Regulatory Notice 21-43

Prohibition on Borrowing From or Lending to Customers

Proposed Amendments to FINRA Rule 3240 and Retrospective Rule Review Report

Comment Period Expires: February 14, 2022

December 16, 2021

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics

- Prohibition on Borrowing From or Lending to Customers
- Senior Investors

Referenced Rules & Notices

- FINRA Rule 3240
- FINRA Rule 3241
- Regulatory Notice 19-27
- Regulatory Notice 20-34
- Regulatory Notice 20-38

Summary

In August 2019, FINRA launched a retrospective review that, among other things, sought stakeholders' input on the effectiveness of Rule 3240 (Borrowing from or Lending to Customers).[1] Based on feedback received during the review, FINRA is proposing amendments to Rule 3240 to:

- emphasize that the rule generally prohibits registered persons from entering into borrowing or lending arrangements with their customers;
- clarify that the rule applies to borrowing or lending arrangements that pre-exist the broker-customer relationship;
- extend the rule to prohibit entering into borrowing or lending arrangements within six months after the broker-customer relationship ends;
- extend the rule to prohibit borrowing or lending arrangements with persons related to either the registered person or the customer, such as an arrangement between the registered person and the customer's spouse or between the registered person's outside business and the customer;
- modernize the "immediate family" definition;
- narrow the scope of the "personal relationship" exception; and
- provide factors for evaluating whether an arrangement is within the "personal relationship" or "business relationship" exceptions.

This *Notice* seeks comment on the proposed amendments to Rule 3240. This *Notice* also summarizes the predominant themes that emerged from stakeholder feedback, provides guidance to aid member firms when evaluating whether to approve a borrowing or lending arrangement that is within one of the limited exceptions to the general prohibition, and invites a broader consideration of the distinctions between Rule 3240 and federal and state approaches for regulating borrowing and lending arrangements between investment adviser representatives and their clients.

FINRA

The proposed rule text is available in Attachment A.

Questions concerning this *Notice* should be directed to:

- Michael Garawski, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8835; or
- Ilana Herscovitz Reid, Assistant General Counsel, OGC, at (202) 728-8268.

Questions concerning the Economic Impact Assessment in this *Notice* should be directed to:

- Paul Rothstein, Senior Director and Assistant Chief Economist, Office of the Chief Economist (OCE), at (314) 922-1535; or
- Vy Nguyen, Principal Research Analyst, OCE, at (202) 728-8078.

Action Requested

FINRA encourages all interested parties to comment. **Comments must be received by February 14, 2022.**

Comments must be submitted through one of the following methods:

- Online using FINRA's comment form for this *Notice*;
- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Notes: All comments received in response to *Regulatory Notices* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[2]

Before becoming effective, a proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[3]

Background & Discussion

Rule 3240 generally prohibits borrowing and lending arrangements between registered persons and their customers. Such loans have the potential for abuse of customers, especially older investors.

The rule has five tailored exceptions, available only when the member firm has written procedures allowing such exceptions and, when required, the registered person notifies the member firm and obtains its approval.[4] The exceptions are for borrowing or lending arrangements that meet one of the following conditions:

- the customer is a member of the registered person's immediate family;
- the customer (i) 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 and (ii) is acting in the course of such business;
- the customer and registered person are both registered persons of the same member firm;
- 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 registered person not maintained a relationship outside of the broker-customer relationship; or
- the lending arrangement is based on a business relationship outside of the broker-customer relationship.[5]

The exceptions are for limited situations where any potential risks are mitigated by the nature of the relationship between the registered person and the customer, the sophistication of the parties or other factors.

FINRA recently conducted a retrospective review of Rule 3240.[6] Stakeholders provided a wide range of views regarding the rule's efficiency. Several external stakeholders said that the rule has been effective in addressing potential misconduct and has appropriate exceptions, although some suggested modernizing the rule's definition of "immediate family." On the other hand, some external stakeholders suggested that the rule should prohibit all borrowing and lending arrangements, without exceptions. In between these two poles, some stakeholders supported stronger controls short of a complete prohibition. These stakeholders suggested applying the general prohibition to arrangements entered into before the start of the broker-customer relationship, extending the general prohibition to circumstances where registered persons may attempt to circumvent the rule by structuring arrangements with persons related to the broker or the customer, and narrowing the exceptions. FINRA also received feedback that the "personal relationship" exception is sometimes exploited by registered persons to avoid the general prohibition.

Having considered this feedback, FINRA is proposing amendments that retain the basic contours of Rule 3240, strengthen the rule's general prohibitions and modernize the "immediate family" exception. As noted below, some of the proposed amendments are consistent with aspects of recently adopted Rule 3241 (Registered Person Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer), which limits registered persons from occupying outside positions of trust for or on behalf of a customer, being named a beneficiary of a customer's estate or receiving a bequest from a customer's estate, and addresses potential conflicts that are similar to those presented by borrowing and lending arrangements with customers.[7]

Proposed Amendments to Rule 3240

The General Prohibition Against Borrowing and Lending Arrangements

Rule 3240 generally prohibits borrowing or lending arrangements between registered persons and their customers. To emphasize this, FINRA proposes to change the rule's title from "Borrowing from or Lending to Customers" to "Prohibition on Borrowing from or Lending to Customers," and to change the title of Rule 3240(a) from "Permissible Lending Arrangements; Conditions" to "General Prohibition; Permissible Borrowing or Lending Arrangements; Conditions."

FINRA is also proposing to strengthen this general prohibition in three ways. First, Rule 3240(a) would be broadened to clarify that the rule's general requirements for borrowing and lending arrangements apply to arrangements that pre-exist a new broker-customer relationship. Currently, Rule 3240(a) provides that "[n]o person associated with a member in any registered capacity may borrow money from or lend money to any customer of such person." Amendments to Rule 3240(a) would further provide that no person associated with a member firm in any registered capacity may initiate a broker-customer relationship with a person with whom the registered person has an existing borrowing or lending arrangement.

Second, proposed Supplementary Material 3240.02 would define "customer" to include, for purposes of Rule 3240, any customer that has, or in the previous six months had, a securities account assigned to the registered person at any member. This would extend the rule's limitations to arrangements entered into within six months after a broker-customer relationship terminates, whether the customer is staying with, or leaving, the member firm. This proposed change aligns with how "customer" is defined for purposes of Rule 3241.[8]

Third, proposed Supplementary Material 3240.05, to be titled "Arrangements with Persons Related to Either the Registered Person or the Customer," would extend the rule's requirements to borrowing or lending arrangements that involve similar conflicts as ones presented by arrangements between registered persons and their customers. Specifically, proposed Supplementary Material 3240.05 would provide that "[a] registered person instructing or asking a customer to enter into a borrowing or lending arrangement with a

person related to the registered person . . . or to have a person related to the customer . . . enter into a borrowing or lending arrangement with the registered person would present similar conflict of interest concerns as borrowing or lending arrangements between the registered person and the customer and would not be consistent with this Rule unless the conditions set forth in [Rule 3240(a)(1), (2), and (3)] are satisfied."[9] This would address the potential for customer abuse that arises when a registered person induces a customer to enter into a borrowing or lending arrangement with a person or entity related to the registered person (*e.g.,* the registered person's immediate family member or outside business) or induces a person or entity related to the customer to enter into an arrangement with the registered person. Proposed Supplementary Material 3240.05 would be similar to the Supplementary Material to Rule 3241, which addresses naming other persons to be a beneficiary of, or receive a bequest from, a customer's estate.[10]

In addition, proposed Supplementary Material 3240.03 would establish that, for purposes of Rule 3240, borrowing and lending arrangements include owner-financing arrangements that do not involve borrowing or lending of money (*e.g.,* installment payment arrangements for property purchases). This would codify an existing interpretation.[11]

The "Immediate Family" Definition

One of the few exceptions to Rule 3240's general prohibition is for borrowing or lending arrangements with a customer who is a member of the registered person's "immediate family."[12] Currently, Rule 3240(c) defines "immediate family" to mean "parents, grandparents, mother-in-law or father-in-law, husband or wife, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, children, grandchildren, cousin, aunt or uncle, or niece or nephew, and any other person whom the registered person supports, directly or indirectly, to a material extent."

FINRA is proposing to modernize the "immediate family" definition to match the definition of the same term in Rule 3241, which also has exceptions when the customer is a member of the registered person's immediate family.[13] Specifically, proposed amendments to Rule 3240(c) would change "husband or wife" to "spouse or domestic partner" and amend the definition to "include step and adoptive relationships." In addition, the "any other person" clause would be limited to "any other person who resides in the same household as the registered person and the registered person financially supports, directly or indirectly, to a material extent."

The "Personal Relationship" and "Business Relationship" Exceptions

Two of the exceptions to the rule's general prohibition are borrowing or lending arrangements based on: (i) a "personal relationship with the customer, such that the loan would not have been solicited, offered, or given had the customer and the registered person not maintained a relationship outside of the broker-customer relationship"; and (ii) a "business relationship outside of the broker-customer relationship."[14]

Out of concern that the "personal relationship" exception may be exploited, FINRA is proposing to narrow this exception. Specifically, the personal relationship exception would be amended to permit only those arrangements that are based on a "close personal relationship between the registered person and the customer maintained outside, and formed prior to, the broker-customer relationship."[15]

Further, proposed Supplementary Material 3240.04 would provide factors for evaluating whether a borrowing or lending arrangement is based on a "close personal relationship" or a "business relationship." The proposed factors would include, but would not be limited to, when the relationship began, its duration and nature, and any facts suggesting that the relationship is not a bona fide "close personal relationship" or "business relationship" or was formed with the purpose of circumventing the purpose of Rule 3240. Illustrative examples of "close personal relationships" would include a childhood or long-term friend, or a godparent. Proposed Supplementary Material 3240.04 is intended to clarify the scope of the "close personal relationship" and "business relationship" exceptions, focus on the most relevant factors when evaluating whether a personal or business relationship exists, and ensure that firms consider meaningfully the potential issues before customer harm occurs.

Notification and Approval Requirements

FINRA also proposes amendments to the rule's notification and approval requirements in Rule 3240(b).

FINRA proposes a clarifying amendment to the rule's existing approval provision. Currently, Rule 3240(b)(1) requires registered persons to provide notice to their member firms of arrangements and modifications to arrangements that fall within three of the exceptions, specifically, arrangements based on personal relationships or business relationships or with persons registered with the same member firm. The rule states that the member firm "shall pre-approve" such arrangements and modifications. The words "shall pre-approve" could imply incorrectly that the member firm must approve the arrangement or modification and may not disapprove the arrangement or modification. To preclude that incorrect interpretation, the proposal would amend Rule 3240(b)(1) to require the registered person to provide the member firm notice of the arrangements or modifications "prior to entering into such arrangements" or "prior to the modification of such arrangements," and to "obtain the member's approval."[16]

Rule 3240(b)(1) would be further amended to apply the notification and approval requirements when a borrowing or lending arrangement pre-exists the broker-customer relationship at the member firm. Specifically, proposed Rule 3240(b)(1)(B) would require registered persons, prior to the initiation of a broker-customer relationship at the member firm, to notify the member firm in writing of existing arrangements with persons who seek to be a customer of the registered person and to obtain the member firm's approval in writing of the broker-customer relationship. When a member firm does not approve

the formation of a broker-customer relationship, the customer could still initiate a broker-customer relationship with another registered person at the same firm.

Proposed amendments to Rule 3240(b)(1) also would require that all required notices—both of pre-existing and contemplated borrowing or lending arrangements—be in writing. In a related change, the rule's record-retention requirements, described in Supplementary Material 3240.01, would be broadened to require retention of the required written notices.[17]

FINRA also proposes to amend Rule 3240(b)(2) and (3), which currently provide that the member firm's written procedures may indicate that registered persons are not required to notify the member firm or receive member firm approval of arrangements that are within the "immediate family" exception or some of the arrangements within the "financial institution" exception. To extend these provisions to pre-existing arrangements of the same nature, Rule 3240(b)(2) and (3) would be amended to provide that the member firm's procedures also may indicate that registered persons are not required to notify the member firm or receive member firm approval of such arrangements either prior to or subsequent to initiating a broker-customer relationship.[18]

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to further analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet its regulatory objective.

Regulatory Need

Rule 3240 prohibits borrowing and lending arrangements between registered persons and their customers except when certain conditions are met, as specified in the rule and described above. Anecdotal evidence from member firms, law clinics and previous enforcement cases suggests some uncertainty about the scope of Rule 3240 and suggests that some registered representatives may try to use the current rule's exceptions in ways that may harm investors. The proposed amendments aim to reduce uncertainty by clarifying the scope of the rule, reduce risks to investors through incremental adjustments to the general prohibition and the exceptions, and modernize the "immediate family" definition.

Economic Baseline

The economic baseline for the proposed rule is Rule 3240 and the member firms' existing internal procedures regarding borrowing from or lending to a customer, and the extent of investor protection and market efficiency that result. As of the end of 2020, there were 617,549 registered representatives and 3,435 registered firms that would be covered by the proposed rule in addition to their customers.[19]

Absent Rule 3240, borrowing and lending arrangements with customers would likely be more widespread and riskier due to conflicts of interest and the superior information that registered persons have about potential risks and returns. Rule 3240 generally prohibits these arrangements, and it mitigates these potential conflicts of interest in those arrangements that are within the exceptions. All arrangements within the exceptions allowed under the rule have to comply with firms' internal procedures, which may be stricter than Rule 3240.

To measure the effectiveness of the current rule, FINRA would need estimates of the reduction in harmful borrowing-lending arrangements as well as any unintended reduction in mutually beneficial borrowing-lending arrangements attributable to the rule and the firms' current internal policies. FINRA does not have these estimates. As an alternative metric, FINRA has evaluated the latest enforcement data related to the rule, which are limited to the cases that are detected and do not represent a complete picture of investor protection under the current rule. The data also do not show the amounts of restitution and investor harm. There were 20 enforcement matters related to borrowing from or lending to customers between March 2018 and March 2020. Three-quarters of these cases involved prohibited borrowing or lending arrangements, while the remaining cases involved arrangements that violated the firm's policy or registered persons who failed to notify the firm of permissible arrangements. In all of these cases, the registered person borrowed money from the customer, and the amounts of money ranged from $500 to $665,000.

Based on examination and investigative findings and comments received, FINRA is concerned that some registered persons may avoid the prohibitions under the current rule, using tactics such as timing the arrangement to be entered into after terminating a broker-customer relationship, using other nominal borrowers such as a spouse or business entity of the registered person, or claiming a personal relationship that is not genuine. For example, FINRA has detected instances in which the registered person re-assigned the customer to another registered person and then immediately entered into a borrowing arrangement with the former customer. The current rule does not specify that such arrangements are prohibited.

Economic Impact

By clarifying several definitions and extending the coverage of the rule's general prohibition, the proposed amendments would likely narrow the scope of arrangements allowed within the exceptions and result in fewer attempts by registered persons to enter into impermissible arrangements. For example, the expected cost of a registered person's attempting to circumvent the general prohibition by making a lending or borrowing request purportedly based on a "personal relationship" or "business relationship" would be higher, as the likelihood of getting caught would increase when firms, registered persons and customers have better information about permitted relationships. The proposed amendments would also eliminate some arrangements that may be allowed under the

current rule. As a result, the probability of customers incurring economic harm and the amount of harm that may occur would likely be reduced. Nevertheless, the proposed rule may preclude arrangements that could be mutually beneficial to customers and registered persons and superior to alternative opportunities for borrowing and lending.

The long-term net impact of the proposed rule on firms' compliance costs is less clear. The proposed rule would likely reduce registered persons' attempts to borrow based on a "personal relationship" exception. Further, with the modernized definition of "immediate family," some arrangements that are currently within the "personal relationship" category would instead qualify as an "immediate family" arrangement, of which firms could choose not to require notification or approval. On the other hand, with the rule extended to cover arrangements that pre-exist the initiation of a broker-customer relationship and to a time period that extends six months after a broker-customer relationship is terminated, firms may be required to receive notice of arrangements that they may not know about under the current rule and to evaluate whether to approve the arrangements or the initiation of a broker-customer relationship. Additionally, firms may incur additional costs of supervising and monitoring due to the extended time period that the proposed rule covers. The extent of net savings or costs to firms for compliance would depend on the relative prevalence of such cases and the additional monitoring costs.

In the short term, firms could incur increased compliance costs. Specifically, firms may have to re-train their staff to become aware of the extended prohibitions, the modernized definition of "immediate family," and the proposed factors to consider for arrangements based on personal and business relationships. While the proposed rule would not apply retroactively,[20] firms may also re-evaluate previously approved arrangements based on "personal relationships" or "business relationships" under the new rule. Additionally, firms may choose to respond to the proposed rule by reviewing their current registered persons' borrowing and lending arrangements with their current and previous customers, to the extent they have not already done so.

For firms that are not already maintaining the written notices and approvals of permitted borrowing or lending arrangements that the proposed amendments will require, there would be additional operational costs. However, FINRA expects the incremental costs to be minimal, as the costs of making and keeping written records are trivial with digital technology.

Alternatives Considered

FINRA considered generally prohibiting all borrowing and lending arrangements between registered persons and customers and eliminating the existing exceptions. As an initial matter, Rule 3240 already contains a general prohibition, and the proposed rule amendments would strengthen it, by extending the time period over which the rule would apply, broadening the kinds of arrangements to which the rule would apply, and narrowing some exceptions.

Moreover, FINRA determined that the enumerated exceptions in Rule 3240, with the proposed adjustments described above, permit arrangements for which the potential benefits outweigh any related risks. For some of the exceptions, such as borrowing or lending arrangements with customers that are financial institutions regularly engaged in the business of providing credit or that are registered persons of the same member firm, or arrangements based on a business relationship outside the broker-customer relationship, there likely would be factors to mitigate the potential for abuse (*e.g.,* sophistication of the customer, the likelihood that the arrangements will be protected with collateral, and any requirement to give notice and obtain approval). Similarly, the exceptions for arrangements with immediate family members or based on a close personal relationship allow for arrangements where the potential for harm is likely mitigated by the nature of the ties between the registered person and the customer.

Guidance Concerning Approvals of Permissible Borrowing or Lending Arrangements

While the retrospective review of FINRA Rule 3240 was being conducted, FINRA published general guidance concerning the requirement in Rule 3241 that a member firm conduct a "reasonable assessment" of the risks created by a registered person being named a beneficiary of, or receiving a bequest from, a customer's estate, or being named as an executor or trustee or holding a power of attorney or similar position for or on behalf of a customer, and a "reasonable determination of whether to approve the registered person's assuming such status or acting in such capacity."[21] Considering that Rules 3240 and 3241 address similar potential conflicts, FINRA believes that similar guidance, with appropriate modifications, will assist member firms when they assess whether to approve a permissible borrowing or lending arrangement.

FINRA expects that when a member firm is required to evaluate whether to approve a borrowing or lending arrangement between a registered person and the registered person's customer, that evaluation would take into consideration several factors, such as:

- any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer;
- the length and type of relationship between the customer and registered person;
- the material terms of the borrowing or lending arrangement;
- the customer's or the registered person's ability to repay the loan;
- the customer's age;
- whether the registered person has been a party to other borrowing or lending arrangements with customers;

- whether, based on the facts and circumstances observed in the member firm's business relationship with the customer, the customer has a mental or physical impairment that renders the customer unable to protect his or her own interests;
- any disciplinary history or indicia of improper activity or conduct with respect to the customer or the customer's account (*e.g.,* excessive trading); and
- any indicia of customer vulnerability or undue influence of the registered person over the customer.

This list is not intended to be an exhaustive list of factors that a member firm may consider when evaluating whether to approve a borrowing or lending arrangement. Moreover, while a listed factor may not be applicable to a particular situation, the factors that a member firm considers should allow for a reasonable assessment of the associated risks of a borrowing or lending arrangement. FINRA does not expect a registered person's assertion that the registered person or the customer has no viable alternative person from whom to borrow money to be dispositive in the member firm's evaluation of whether to approve a borrowing or lending arrangement.

Although Rule 3240(a)(2) establishes five limited categories of permissible borrowing and lending arrangements, given the potential conflicts of interest, a member firm should reasonably assess the associated risks of a permissible borrowing or lending arrangement. If possible, as part of the member firm's evaluation of whether to approve a borrowing or lending arrangement, FINRA expects a member firm to try to discuss the arrangement with the customer.

Discussion of Investment Adviser Regulation

The risks presented by borrowing and lending arrangements with customers are not unique to arrangements with registered persons of broker-dealers. Comparable risks may be present in borrowing or lending arrangements with other financial professionals, such as supervised persons of investment advisers. Despite these commonalities, how borrowing and lending arrangements are regulated is not uniform, which may result in different levels of investor protection depending on which kind of financial professional is involved. To encourage and inform a broader consideration of the issues presented by borrowing and lending arrangements between financial professionals and their customers—including whether the attendant risks warrant a more consistent overall regulatory approach—FINRA identifies below some similarities and differences between Rule 3240 and the federal and state regulatory approaches for investment advisers and their supervised persons.[22]

As explained above, Rule 3240 is a prescriptive rule that generally prohibits borrowing or lending arrangements between registered persons and their customers while allowing for some specified, tailored exceptions. Furthermore, those few exceptions have restrictions on their availability. None is available unless the registered person's employing member

firm has written procedures allowing them, and some are available only if the registered person also provides notice to, and receives approval from, the employing member firm. In addition, as described in the new guidance above, when a member firm evaluates whether to approve a borrowing or lending arrangement, it should first make a reasonable assessment of the associated risks of a borrowing or lending arrangement. While FINRA's proposed changes to Rule 3240 would strengthen the rule's prohibitions and narrow its exceptions, they would not alter the fundamental framework for regulating borrowing and lending arrangements between customers and persons registered with broker-dealers.

By comparison, the federal regulatory landscape for investment advisers and their supervised persons takes a different approach. FINRA is not aware of any federal laws, rules or regulations that expressly address borrowing or lending arrangements between investment advisers and their clients. Rather, as fiduciaries, investment advisers must eliminate or make full and fair disclosure of all material facts relating to the advisory relationship and of conflicts of interest that might incline an investment adviser, consciously or unconsciously, to render advice that is not disinterested, and the client must provide informed consent to the conflict.[23] Thus, for SEC-registered investment advisers and their supervised persons, engaging in a borrowing or lending arrangement with a client may constitute a breach of fiduciary duty if conflicts of interest are not adequately disclosed to the client, and the client does not give informed consent. In addition, Advisers Act Rule 204A-1 requires SEC-registered investment advisers to establish, maintain, and enforce a written code of ethics.[24] The rule does not expressly require a code of ethics to address borrowing or lending arrangements between investment advisers and their clients, but an investment adviser may choose to cover such arrangements in its code of ethics.

With respect to state regulation, some states have adopted North American Securities Administrators Association (NASAA) model rules that prohibit state-registered investment advisers and their investment adviser representatives from engaging in borrowing or lending arrangements with clients, subject to limited exceptions.[25] The available exceptions vary by state and include, for example, when the client is a broker-dealer, an affiliate of the investment adviser, a financial institution engaged in the business of loaning funds, or a family member.[26] By comparison, Rule 3240 has more categories of exceptions than the NASAA model rules, but also includes additional restrictions on their availability that require the employing broker-dealer's involvement.

FINRA encourages a broader dialogue about whether—considering the similarities between some of the services offered by brokers that FINRA regulates and investment advisers, and the similar risks presented when any financial professional borrows from or lends money to customers—a more uniform regulatory approach would enhance investor protection.

Request for Comments on Proposed Amendments to Rule 3240

FINRA requests comment on the proposed amendments to Rule 3240. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. Should the general prohibition on borrowing from or lending to customers be extended to prohibit arrangements entered into within six months after a broker-customer relationship terminates, as proposed?
2. Rule 3240 currently has five tailored exceptions to the general prohibition on borrowing and lending arrangements. Should any exceptions be eliminated or added? If so, which ones?
3. Should the "personal relationship" exception be narrowed to permit only those arrangements based on a close personal relationship between the registered person and the customer maintained outside, and formed prior to, the broker-customer relationship, as proposed?
4. Does your firm have written procedures that allow borrowing from or lending to customers under certain conditions? If so:
    a. What borrowing or lending arrangements does your firm permit?
    b. If your firm permits arrangements within the "immediate family" or "financial institution" exceptions, what notice and approval requirements does your firm require, if any?
    c. Does your firm have any specific procedures for borrowing and lending arrangements between registered persons and customers who are senior investors?
5. Has your firm identified any unintended consequences of prohibiting registered persons from borrowing from or lending to customers, or permitting registered persons to enter into any of the arrangements that are within the exceptions set forth in Rule 3240(a)(2)?
6. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
    a. What are these economic impacts and what are their primary sources?
    b. To what extent would these economic impacts differ by business attributes, such as size of firm or differences in business models?
    c. What would be the magnitude of these impacts, including costs and benefits?
    d. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?
7. As explained above, there are differences in how Rule 3240 and federal and state investment adviser laws regulate borrowing and lending arrangements. Would a more consistent approach to regulating this activity enhance investor protection? If so, what approach should be used and why?

Endnotes

1. *See* Regulatory Notice 19-27 (August 2019). The review of Rule 3240 was one part of a retrospective review to assess the effectiveness and efficiency of FINRA rules and administrative processes that help protect senior investors from financial exploitation. In October 2020, FINRA published a report that summarized other aspects of that retrospective rule review. *See* Regulatory Notice 20-34 (October 2020).
2. Parties should submit in their comments only personally identifiable information, such as phone numbers and addresses, that they wish to make available publicly. FINRA, however, reserves the right to redact or edit personally identifiable information from comment submissions. FINRA also reserves the right to redact, remove or decline to post comments that are inappropriate for publication, such as vulgar, abusive or potentially fraudulent comment letters.
3. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
4. *See* Rule 3240(a) and (b).
5. *See* Rule 3240(a)(2)(A)-(E).
6. *See Regulatory Notice 20-34* for a detailed description of the retrospective review process that FINRA used.
7. *See also* Regulatory Notice 20-38 (October 2020). Rule 3241 became effective on February 15, 2021.
8. *See* Rule 3241.01.
9. The conditions in Rule 3240(a)(1), (2) and (3) are that the member has written procedures allowing the borrowing and lending of money between registered persons and customers; that the borrowing or lending arrangement fall within one of the exceptions; and that the notification and approval requirements are satisfied.
10. *See* Rule 3241.06.
11. *See, e.g.,* James K. Breeze, Letter of Acknowledgment, Waiver and Consent, Case ID 2008012846501 (June 30, 2009); Vincenzo G. Covino, Letter of Acknowledgment, Waiver and Consent, Case ID 2009020793901 (Feb. 9, 2012).
12. *See* Rule 3240(a)(2)(A).
13. *See* Rule 3241(a)(1)(A), (a)(2)(A).
14. *See* Rule 3240(a)(1)(D) and (E).
15. *See* proposed Rule 3240(a)(1)(D).
16. *See* proposed Rule 3240(b)(1)(A).
17. Supplementary Material 3240.01 would also be amended to provide that the record-retention requirements are for purposes of Rule 3240(b), not just Rule 3240(b)(1). As explained above, Rule 3240(b)(1) expressly requires notice and approval of arrangements that are within three of the rule's exceptions. While Rule 3240(b)(2) and (3) do not expressly require notice and approval of arrangements within the other two exceptions, those subparagraphs imply that member firms may choose to require such notice and approval.
18. The proposed rule change would not apply retroactively to loans that exist prior to the effective date of the rule changes and are permissible under current Rule 3240. The proposed rule changes would apply, however, when such loans are modified or when the parties to such loans seek to initiate a new broker-customer relationship.

19. *See* 2021 FINRA Industry Snapshot. There is no data of the number of customers of the registered firms.

20. *See supra* note 18.

21. *See* Rule 3241(b)(1); *Regulatory Notice* 20-38 (October 2020); *see also* Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of SR-FINRA-2020-020).

22. The SEC has long recognized the investor confusion about the different regulatory regimes for broker-dealers and investment advisers, and it has previously considered potential harmonization of regulatory requirements. *See, e.g.,* Securities Exchange Act Release No. 69013 (March 1, 2013), 78 FR 14848, 14861-64 (March 7, 2013) (Request for Data and Other Information in File No. 4-606); Securities Exchange Act Release No. 83063 (April 18, 2018), 83 FR 21416, 21417 (May 9, 2018) (Notice of Proposed Rule in S7-08-18); Investment Advisers Act Release No. 4889 (April 18, 2018), 83 FR 21203, 21211-14 (May 9, 2018) (Proposed Interpretation and Request for Comment on Enhancing Investment Adviser Regulation, File No. S7-09-18).

23. *See* Section 206 of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. 80b-6; Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019), 84 FR 33669, 33676 (July 12, 2019).

24. *See* 17 CFR 275.204A-1.

25. *See* NASAA Model Rule USA 2002 502(b), Prohibited Conduct in Providing Investment Advice; NASAA Model Rule 102(a)(4)-1, Unethical Business Practices of IAs, IARs and Federal Covered Advisers; *see, e.g.,* Delaware (6 Del. Admin. Code 200-G-709); Florida (Fla. Admin. Code 69W-600.0131); Colorado (3 Colo. Code Regs. 704-1:51-4.8(IA)); Hawaii (Haw. Admin. R. 16-39-470); Iowa (Iowa Admin. Code 191-50.38(502)); Kansas (Kan. Admin. Regs. 81-14-5); and Mississippi (Miss. Admin. Code 1-14-6.25).

26. *See supra* note 25.

Attachment A

Attachment A shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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FINRA RULES

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3000. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

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3200. RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

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3240. Prohibition on Borrowing From or Lending to Customers

(a) General Prohibition; Permissible Borrowing or Lending Arrangements; Conditions

No person associated with a member in any registered capacity may borrow money from or lend money to any customer of such person, or initiate a broker-customer relationship with a person with whom the registered person has an existing borrowing or lending arrangement, unless:

(1) the member has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member;

(2) the borrowing or lending arrangement meets one of the following conditions:

(A) the customer is a member of such person's immediate family;

(B) the customer (i) 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 and (ii) is acting in the course of such business;

(C) the customer and the registered person are both registered persons of the same member;

(D) the lending arrangement is based on a close personal relationship between the registered person and[with] the customer[, such that the loan would not have been solicited, offered, or given had the customer and the registered person not] maintained [a relationship] outside of, and formed prior to, the broker-customer relationship; or

(E) the lending arrangement is based on a business relationship outside of the broker-customer relationship; and

(3) the requirements of paragraph (b) of this Rule are satisfied.

(b) Notification and Approval

(1) With respect to borrowing or lending arrangements described in paragraphs (a)(2)(C), (D), or (E) of this Rule:

(A) The registered person shall, prior to entering into such arrangements, notify the member in writing and obtain the member's approval in writing of [the]such [borrowing or lending] arrangements [described in paragraphs (a)(2)(C), (D), and (E) above prior to entering into such arrangements and the member shall pre-approve in writing such arrangements]. The registered person shall also, prior to the modification of such arrangements, notify the member in writing and obtain the member's [shall pre-]approv[e]al in writing of any modifications to such arrangements, including any extension of the duration of such arrangements.

(B) The registered person shall, prior to the initiation of a broker-customer relationship at the member, notify the member in writing of such existing arrangements with persons who seek to be a customer of the registered person, and obtain the member's approval in writing of the broker-customer relationship.

(2) With respect to the borrowing or lending arrangements described in paragraph (a)(2)(A) of this Rule[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 borrowing or lending arrangements or initiating a broker-customer relationship.

(3) With respect to the borrowing or lending arrangements described in paragraph (a)(2)(B) of this Rule[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 borrowing or lending arrangements or initiating a broker-customer relationship, 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 [sub]paragraph (b)(3), the member may rely on the registered person's representation that the terms of the loan meet the above-described standards.

(c) Definition of Immediate Family

The term "immediate family" means parents, grandparents, mother-in-law or father-in-law, [husband or wife]spouse or domestic partner, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, children, grandchildren, cousin, aunt or uncle, or niece or nephew, and any other person who resides in the same household as the registered person and[whom] the registered person financially supports, directly or indirectly, to a material extent. The term includes step and adoptive relationships.

• • • Supplementary Material: ----------

.01 Record Retention. For purposes of paragraph (b)[(1)] of this Rule, members shall preserve the written notice and [pre-]approval for at least three years after the date that the borrowing or lending arrangement has terminated or for at least three years after the registered person's association with the member has terminated.

.02 Customer. For purposes of this Rule, a "customer" would include any customer that has, or in the previous six months had, a securities account assigned to the registered person at any member.

.03 Owner-Financing Arrangements. For purposes of this Rule, borrowing and lending arrangements include owner-financing arrangements that do not involve borrowing or lending of money.

.04 Close Personal Relationships and Business Relationships. Factors that are relevant to whether a borrowing or lending arrangement is based on a "close personal relationship" or a "business relationship," within the meaning of paragraphs (a)(2)(D) and (E) of this Rule, include, but are not limited to, when the relationship began, its duration and nature, and any facts suggesting that the relationship is not a bona fide "close personal relationship" or "business relationship" or was formed with the purpose of circumventing the purpose of Rule 3240. Examples of relationships that are "close personal relationships" include, but are not limited to, a childhood or long-term friend, a godparent, and other similarly close personal relationships.

.05 Arrangements with Persons Related to Either the Registered Person or the Customer. A registered person instructing or asking a customer to enter into a borrowing or lending arrangement with a person related to the registered person (e.g., the registered person's immediate family member or outside business) or to have a person related to the customer (e.g., the customer's immediate family member or business) enter into a borrowing or lending arrangement with the registered person would present similar conflict of interest concerns as borrowing or lending arrangements between the registered person and the customer and would not be consistent with this Rule unless the conditions set forth in paragraphs (a)(1), (2), and (3) of this Rule are satisfied.

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