers.** A member may fulfill the obligation set forth in paragraph (b)(2)(A) of this Rule for an institutional account, as defined in Rule 4512(c), by complying with the requirements of Rule 2111(b).
>
> Members are reminded that Rule 2111(b) requires members to have a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. FINRA notes that firms with existing institutional customers should evaluate any current documentation they may have from an institutional customer under FINRA Rule 2111(b) to ensure that it complies with the requirements of proposed FINRA Rule 4330 and the securities lending transactions contemplated thereby.

4. Develop Industry Disclosure Form Template

Proposed FINRA Rule 4330(b)(2)(B) requires a member to provide a customer, prior to first entering into securities borrows with a customer, with risk and financial disclosures that must be in writing. SIFMA noted that FINRA acknowledged in the Proposing Release that it would not object to the development of an industry standard risk disclosure form for purposes of complying with proposed FINRA Rule 4330(b)(2)(B). SIFMA stated it believes "that such an approach has worked well in other contexts (e.g., the options disclosure document, portfolio margining, prime brokerage 150 and 151 agreements), and would greatly help to alleviate confusion and establish uniformity across the industry." SIFMA requested that FINRA extend the deadline for compliance with the requirements of proposed FINRA Rule 4330(b)(2)(B) to send written disclosure to customers to 180 days after the effective date of the proposed rule change "in order to provide sufficient time to draft, review, discuss, revise and ultimately approve an appropriate and comprehensive industry standard risk disclosure form."

In that regard, SIFMA stated that it has established a working group to create such a template industry standard risk disclosure form and that it intends to provide a draft of the template to FINRA for review, discussion and comment, with the aim of establishing mutually-agreeable standards between regulators and the industry.

FINRA recognizes the benefit of developing standard templates that firms may use at their option and that such a template may reduce compliance costs for firms creating and maintaining the disclosures required under proposed FINRA Rule 4330(b)(2)(B). In addition, SIFMA raised concerns that the effective date of the proposed rule may result in firms having to do a separate mailing of the disclosures to customers, instead of including such disclosures in the next regularly scheduled delivery of quarterly customer account statements.

FINRA understand SIFMA's concern and, as a result, is proposing to extend the compliance date by which members must provide customers with the disclosures required under proposed FINRA Rule 4330(b)(2)(B) to 180 days following the effective date of the proposed rule change. FINRA believes this timeframe will allow firms to develop disclosure documents and align the mailing of the disclosure documents with the mailing of quarterly customer account statements to customers. In addition, while FINRA will work with industry groups that are developing templates, FINRA notes that use of a standard template would not guarantee compliance with or create any safe harbor with respect to FINRA rules, the federal securities laws or state laws. The obligation to develop a written risk and financial disclosure document under proposed FINRA Rule 4330(b)(2)(B) is not a "one-size-fits-all" requirement, and firms must tailor the disclosure to fit their particular situation.

D. Proposed FINRA Rule 4340

No comments were received on this proposed rule.

FINRA believes that the foregoing, along with the discussion in the Proposing Release, fully responds to the issues raised by the commenters. If you have any questions, please contact me at 202-728-6903.

Sincerely,

Kosha K. Dalal