Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * 135

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. * SR 2024 - * 001
Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☑ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☑ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) * ☐ Section 806(e)(2) * ☐

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934
Section 3C(b)(2) * ☐

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed rule change to amend FINRA Rule 3240 (Borrowing From or Lending to Customers).

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Michael Last Name * Garawski

Title * Associate General Counsel

E-mail * Michael.Garawski@finra.org

Telephone * (202) 728-8835 Fax

Signature

Pursuant to the requirements of the Securities Exchange of 1934, Financial Industry Regulatory Authority has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 01/02/2024

By Patrice Gliniecki
(Name *)

(Title *)
Senior Vice President and Deputy General Cou

NOTE: Clicking the signature block at right will initiate digitally signing the form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Patrice Gliniecki
Digitally signed by Patrice Gliniecki
Date: 2024.01.02 12:43:18 -05'00'

Required fields are shown with yellow backgrounds and astericks.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information *

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change *

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 1A - Notice of Proposed Rule Change, Security-Based Swap Submission, or Advanced Notice by Clearing Agencies *

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2- Notices, Written Comments, Transcripts, Other Communications

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FINRA-2024-001 Exhibit 2a.pdf
FINRA-2024-001 Exhibit 2b.pdf

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

☐ Exhibit Sent As Paper Document

Exhibit 3 - Form, Report, or Questionnaire

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

☐ Exhibit Sent As Paper Document

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

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FINRA-2024-001 Exhibit 5.docx

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] the Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend FINRA Rule 3240 (Borrowing From or Lending to Customers).

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

Rule 3240 generally prohibits, with exceptions, registered persons from borrowing money from or lending money to their customers. The rule has five tailored exceptions, available only when the registered person's member firm has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member, the borrowing or lending arrangements meet the

[1] 15 U.S.C. 78s(b)(1).

conditions in one of the exceptions[2] and, when required, the registered person notifies the member of a borrowing or lending arrangement, prior to entering into such arrangement, and obtains the member's pre-approval in writing. The exceptions are for limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers.

Rule 3240 was last amended in 2010, when it became part of the consolidated FINRA rulebook.[3] In August 2019, FINRA launched a retrospective review of Rule 3240, as part of a larger retrospective review of FINRA's rules and administrative processes that help protect senior investors from financial exploitation.[4] In December 2021, FINRA published Regulatory Notice 21-43 ("Notice 21-43"), which (1) summarized the predominant themes that emerged during the retrospective review of Rule 3240; (2) issued guidance concerning approvals of permissible borrowing or lending arrangements; and (3) based on feedback received during the retrospective rule review, sought comment on proposed amendments to Rule 3240.[5]

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2 See Rule 3240(a)(2)(A) (the "immediate family exception"); Rule 3240(a)(2)(B) (the "financial institution exception"); Rule 3240(a)(2)(C) (the "registered persons exception"); Rule 3240(a)(2)(D) (the "personal relationship exception"); Rule 3240(a)(2)(E) (the "business relationship exception").

3 See Regulatory Notice 10-21 (April 2010).

4 See Regulatory Notice 19-27 (August 2019). In October 2020, FINRA published a report that summarized other aspects of that retrospective rule review. See Regulatory Notice 20-34 (October 2020).

5 In Notice 21-43, FINRA also discussed some similarities and differences between Rule 3240 and the federal and state regulatory approaches for investment advisers

Proposed Rule Change

FINRA is proposing to amend Rule 3240 to strengthen the general prohibition against borrowing and lending arrangements, narrow some of the existing exceptions to that general prohibition, modernize the immediate family exception, and enhance the requirements for giving notice to members and obtaining members' approval of such arrangements.[6]

The General Prohibition on Borrowing From or Lending to Customers

Rule 3240 generally prohibits registered persons from borrowing from or lending to their customers. To make this regulatory purpose more prominent, the proposed rule change would amend the rule's title from "Borrowing From or Lending to Customers" to "Prohibition on Borrowing From or Lending to Customers," and change the title of Rule 3240(a) from "Permissible Lending Arrangements; Conditions" to "General Prohibition; Permissible Borrowing or Lending Arrangements; Conditions." These changes would emphasize that the rule is, first and foremost, a general prohibition.

In addition, the proposed rule change would strengthen this general prohibition in three ways. First, Rule 3240(a) would be amended to clarify that the rule's general requirements concerning borrowing and lending arrangements—including the general prohibition—apply to arrangements that pre-exist a new broker-customer relationship.

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and their supervised persons, and encouraged a broader dialogue about whether a more uniform regulatory approach would enhance investor protection.

6 Where appropriate in context, FINRA refers herein to "borrowing and lending" rather than "borrowing or lending." No references to "borrowing and lending," however, should be interpreted to mean that Rule 3240 only applies to arrangements that have both a borrowing component and a separate lending component. Rule 3240 generally prohibits registered persons from borrowing money from or lending money to a customer.

Currently, Rule 3240(a) begins, "[n]o person associated with a member in any registered capacity may borrow money from or lend money to any customer of such person . . . ." FINRA is proposing to amend this introductory clause in Rule 3240(a) to also prohibit registered persons from initiating a broker-customer relationship with a person with whom the registered person has an existing borrowing or lending arrangement.

Second, FINRA is proposing to add Rule 3240.02 (Customer). Proposed Rule 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 borrowing or lending arrangements entered into within six months after a broker-customer relationship terminates. This proposed definition would align with the definition of "customer" in FINRA Rule 3241 (Registered Person Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer), a rule that addresses similar types of conflicts.[7]

Third, FINRA is proposing to add Rule 3240.05 (Arrangements with Persons Related to Either the Registered Person or the Customer). Proposed Rule 3240.05 would extend the rule's requirements to borrowing or lending arrangements that involve similar conflicts as ones presented by arrangements directly between registered persons and their customers. Specifically, proposed Rule 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 (e.g., the registered person's immediate family member or outside business) or to have a person related to the customer (e.g., the

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7 See Rule 3241.01 (Customer).

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 [3240] unless the conditions set forth in [Rule 3240(a)(1), (2), and (3)] are satisfied."[8] 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 or, likewise, induces a customer to have a person or entity related to the customer enter into an arrangement with the registered person.[9]

In addition, FINRA is proposing to add Rule 3240.03 (Owner-Financing Arrangements) to expressly state that, for purposes of Rule 3240, borrowing or lending arrangements include owner-financing arrangements. For example, Rule 3240 would apply to situations where a registered person purchases real estate from his customer, the customer agrees to finance the purchase, and the registered person provides a promissory note for the entire purchase price or arranges to pay in installments.[10]

The "Immediate Family" Definition

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8 The conditions in Rule 3240(a)(1), (2) and (3) are that the member has written procedures allowing the borrowing or lending of money between registered persons and customers; the borrowing or lending arrangement meets one of the conditions; and the notification and approval requirements are satisfied.

9 Proposed Rule 3240.05 is based, in part, on feedback received during the retrospective review that some registered persons attempt to circumvent Rule 3240 by structuring arrangements with persons related to the registered person or the customer.

10 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).

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.[11] 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."

During the retrospective review of Rule 3240, FINRA received feedback that the definition of "immediate family" should be modernized. The proposed rule change would modernize the "immediate family" definition to match the definition of the same term in Rule 3241, which also has exceptions for situations in which the customer is a member of the registered person's immediate family.[12] Specifically, the proposed rule change to Rule 3240(c) would replace "husband or wife" with "spouse or domestic partner" and amend the definition so that it "includes step and adoptive relationships." In addition, the "any other person" clause would be revised to 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

Currently, two exceptions to the rule's general prohibition are for arrangements based on (1) 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

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11 See Rule 3240(a)(2)(A).

12 See Rule 3241(a)(1)(A) and (a)(2)(A) and (c).

maintained a relationship outside of the broker-customer relationship"; and (2) a "business relationship outside of the broker-customer relationship."[13] Due to concerns expressed during the retrospective review of Rule 3240 that the personal relationship exception may be exploited—and to make more clear what kinds of personal relationships would be within the exception—FINRA proposes to narrow the personal relationship exception to arrangements that are based on a "bona fide, close personal relationship between the registered person and the customer maintained outside of, and formed prior to, the broker-customer relationship."[14] This language would replace the requirement 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" to narrow the scope of the exception and clarify the types of relationships that would be within the exception. For similar reasons, FINRA proposes to amend the business relationship exception to be limited to arrangements that are based on a "bona fide business relationship outside of the broker-customer relationship."[15]

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13 See Rule 3240(a)(2)(D) and (E). Although Rule 3240(a)(2)(D) and (E) refer to "the lending arrangement," and do not explicitly mention a "borrowing arrangement," these exceptions are not intended to exclude borrowing arrangements. FINRA therefore proposes a technical amendment to make clear that those exceptions apply to "borrowing or lending" arrangements based on a personal relationship or a business relationship.

14 Where appropriate in context, FINRA refers herein to proposed Rule 3240(a)(2)(D) as the "close personal relationship exception." See also supra note 2 (defining current Rule 3240(a)(2)(D) as the "personal relationship exception").

15 The term "bona fide" in the close personal relationship and business relationship exceptions was not included in the proposal in Notice 21-43. FINRA proposes to add the term "bona fide" to emphasize that for either of these exceptions to apply, the close personal relationship or business relationship must be legitimate. Adding the term "bona fide" would also align with language in proposed Rule 3240.04, discussed below.

In addition to narrowing the personal relationship and business relationship exceptions, FINRA is proposing to add Rule 3240.04 (Close Personal Relationships; Business Relationships), which 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 bona fide or was formed with the purpose of circumventing the purpose of Rule 3240. Proposed Rule 3240.04 is intended to help establish the scope of the close personal relationship and business relationship exceptions, focus on the most relevant factors when evaluating whether a close personal relationship or business relationship exists, and ensure that members consider meaningfully the potential issues involved in the proposed arrangement.

To provide even more guidance about the scope of the close personal relationship and business relationship exceptions, proposed Rule 3240.04 would also provide illustrative examples of these relationships. Specifically, it would provide that 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 relationships. Additionally, proposed Rule 3240.04 would provide that an example of a business relationship includes, but is not limited to, a loan from a registered person to a small outside business that the registered person co-owned for years for the sole purpose of providing the business with additional operating capital.[16]

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[16] The proposal in Notice 21-43 did not include an illustrative example of a business relationship in proposed Rule 3240.04. It has been added in response to comments to Notice 21-43 requesting examples of relationships within that exception.

Notification and Approval Requirements

The proposed rule change would also amend Rule 3240's notification and approval requirements. Currently, Rule 3240(b) contains notification and approval requirements for borrowing or lending arrangements within the five exceptions, which vary depending on which exception applies. With respect to the personal relationship, business relationship, and registered persons exceptions, Rule 3240(b)(1) provides that a registered person shall notify the member of borrowing or lending arrangements prior to entering into such arrangements, and that the member shall pre-approve in writing such arrangements.[17] With respect to the immediate family member exception, Rule 3240(b)(2) provides, in pertinent part, that a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval. With respect to the financial institution exception, Rule 3240(b)(3) provides, in pertinent part, that a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval, 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."

FINRA is proposing several amendments to all these notification and approval requirements. First, FINRA is proposing to amend Rule 3240(b)(1) to clarify that, although registered persons are required to obtain the member's prior approval of arrangements within the close personal relationship, business relationship, or registered persons exceptions, the member is not required to approve such arrangements. As explained above, Rule 3240(b)(1) currently provides that the member "shall pre-approve"

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17 Rule 3240(b)(1) contains similar notification and approval requirements for modifications to borrowing or lending arrangements.

such arrangements, which could imply incorrectly that the member must approve the arrangement or modification and may not disapprove it. To preclude this incorrect interpretation, the proposed rule change would delete the "shall pre-approve" language and instead require the registered person to provide the member with notice of the arrangements or modifications "prior to entering into such arrangements" or "prior to the modification of such arrangements" and "obtain the member's approval."[18]

The proposed rule change would also amend the notification and approval requirements that apply to borrowing or lending arrangements within the registered persons, personal relationship and business relationship exceptions, to correspond with the proposed amendments that would clarify that the general prohibition applies to pre-existing arrangements. Specifically, proposed Rule 3240(b)(1)(B) would require registered persons, prior to the initiation of a broker-customer relationship at the member with a person with whom the registered person has an existing borrowing or lending arrangement, to notify the member in writing of existing arrangements within the registered persons, personal relationship and business relationship exceptions and obtain the member's approval in writing of the broker-customer relationship.[19]

Further, the proposed rule change would require that all notices required under Rule 3240 be in writing and retained by the member. Currently, Rule 3240 does not specify that notice must be given in writing, and the record-retention provision in Rule 3240.01 requires members only to preserve written approvals. The proposed rule change

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18 See proposed Rule 3240(b)(1)(A).

19 In such situations, if the member does not approve the formation of a broker-customer relationship with the registered person who provided such notice, the customer would still be permitted to seek to initiate a broker-customer relationship with another registered person at the same member.

would require registered persons to give written notice and require members to preserve records of such written notice for at least three years.[20]

The proposed rule change would also amend the provisions that address notice and approval of arrangements within the immediate family and financial institution exceptions, to correspond with the proposed amendments that would clarify that the general prohibition applies to arrangements that pre-exist the broker-customer relationship. Currently, under Rule 3240(b)(2) and (3), the member's written procedures may indicate that registered persons are not required to notify the member or receive member approval of arrangements within the immediate family exception or arrangements within the financial institution exception that meet the additional conditions set forth in Rule 3240(b)(3). To extend these provisions to pre-existing arrangements, the proposed rule change would amend Rule 3240(b)(2) and (3) to provide that the member's procedures may also indicate that registered persons are not required to notify the member or receive member approval of such arrangements either prior to or subsequent to initiating a broker-customer relationship.

Finally, in response to comments received in response to Notice 21-43, the proposed rule change would establish new obligations on a member when receiving notice of a borrowing or lending arrangement. Specifically, FINRA is proposing to add

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[20] See proposed amendments to Rule 3240(b)(1)(A) and (b)(1)(B) and Rule 3240.01. Rule 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) requires notice and approval of arrangements that are within the personal relationship, business relationship, and registered persons exceptions. While Rule 3240(b)(2) and (3) do not expressly require notice and approval of arrangements within the immediate family member and financial institution exceptions, those subparagraphs imply that members may choose to require such notice and approval of those arrangements.

Rule 3240.06 (Obligations of Member Receiving Notice). Proposed Rule 3240.06 would provide that upon receiving written notice under Rule 3240, the member shall perform a reasonable assessment of the risks created by the borrowing or lending arrangement with a customer, modification to the borrowing or lending arrangement with a customer, or existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person. It would further provide that the member shall also make a reasonable determination of whether to approve the borrowing or lending arrangement, modification to the borrowing or lending arrangement, or, where there is an existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person, the broker-customer relationship. Proposed Rule 3240.06 would be similar to Rule 3241(b)(1), which requires members to perform a "reasonable assessment" and "reasonable determination" when receiving notice of a registered person being named a customer's beneficiary or holding a position of trust for a customer, and to supplementary material to FINRA Rule 3270 (Outside Business Activities of Registered Persons) that provides factors members must consider upon receiving written notice of an outside business activity.[21]

FINRA intends that a member's "reasonable assessment" and "reasonable determination" for purposes of proposed Rule 3240.06 would be informed by guidance that FINRA has already provided to members in Notice 21-43.[22] Specifically, FINRA

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21 See Rule 3270.01 (Obligations of Member Receiving Notice).

22 FINRA has explained that this guidance was similar to general guidance that FINRA had published concerning the "reasonable assessment" and "reasonable determination" requirements in Rule 3241. See Notice 21-43, at n.21 (citing Rule 3241(b)(1), Regulatory Notice 20-38 (October 2020), and Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-020)).

expects that a member's "reasonable assessment" would take into consideration several factors, such as:

(1) any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer;

(2) the length and type of relationship between the customer and registered person;

(3) the material terms of the borrowing or lending arrangement;

(4) the customer's or the registered person's ability to repay the loan;

(5) the customer's age;

(6) whether the registered person has been a party to other borrowing or lending arrangements with customers;

(7) whether, based on the facts and circumstances observed in the member'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;

(8) 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

(9) any indicia of customer vulnerability or undue influence of the registered person over the customer.

This list is not intended to be exhaustive. Moreover, while a listed factor may not be applicable to a particular situation, the factors that a member considers should allow for a reasonable assessment of the associated risks so that the member can make a reasonable determination of whether to approve the borrowing or lending arrangement, modification to the borrowing or lending arrangement, or, where there is an existing borrowing or lending arrangement with a person who seeks to be a customer of the

registered person, the broker-customer relationship. 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's assessment. If possible, as part of the member's reasonable assessment of the risks, FINRA would expect a member to try to discuss the arrangement with the customer.[23]

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice.

(b) Statutory Basis

FINRA believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[24] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA believes that, by strengthening and modernizing Rule 3240, the proposed rule change would enhance investor protection. The proposed rule change would reduce risks to investors through incremental adjustments that strengthen the general prohibition against borrowing and lending arrangements and narrow the few exceptions to the rule. In addition, the proposed rule change would facilitate compliance by clarifying the scope

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23 FINRA notes that the proposed rule change would impact members that have elected to be treated as capital acquisition brokers ("CABs"), given that the CAB Rules incorporate the impacted FINRA rule by reference.

24 15 U.S.C. 78o-3(b)(6).

of the general prohibition and the personal relationship and business relationship exceptions.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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.

(a) Regulatory Need

Rule 3240 generally prohibits registered persons from borrowing from or lending to their customers except when certain conditions are met, as specified in Rule 3240 and described above. Anecdotal evidence from member firms, law clinics, and previous enforcement cases—as well as FINRA's experience in examining and enforcing for compliance with Rule 3240—suggests that there is some ambiguity about the scope of Rule 3240 and certain risks to investors due to conflicts of interest and the superior information that registered persons have about potential risks and returns. As discussed further below, the proposed rule change would reduce ambiguity and aim to mitigate these risks.

(b) Economic Baseline

The economic baseline for the proposed rule change is Rule 3240, members' 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 2022, there were 620,882 registered persons and 3,378 registered member firms that would be covered by the proposed rule change, in addition to the registered persons' customers.[25]

Absent Rule 3240, borrowing or lending arrangements between registered persons and their 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 establishes processes that may help mitigate the potential conflicts of interest in those arrangements that are within the exceptions. In this regard, registered persons may not enter into borrowing or lending arrangements that are within the rule's exceptions unless the registered person's member firm has written procedures allowing the borrowing or lending of money between such registered persons and their customers, and unless the registered person complies with any applicable notification and approval requirements. Members may adopt procedures that are stricter than Rule 3240. However, for purposes of conducting an economic analysis, FINRA does not have comprehensive information readily available about members' borrowing or lending policies or practices.

To understand the potential harm from impermissible borrowing or lending arrangements, FINRA reviewed final FINRA enforcement cases that involved findings of

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25 See 2023 FINRA Industry Snapshot, https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf. There is no data of the number of customers of the registered member firms.

Rule 3240 violations. Between January 2018 and December 2021, there were an average of 15 such enforcement cases per year, totaling 58 cases over the four-year period.[26] The number of cases year over year did not display a noticeable trend. The customer was the borrower in only one of the cases, and the registered person was the borrower in the other 57 cases. The amounts of borrowed or lent money ranged from $1,800 to $1,350,000, with a mean of $163,509 and a median of $70,000.

Customer harm occurs if a loan from the customer is not repaid according to its terms,[27] or if the terms of the loan are substantially worse when compared to prevailing market terms for loans to comparable borrowers. In the enforcement cases in the review period, the customers were often repaid, though it is uncertain whether they were repaid according to the terms of the loan or how those terms would have compared to prevailing market terms. FINRA notes the number of enforcement cases does not represent all violations of Rule 3240 that may have occurred, and thus, does not provide a complete picture of the economic baseline of customer harm.

FINRA also reviewed disclosures on Forms U4 and U5 of consumer-initiated, investment-related arbitrations, civil litigation or customer complaints (written or oral) that included allegations related to a registered person (or former registered person)

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[26] The number of enforcement cases includes the FINRA disciplinary actions that resulted in a Letter of Acceptance, Waiver, and Consent (AWC), an Order Accepting Settlement (OAS), or a decision issued by FINRA's Office of Hearing Officers, and that resulted in findings that the respondent violated Rule 3240. The number does not include matters resulting in Cautionary Action.

[27] "Not repaid according to its terms" could include, but is not limited to, situations in which a customer is not repaid in full or not repaid at the interest rate or by the date agreed upon.

borrowing money from or lending money to a customer. This information complements the information from the enforcement cases regarding the potential harm caused by impermissible borrowing or lending arrangements, although the disclosures do not necessarily indicate whether or how Rule 3240 was violated. From 2018 to 2021, there was a total of 100 such disclosures over the four-year period, which averaged to 23 disclosures per year. The number of such disclosures declined from 38 in 2018 to 19 in 2021. In 28 of the total 100 identified disclosures, the amount of the compensatory damages claim was not known.[28] In the remaining 70 disclosures excluding two outliers,[29] the alleged compensatory damages claims ranged from $1,800 to $3.7 million, with a mean of $224,760 and a median of $94,600. Fifty-three of the 100 disclosures resulted in settlements, which ranged from $1,800 to $1.3 million. Five of the disclosures resulted in an arbitration award between $2,000 and $150,000. One disclosure resulted in a civil judgment of $85,000.

The extent to which data concerning these consumer-initiated events may inform an economic baseline has some limitations. First, some disclosures allege harm caused by conduct in addition to borrowing from or lending to a customer, such as recommending unsuitable investments, so FINRA is unable to determine how much of the alleged harm derives from allegations related to borrowing or lending. Second, the alleged compensatory damages could be a poor proxy for measuring customer harm

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[28] For example, in one disclosure, a family member filed the complaint on behalf of a deceased customer without knowing the exact amount borrowed.

[29] In two disclosures, the alleged compensatory damages were $20 million and $43 million, both of which are more than three standard deviations from the mean. FINRA removed these data points in calculating the mean and median to avoid biases caused by outliers.

because the disclosures did not specifically mention the borrowed amounts or have details about whether the loan was repaid, and because nearly all alleged compensatory damages claims were not adjudicated. Nevertheless, to the extent some of the disclosures are of settlements, awards or judgments, those provide a better gauge of the potential customer harm than mere allegations of compensatory damages. Thus, the disclosure data provides a perspective, in addition to the enforcement data, on the prevalence and the scope of borrowing or lending arrangements between registered persons and customers.

To supplement the quantitative analysis above, FINRA also considered its own experience with examining and enforcing for compliance with Rule 3240. Specifically, FINRA is concerned that some registered persons attempt to circumvent the current rule, using tactics such as timing a borrowing or lending 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 bona fide. 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. These kinds of arrangements present the same kinds of conflicts of interest that Rule 3240 is intended to address, and, as such, also inform the economic baseline.

(c) Economic Impact

By extending the coverage of the rule's general prohibition, narrowing some exceptions, and clarifying certain aspects of the rule, the proposed rule change would result in fewer attempts by registered persons to enter into impermissible arrangements. For example, the expected cost of attempting to enter into a borrowing or lending

arrangement that is not within the exceptions would be higher, as the likelihood of getting caught would increase when members, registered persons and customers have better information about permitted arrangements. Further, by reducing ambiguity regarding permissible borrowing or lending arrangements, a registered person who currently avoids a permissible and mutually beneficial borrowing or lending arrangement may be more comfortable entering into such an arrangement because of the proposed rule change.

The proposed rule change would prohibit some arrangements that are allowed under the current rule. For example, the general prohibition does not currently extend to arrangements entered into within six months after a broker-customer relationship ends; under the proposed rule change, it would. Additionally, the proposed rule change would narrow the personal relationship exception, prohibiting some of the arrangements that are permissible under the current rule. FINRA recognizes, however, that the proposed rule change may preclude arrangements that could be mutually beneficial to customers and registered persons and superior to alternative opportunities for borrowing or lending. Furthermore, requiring members to make a reasonable assessment of the risks and a reasonable determination of whether to approve the arrangement or new broker-customer relationship, as the case may be, may lead some members to disallow these arrangements altogether to avoid the cost of making the required assessments and determinations.

The long-term net impact of the proposed rule change on members' compliance costs is less clear. The proposed rule change would likely reduce registered persons' attempts to borrow based on the close personal relationship exception. Further, with the proposed modernized definition of "immediate family," some arrangements that are currently within the personal relationship exception would instead be within the immediate family exception, of which members could choose not to require notification

or approval. On the other hand, by clarifying that the rule covers arrangements that pre-exist the initiation of a broker-customer relationship and extending the rule six months after a broker-customer relationship is terminated, members would start receiving notice of the kinds of arrangements of which they are not currently receiving notice and would be required to evaluate whether to approve the arrangement or a new broker-customer relationship, as applicable. Additionally, members may incur additional costs of supervising and monitoring due to the extended time period that the proposed rule change covers. The extent of net savings or costs to members for compliance would depend on the relative prevalence of such cases and the additional monitoring costs.

The proposed rule change requiring members that receive notice of an arrangement to perform a reasonable assessment of the risks created by the arrangement could also raise members' compliance costs in the long term to the extent that members are not currently conducting these assessments. While the current rule requires members, upon receiving notice of an arrangement, to approve the arrangement in writing, the current rule does not require members to conduct a reasonable assessment of the risks of the arrangement prior to giving approval. Some members may already have a robust assessment process while some may have to adjust their process to comply with the proposed rule change. As a result, the compliance cost of the approval process for members that would have to make the adjustments could increase.

Members may also incur increased compliance costs in the short term. Specifically, members may need to update their written procedures in light of the proposed rule change given that Rule 3240 prohibits all arrangements unless the member has procedures permitting them. Members may also have to re-train their staff to become aware of the extended prohibitions, the modernized definition of "immediate family," the

proposed factors to consider for arrangements based on close personal relationships and business relationships, and the "reasonable assessment" and "reasonable determination" requirements. While the proposed rule change would not apply retroactively, as discussed below, members may elect to re-evaluate previously approved arrangements under the proposed rule change. Additionally, members may choose to respond to the proposed rule change by reviewing their current registered persons' borrowing or lending arrangements with their current and previous customers, to the extent they have not already done so.

For members that are not already maintaining written notices and approvals of borrowing or lending arrangements that the proposed rule change would 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.

(d) Alternatives Considered

FINRA considered generally prohibiting all borrowing or lending arrangements between registered persons and customers and eliminating the existing exceptions. FINRA does not propose a complete prohibition for several reasons. As an initial matter, Rule 3240 already contains a general prohibition, and the proposed rule change would strengthen it, by clarifying that it applies to pre-existing arrangements, extending the time period over which the rule would apply, adopting supplementary material that addresses conduct by registered persons regarding arrangements with persons related to the registered person or to the customer, and narrowing some exceptions.

Moreover, as discussed below, FINRA determined that the enumerated exceptions in Rule 3240, with the proposed rule change described above, are for limited situations

where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers. See discussion infra Section 5.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Notice 21-43. Six comments were received in response to Notice 21-43. A copy of Notice 21-43 appears in Exhibit 2a. Copies of the comment letters received in response to Notice 21-43 appear in Exhibit 2b. Of the six comment letters received, three were in favor of the proposed rule change,[30] two were opposed,[31] and one raised issues that were beyond the scope of Rule 3240.[32]

The comments and FINRA's responses are set forth in detail below.

General Support for the Proposal

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30 See Letter from Michael Edmiston, President, Public Investors Advocate Bar Association, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("PIABA"); letter from Bernard V. Canepa, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("SIFMA"); letter from Alice L. Stewart et al., Esquire, Director, University of Pittsburgh Securities Arbitration Clinic and Professor of Law, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("University of Pittsburgh").

31 See Letter from Jenice L. Malecki, Malecki Law, to Marcia E. Asquith, Executive Vice President, Board and External Relations, FINRA, dated February 14, 2022 ("Malecki"); letter from Melanie Senter Lubin, President, North American Securities Administrators Association, Inc., to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("NASAA").

32 See Comment submission from Caleb Benore, dated December 29, 2021 ("Benore").

Three commenters expressed support for the proposal in Notice 21-43.[33] SIFMA noted that the proposal would provide greater clarity and guidance to members in assessing which arrangements may be permissible under the exceptions to the prohibition. PIABA specifically expressed support for applying Rule 3240 to arrangements that pre-exist the broker-customer relationship, extending the definition of customer to those who had accounts with a registered person in the previous six months, and making clear that the same or very similar conflicts of interest are present if a registered representative's close family member obtains a loan from a registered representative's customer. University of Pittsburgh expressed support for nearly every change proposed in Notice 21-43.[34] PIABA, SIFMA and University of Pittsburgh all supported the proposed modernization of the "immediate family" definition.[35]

General Opposition to the Proposal

NASAA and Malecki did not support the proposal in Notice 21-43 because they both would favor an outright prohibition on borrowing from or lending to customers.[36] NASAA stated that the proposed changes would continue to subject registered persons to disparate regulatory requirements. In particular, NASAA noted that its model rule concerning Dishonest or Unethical Business Practices of Broker-Dealers and Agents,

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33 See PIABA, SIFMA and University of Pittsburgh.

34 While generally supporting the proposal, University of Pittsburgh had comments regarding the business relationship exception, and PIABA had comments regarding the definition of "customer." Those comments are discussed below.

35 NASAA, which generally opposed the proposal, also expressed support for the modernization of the definition of "immediate family."

36 In the alternative, NASAA and Malecki recommended various changes to Rule 3240, should it continue to permit any kinds of borrowing or lending arrangements. Those comments are discussed below.

which lists acts and practices that are considered contrary to high standards of commercial honor and just and equitable principles of trade, prohibits agents from "[e]ngaging in the practice of lending or borrowing money or securities from a customer, or acting as a custodian for money, securities or an executed stock power of a customer."[37]

During the retrospective review of Rule 3240, while some stakeholders also suggested that all borrowing and lending arrangements should be prohibited, others commented that the rule has appropriate exceptions or that the rule should have stronger controls short of a complete prohibition.[38] In evaluating this wide range of views, FINRA considered, as stated in Notice 21-43, whether the rule should generally prohibit all borrowing and lending arrangements between registered persons and customers with no exceptions. FINRA decided against this approach, however, for several reasons.

First, Rule 3240 already contains a general prohibition that the proposed rule change would strengthen by extending the period over which the rule would apply,

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37 See Dishonest or Unethical Business Practices of Broker-Dealers and Agents (adopted May 23, 1983), https://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf. NASAA also commented that its model rule concerning unethical business practices of investment advisers includes a similar prohibition. See NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers Model Rule 102(a)(4)-1 (2019), available at https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf (providing that an investment adviser, an investment adviser representative or a federal covered adviser shall not engage in unethical business practices, including, among other things, "[b]orrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds" or "[l]oaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser").

38 See Notice 21-43.

clarifying that the prohibition applies to pre-existing arrangements, and narrowing some of the exceptions. Second, FINRA believes that all the exceptions are tailored to permit arrangements for which the potential benefits outweigh related potential risks. The exceptions allow for narrow situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced. Third, Rule 3240 also contains several protections that restrict a registered person's ability to enter into an arrangement within the five exceptions (i.e., that no arrangements within the exceptions are permitted absent a member's procedures allowing the borrowing or lending of money between registered persons and customers and absent the registered person's compliance with applicable notice and approval requirements). These protections would be further strengthened through the proposed rule change to require members, when receiving written notice of a borrowing or lending arrangement, to make a reasonable assessment of the risks created by a borrowing or lending arrangement and a reasonable determination of whether to approve it.

FINRA does not believe that NASAA's model rule concerning the unethical business practices of broker-dealers and agents warrants changing the general approach of Rule 3240 as a general prohibition with narrow exceptions and associated protections. As explained above, one of the paragraphs in the NASAA model rule prohibits broker-dealer agents from engaging in the practice of borrowing or lending money or securities from a customer. Although some states have adopted that paragraph of the NASAA

model rule verbatim,[39] some states have laws or regulations concerning borrowing or lending that are, in many respects, more similar to Rule 3240,[40] or even incorporate Rule 3240 by reference.[41] Moreover, FINRA has not identified any broker-dealer laws or regulations concerning borrowing or lending arrangements in several states that have high concentrations of FINRA-registered broker-dealer firms and branches.[42] Considering that Rule 3240 has a general prohibition on both borrowing arrangements and lending arrangements, limited tailored exceptions, and associated protections, including written-procedures requirements and notice-and-approval requirements, FINRA's rule—in its current form and as proposed—is as strong, if not stronger, than many states' laws.

In addition, NASAA commented that all borrowing and lending arrangements should be prohibited because the conflicts of interest that such arrangements create cannot be mitigated by member firm policies and procedures. NASAA contended that its position is consistent with the Commission's approach regarding certain other broker-

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39 See, e.g., Georgia (Ga. Comp. R. & Regs. 590-4-5-.16(2)(b)(1) (2011)); Massachusetts (950 Mass. Code Regs. 12.204(1)(b)(1) (2020)); Pennsylvania (10 Pa. Code § 305.019(c)(2)(i) (2018)).

40 See, e.g., Connecticut (Conn. Agencies Regs. § 36b-31-15b(a)(1) (1995)); Michigan (Mich. Admin. Code r.451.4.27(3)(a) (2019)); New Jersey (N.J. Admin. Code § 13:47A-6.3(a)(43) and (44) (2017)); North Carolina (18 N.C. Admin. Code 6A.1414(c)(1) (1988)).

41 See, e.g., Colorado (Colo. Code Regs. 704-1 § 51-4.7(H)(2) (2019)); Florida (Fla. Admin. Code Ann. r.69W-600.013(2)(a) (2021)); Nevada (Nev. Admin. Code § 90.327(1)(d)(1) and Nev. Admin. Code § 90.321(1) (2008)).

42 Specifically, FINRA has not identified state broker-dealer laws or regulations prohibiting borrowing or lending with customers in New York, California, Illinois or Texas. See generally 2023 FINRA Industry Snapshot at 22-23, available at https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf.

dealer conflicts of interest. In this regard, NASAA wrote that the Commission recognized in the context of Regulation Best Interest ("Reg BI") that some conflicts are so pervasive that they cannot reasonably be mitigated and must be eliminated in their entirety. NASAA contended that the direct personal incentives inherent in borrowing and lending arrangements, and the desire to collect or the duty to pay a customer, are of equal if not greater concern.

FINRA believes that the regulatory approach used in Rule 3240 is generally consistent with the approach the Commission took with Reg BI. Reg BI establishes a standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any "securities transaction or investment strategy involving securities."[43] FINRA notes that Reg BI requires broker-dealers to address conflicts of interest associated with recommendations, including through mitigation, and in certain circumstances where the Commission determined that such conflicts cannot be reasonably mitigated, through elimination. Rule 3240 is generally consistent with the spirit of this regulatory approach. In this regard, Rule 3240 generally prohibits most borrowing and lending arrangements and, thus, eliminates the potential conflicts these arrangements would present. Moreover, the proposed rule change would strengthen the general prohibition, by clarifying that it applies to arrangements that pre-exist a broker-customer relationship, extending it to arrangements that arise within six months after a broker-customer relationship ends, and adding supplementary material concerning conduct by registered persons regarding arrangements with persons related to the registered person or to the customer. Furthermore, as discussed, the rule's tailored

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43 See 17 CFR 240.15l-1(a)(1).

exceptions, which would be narrowed under the proposed rule change, are for situations where the potential benefits of the borrowing or lending arrangement—including the benefits of being able to enter into some arrangements without a notice and approval process—outweigh related potential risks. In addition, the rule has additional protections (i.e., the written-procedures requirement and the notice and approval requirements) that would be further enhanced by requiring firms to make a reasonable assessment of the risks and a reasonable determination of whether to approve the arrangement.[44]

In addition, NASAA suggested that FINRA should clarify that members may impose more stringent controls up to and including a total prohibition of borrowing and lending arrangements. When FINRA proposed to adopt Rule 3240 as part of the consolidated FINRA rulebook, it indicated that members can choose to permit registered persons to borrow money from or lend money to their customers consistent with the requirements of the rule or may be more restrictive, including prohibiting borrowing or lending arrangements in whole or in part.[45] In light of NASAA's suggestion, if the proposed rule change is approved, FINRA would reiterate this guidance in the Regulatory Notice announcing the approval of the proposed rule change.

The Immediate Family Exception

NASAA recommended eliminating the immediate family exception because elder financial exploitation is often perpetrated by family members. NASAA also contended

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44 Moreover, the member's reasonable assessment and determination would be informed by guidance in Notice 21-43 that the member's reasonable assessment of the risks may include consideration of, among other factors, "any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer."

45 See Securities Exchange Act Release No. 61302 (January 6, 2010), 75 FR 1672, 1673 (January 12, 2010) (Notice of Filing of File No. SR-FINRA-2009-095).

that, if the current rule framework is maintained, notification and approval should be required for arrangements with immediate family members, particularly where the customer is a senior or may otherwise be a vulnerable adult under applicable state law. Malecki also raised concerns regarding elder financial exploitation and noted that debt situations can easily cause serious friction within family and friends. Malecki commented that the immediate family exception is too broad, and that only a narrow exception for educational debt for children should be permitted when brokers manage their own children's accounts.

Except for proposing to modify the definition of "immediate family," FINRA does not propose to amend the existing immediate family exception or require notice and approval of arrangements with immediate family members. As explained above, the narrow exceptions to the rule—including for arrangements with immediate family members—are for situations where FINRA believes the likelihood that the registered person has borrowed from or lent money to a customer by virtue of the broker-customer relationship is reduced, and the rule contains additional protections that restrict a registered person's ability to enter into an arrangement within the exceptions.

FINRA believes that Malecki's suggestion to limit the immediate family exception to educational debt for children would narrow the exception too much. There are numerous other examples of beneficial borrowing or lending arrangements between immediate family members, including senior family members.[46] Such loans may cover, for example, medical expenses, child care or elder care expenses, emergency home repair costs, or expenses in the wake of a job loss, or they may support a family member's small

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[46] FINRA notes that the statements in this section that apply to senior family members also apply to other family members who may be vulnerable adults.

business at an interest rate lower than commercially available. Furthermore, FINRA continues to believe, as it did when it previously eliminated from the predecessor to Rule 3240 notice and approval requirements for arrangements with immediate family members, that such requirements may invade the legitimate privacy interests of customers and registered persons.[47] Thus, FINRA believes the potential risks are outweighed by the potential benefits of permitting immediate family members to privately borrow from and lend to each other.

FINRA also reiterates that a registered person is prohibited from entering into a borrowing or lending arrangement with a customer who is an immediate family member, including one who is a senior investor, unless the member adopts written procedures permitting such arrangements. As explained above, members may choose to prohibit all borrowing and lending arrangements, allow only some of the exceptions enumerated in Rule 3240(a)(2), or impose limitations on the exceptions. FINRA believes that, by strengthening the general prohibition and narrowing its exceptions, the proposed rule change would further protect all investors, including senior investors.[48]

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47 See Securities Exchange Act Release No. 49081 (January 14, 2004), 69 FR 3410 (January 23, 2004) (Notice of Filing of File No. SR-NASD-2004-05) (explaining, among other things, that such requirements may invade the legitimate privacy interests of customers and registered persons).

48 FINRA has maintained a longstanding commitment to protecting senior investors and continues to work to address risks facing this investor population as part of its regulatory mission, including by adopting rules that are intended to address risks related to possible financial exploitation of senior investors. See, e.g., FINRA, Protecting Senior Investors 2015-2020 (April 30, 2020); Regulatory Notice 20-34; Rule 2165 (Financial Exploitation of Specified Adults); Rule 4512.06 (Trusted Contact Person). FINRA further notes that Rule 2010 (Standards of Commercial Honor and Principles of Trade)—which provides that a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade—protects investors from unethical behavior and is broad enough to cover a wide range of unethical conduct.

The Personal Relationship and Business Relationship Exceptions

Several commenters addressed the personal relationship and business relationship exceptions. Malecki commented that these two exceptions are too broad. Likewise, University of Pittsburgh requested that Rule 3240 limit the business relationship exception to the financial industry and noted that a registered person getting regular haircuts from a hairstylist should not fit within the business relationship exception. University of Pittsburgh also requested that FINRA provide examples of qualifying business relationships and more information about whether a business relationship qualifies for the exception. On this last point, University of Pittsburgh suggested that useful factors may include (1) the financial risks for the parties; (2) the industry involved; and (3) any other factor that may help determine the trust established between the parties and the comparative risks of their past business practices and their potential borrower-lender agreements.

FINRA shares some of these concerns and accordingly has proposed to narrow the personal relationship exception and to provide factors that are relevant to assessing whether a relationship falls within the scope of either exception. Beyond what FINRA proposed in Notice 21-43—and in response to the comments—FINRA proposes additional amendments to expressly provide that the personal and business relationships must be "bona fide"[49] and provide that an illustrative example of a "business relationship" is a loan from a registered person to a small outside business that the

[49] See proposed Rule 3240(a)(2)(D) and (E).

registered person co-owned for years for the sole purpose of providing the business with additional operating capital.[50]

FINRA does not believe, however, that additional changes to the personal and business relationship exceptions are warranted. The personal relationship exception, as proposed to be amended, would not permit "virtually anyone" to enter into a borrowing or lending arrangement.[51] Rather, the proposed rule change would narrow the personal relationship exception significantly, to apply only to personal relationships that are "bona fide" and "close," and maintained outside of, and formed prior to, the broker-customer relationship. This narrower definition would reduce the risk that a registered person would concoct a personal relationship with a customer for the purpose of entering into a borrowing or lending arrangement with that customer, and it would address concerns expressed during the retrospective rule review that the exception can be exploited.

Likewise, FINRA believes that the business relationship exception, as proposed to be amended, is appropriately tailored. Rule 3240 currently requires that the qualifying business relationships be "outside of the broker-customer relationship." This language serves to separate the business relationship from the broker-customer relationship, and thus mitigate the potential conflict of interest. The proposed rule change would further narrow this exception by requiring that the business relationship be "bona fide." FINRA does not believe that the "business relationship" exception should be further limited to

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50 See proposed Rule 3240.04. FINRA agrees that a loan from a customer from whom the registered person purchases non-commercial consumer goods or services, such as hair styling services, would not fit within the business relationship exception.

51 See Malecki.

only the financial industry. There is no indication that the risks related to arrangements based on a bona fide business relationship turn on the industry or sector involved.

With respect to University of Pittsburgh's suggested factors, FINRA notes that the proposed rule change would require members, when receiving written notice under Rule 3240, to perform a reasonable assessment of the risks created and make a reasonable determination of whether to approve the arrangement or broker-customer arrangement, as the case may be. As explained above, a member's reasonable assessment and determination would be informed by the guidance already provided in Notice 21-43, which includes a non-exhaustive list of factors to consider when evaluating whether to approve a borrowing or lending arrangement. For example, these factors include, among others, any potential conflicts of interest, the length and type of relationship, the material terms of the arrangement, and the customer's or registered person's ability to repay the loan. These factors are broad enough to cover many of the kinds of specific considerations suggested by University of Pittsburgh, including its suggestion that members consider the industry that the loan involves.

Definition of "Customer"

Under the proposed rule change, the rule's prohibition would extend to arrangements with any customer who, within the previous six months, had a securities account assigned to the registered person at any member firm.[52] NASAA suggests that the period of time used in proposed Rule 3240.02 should be one year, instead of six

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[52] See proposed Rule 3240.02.

months, because Rule 4111 (Restricted Firm Obligations) uses a one-year lookback period.[53]

The Rule 4111 lookback periods (including, among others, the one-year lookback period that pertains to "Registered Persons In-Scope"[54]) impact how Rule 4111 identifies firms with a significant history of misconduct. FINRA, however, has proposed a six-month period of time to align proposed Rule 3240.02 with the six-month period in the definition of "customer" in Rule 3241, because Rule 3241 addresses similar potential conflicts of interest as Rule 3240.[55] Moreover, FINRA believes the six-month lookback period in proposed Rule 3240.02 strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change and imposing requirements that are reasonable and appropriate, including reasonable requirements on members in tracking transfers of customers' accounts.[56]

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53 PIABA also suggests that the period of time used in proposed Rule 3240.02 should be one year or more, instead of six months, and cites the time it could take to "unwind some position a registered representative might recommend." It is unclear, however, what kinds of positions this comment pertains to or what would need to be unwound.

54 See Rule 4111(i)(13).

55 Like Rule 3240, Rule 3241 addresses situations that may create potential conflicts of interest between registered persons and their customers. Specifically, Rule 3241 addresses the potential conflicts that registered persons may face when they are named a customer's beneficiary, executor or trustee, or hold a power of attorney or similar position for or on behalf of a customer. It limits any registered person from being named a beneficiary, executor or trustee, or to have a power of attorney or similar position of trust for or on behalf of a customer, and protects investors by requiring members to affirmatively address registered persons being named beneficiaries or holding positions of trusts for customers. See Regulatory Notice 20-38 (Oct. 29, 2020).

56 Prior to the adoption of Rule 3241, many members "prohibit[ed] or impos[ed] limitations on being named as a beneficiary or to a position of trust when there is not a familial relationship," but FINRA "observed situations where registered

Supervision and Customer-Disclosure Requirements

NASAA suggested that members should be required to incorporate specific supervisory procedures for assessing, and after approving, a borrowing or lending arrangement. Specifically, NASAA commented that the member should be required to document (1) the steps it undertook to assess the risk prior to approving the arrangement; (2) the steps it will take to minimize the conflict of interest; (3) how it communicated to the customer the risk created by the lending arrangement or repayment terms so that the customer appreciates the risk; and (4) an outline of the supervisory measures that it will take. Regarding the member's assessment of a borrowing or lending arrangement, NASAA contended that the rule should require members to evaluate borrowing and lending arrangements, and that the member's assessment should include an interview (preferably by a compliance officer) with the customer outside of the presence of the registered person or, where that is not possible, other verification that the customer benefits from and entered into the arrangement on his or her own volition and without

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representatives tried to circumvent firm policies, such as resigning as a customer's registered representative [and] transferring the customer to another registered representative." See Regulatory Notice 20-38. "To address attempted circumvention of the restrictions (e.g., by closing or transferring a customer's account)," FINRA defined "customer" in Rule 3241 to include "any customer that has, or in the previous six months had, a securities account assigned to the registered person at any member firm." Id.; Rule 3241.01. When proposing Rule 3241, FINRA explained that the inclusion of the six-month look-back period "is important in addressing potential conflicts of interest and circumvention of the proposed rule change." See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41256 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-20). FINRA further explained, in response to a comment suggesting that the proposed definition of "customer" include a 12-month lookback provision, that it "believes the six-month period strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change by transferring the customer account to another representative and imposing reasonable requirements on member firms in tracking account transfers." Id.

pressure. Regarding supervision after approving an arrangement, NASAA commented that members should closely monitor the account of a customer who is a party to a borrowing or lending arrangement and impose formal conditions, apply heightened scrutiny to these accounts on an ongoing, annual review basis, place the registered person on heightened supervision, and conduct additional reviews on trades and transactions to ensure that recommendations are suitable. Similarly, Malecki commented that all loans except for educational debt for children should be supervised, and that "supervision of loans" should be aligned with FINRA rules regarding outside business activities and private securities transactions.[57]

The fundamental approach of FINRA's supervision rule is to require members to establish and maintain a system to supervise the activities of each associated person that is "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[58] Likewise, the written supervisory procedures required by FINRA's supervision rule must be "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[59] In guidance, FINRA has previously explained that written supervisory procedures should include a description of the controls and procedures used by members to deter and detect misconduct and improper activity.[60] Additionally, at a minimum,

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57 See Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person).

58 See Rule 3110(a); see also NASD Notice to Members 99-45 (June 1999).

59 See Rule 3110(a)(1) and (b)(1).

60 See NASD Notice to Members 98-96 (December 1998); see also NASD Notice to Members 99-45, supra note 58.

written supervisory procedures should include and describe (1) the specific identification of the individual(s) responsible for supervision; (2) the supervisory steps and reviews to be taken by the appropriate supervisor; (3) the frequency of such reviews; and (4) how such reviews shall be documented.[61] FINRA does not believe it is necessary or appropriate to further prescribe specific supervisory procedures that members should use when supervising for compliance with Rule 3240.

In response to the comments, however, FINRA is proposing stronger controls for when a member considers whether to approve a borrowing or lending arrangement or, where there is a pre-existing borrowing or lending arrangement, a new broker-customer relationship—specifically, the proposed requirement that a member, upon receiving written notice under Rule 3240, perform a "reasonable assessment" of the risks and a "reasonable determination" of whether to approve the arrangement or new broker-customer relationship, as the case may be.[62] As explained above, FINRA intends that a member's reasonable assessment and reasonable determination would be informed by the guidance that FINRA provided in Notice 21-43 concerning the factors members may consider when assessing whether to approve a borrowing or lending arrangement. FINRA believes this guidance would help members, when performing the reasonable assessments and determinations required under the proposed rule change, evaluate the

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61 See NASD Notice to Members 98-96, supra note 60; see also NASD Notice to Members 99-45, supra note 58.

62 See proposed Rule 3240.06.

key risks and conflicts and afford appropriate flexibility in evaluating which factors may apply to a particular situation.[63]

In a related comment, NASAA suggested that FINRA should require registered persons, at a minimum, to disclose to customers the factors listed in the guidance provided in Notice 21-43. Although NASAA refers to those factors as "the Proposal's recommended disclosures," the factors in Notice 21-43 are intended to help guide a member's assessment of whether to approve a loan; they were not designed or intended to be the basis of customer disclosures about a loan. Nevertheless, FINRA notes that that guidance states that FINRA expects a member, if possible and as part of the member's evaluation of whether to approve a borrowing or lending arrangement, to try to discuss the arrangement with the customer.

Retroactivity

NASAA commented that applying the proposed rule change retroactively could provide benefits to investors and recommended retroactive disclosure of pre-existing borrowing and lending arrangements.[64] FINRA seeks, however, to avoid creating

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63 With respect to Malecki's comment that "supervision of loans" should be aligned with FINRA rules regarding outside business activities and private securities transactions, FINRA notes that Rule 3270 does not require members to "supervise" outside business activities. However, if a loan constitutes a private securities transaction, then Rule 3280—and any applicable supervisory obligations—would apply. See Rule 3280(c)(2) (discussing supervisory requirements involving private securities transactions for compensation); 3280(d) (discussing private securities transactions not for compensation, where a member may "at its discretion" require the person to adhere to specified conditions); 3280(e)(1) (defining "private securities transaction" and several exclusions to that definition).

64 FINRA assumes that NASAA's comment about "pre-existing" arrangements concerns arrangements that were entered into before the effective date of the proposed rule change.

situations that would require registered persons and customers to terminate borrowing or lending arrangements or broker-customer relationships that, when entered into, were permissible under the current version of Rule 3240. In general, the proposed rule change would not apply retroactively to borrowing or lending arrangements that were entered into prior to the effective date of the proposed rule change and were permissible under the current version of Rule 3240.[65] Rather, the proposed rule change would apply only to (1) new arrangements and new broker-customer relationships that occur after the effective date of the proposed rule change; and (2) modifications that occur after the effective date of the proposed rule change of borrowing or lending arrangements that were entered into before the effective date.[66] Although FINRA is not proposing to require members to re-evaluate previously approved arrangements, members would have the discretion to do so.[67]

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65 For example, the proposed rule change to narrow the personal relationship exception would not apply retroactively to a borrowing or lending arrangement that was entered into prior to the effective date of the proposed rule change and that was permissible under the current personal relationship exception.

66 FINRA reiterates, however, that the current rule's general prohibition against borrowing and lending arrangements between registered persons and customers already applies to arrangements that pre-existed the formation of the broker-customer relationship, and that the proposed rule change would clarify that scope.

67 FINRA also notes that FINRA's supervision rule would require a member to follow-up on "red flags" indicating problematic activity related to borrowing or lending arrangements between registered persons and their customers, including arrangements that were entered into prior to the effective date of the proposed amendments. See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-20) (explaining that Rule 3110 (Supervision) includes the "longstanding obligation to follow-up on 'red flags' indicating problematic activity").

Harmonization of Regulatory Approaches to Financial Professionals' Borrowing and Lending Arrangements

In Notice 21-43, FINRA described some similarities and differences between Rule 3240 and the federal and state regulatory approaches for investment advisers and their supervised persons. FINRA sought to encourage and inform a broader dialogue about whether the similar risks presented when any financial professional borrows from or lends money to customers warrants a more uniform approach to regulating this activity. SIFMA commented that it welcomes a discussion on harmonizing the regulatory approaches, where appropriate.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[68]

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

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68 15 U.S.C. 78s(b)(2).

11. Exhibits

Exhibit 1. Completed notice of the proposed rule change for publication in the Federal Register.

Exhibit 2a. Notice 21-43 (December 2021).

Exhibit 2b. Copies of the comment letters received in response to Notice 21-43 (December 2021).

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2024-001)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 3240 (Borrowing From or Lending to Customers)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend Rule 3240 (Borrowing From or Lending to Customers) to strengthen the general prohibition against borrowing and lending arrangements, narrow some of the existing exceptions to that general prohibition, modernize the immediate family exception, and enhance the requirements for giving notice to members and obtaining members' approval of such arrangements.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

Rule 3240 generally prohibits, with exceptions, registered persons from borrowing money from or lending money to their customers. The rule has five tailored exceptions, available only when the registered person's member firm has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member, the borrowing or lending arrangements meet the conditions in one of the exceptions[3] and, when required, the registered person notifies the member of a borrowing or lending arrangement, prior to entering into such arrangement,

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3 See Rule 3240(a)(2)(A) (the "immediate family exception"); Rule 3240(a)(2)(B) (the "financial institution exception"); Rule 3240(a)(2)(C) (the "registered persons exception"); Rule 3240(a)(2)(D) (the "personal relationship exception"); Rule 3240(a)(2)(E) (the "business relationship exception").

and obtains the member's pre-approval in writing. The exceptions are for limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers.

Rule 3240 was last amended in 2010, when it became part of the consolidated FINRA rulebook.[4] In August 2019, FINRA launched a retrospective review of Rule 3240, as part of a larger retrospective review of FINRA's rules and administrative processes that help protect senior investors from financial exploitation.[5] In December 2021, FINRA published Regulatory Notice 21-43 ("Notice 21-43"), which (1) summarized the predominant themes that emerged during the retrospective review of Rule 3240; (2) issued guidance concerning approvals of permissible borrowing or lending arrangements; and (3) based on feedback received during the retrospective rule review, sought comment on proposed amendments to Rule 3240.[6]

Proposed Rule Change

FINRA is proposing to amend Rule 3240 to strengthen the general prohibition against borrowing and lending arrangements, narrow some of the existing exceptions to

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4 See Regulatory Notice 10-21 (April 2010).

5 See Regulatory Notice 19-27 (August 2019). In October 2020, FINRA published a report that summarized other aspects of that retrospective rule review. See Regulatory Notice 20-34 (October 2020).

6 In Notice 21-43, FINRA also discussed some similarities and differences between Rule 3240 and the federal and state regulatory approaches for investment advisers and their supervised persons, and encouraged a broader dialogue about whether a more uniform regulatory approach would enhance investor protection.

that general prohibition, modernize the immediate family exception, and enhance the requirements for giving notice to members and obtaining members' approval of such arrangements.[7]

The General Prohibition on Borrowing From or Lending to Customers

Rule 3240 generally prohibits registered persons from borrowing from or lending to their customers. To make this regulatory purpose more prominent, the proposed rule change would amend the rule's title from "Borrowing From or Lending to Customers" to "Prohibition on Borrowing From or Lending to Customers," and change the title of Rule 3240(a) from "Permissible Lending Arrangements; Conditions" to "General Prohibition; Permissible Borrowing or Lending Arrangements; Conditions." These changes would emphasize that the rule is, first and foremost, a general prohibition.

In addition, the proposed rule change would strengthen this general prohibition in three ways. First, Rule 3240(a) would be amended to clarify that the rule's general requirements concerning borrowing and lending arrangements—including the general prohibition—apply to arrangements that pre-exist a new broker-customer relationship. Currently, Rule 3240(a) begins, "[n]o person associated with a member in any registered capacity may borrow money from or lend money to any customer of such person . . . ." FINRA is proposing to amend this introductory clause in Rule 3240(a) to also prohibit

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7 Where appropriate in context, FINRA refers herein to "borrowing and lending" rather than "borrowing or lending." No references to "borrowing and lending," however, should be interpreted to mean that Rule 3240 only applies to arrangements that have both a borrowing component and a separate lending component. Rule 3240 generally prohibits registered persons from borrowing money from or lending money to a customer.

registered persons from initiating a broker-customer relationship with a person with whom the registered person has an existing borrowing or lending arrangement.

Second, FINRA is proposing to add Rule 3240.02 (Customer). Proposed Rule 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 borrowing or lending arrangements entered into within six months after a broker-customer relationship terminates. This proposed definition would align with the definition of "customer" in FINRA Rule 3241 (Registered Person Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer), a rule that addresses similar types of conflicts.[8]

Third, FINRA is proposing to add Rule 3240.05 (Arrangements with Persons Related to Either the Registered Person or the Customer). Proposed Rule 3240.05 would extend the rule's requirements to borrowing or lending arrangements that involve similar conflicts as ones presented by arrangements directly between registered persons and their customers. Specifically, proposed Rule 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 (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

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8 See Rule 3241.01 (Customer).

and would not be consistent with this Rule [3240] 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 or, likewise, induces a customer to have a person or entity related to the customer enter into an arrangement with the registered person.[10]

In addition, FINRA is proposing to add Rule 3240.03 (Owner-Financing Arrangements) to expressly state that, for purposes of Rule 3240, borrowing or lending arrangements include owner-financing arrangements. For example, Rule 3240 would apply to situations where a registered person purchases real estate from his customer, the customer agrees to finance the purchase, and the registered person provides a promissory note for the entire purchase price or arranges to pay in installments.[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

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9 The conditions in Rule 3240(a)(1), (2) and (3) are that the member has written procedures allowing the borrowing or lending of money between registered persons and customers; the borrowing or lending arrangement meets one of the conditions; and the notification and approval requirements are satisfied.

10 Proposed Rule 3240.05 is based, in part, on feedback received during the retrospective review that some registered persons attempt to circumvent Rule 3240 by structuring arrangements with persons related to the registered person or the customer.

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).

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."

During the retrospective review of Rule 3240, FINRA received feedback that the definition of "immediate family" should be modernized. The proposed rule change would modernize the "immediate family" definition to match the definition of the same term in Rule 3241, which also has exceptions for situations in which the customer is a member of the registered person's immediate family.[13] Specifically, the proposed rule change to Rule 3240(c) would replace "husband or wife" with "spouse or domestic partner" and amend the definition so that it "includes step and adoptive relationships." In addition, the "any other person" clause would be revised to 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

Currently, two exceptions to the rule's general prohibition are for arrangements based on (1) 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 (2) a

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12 See Rule 3240(a)(2)(A).

13 See Rule 3241(a)(1)(A) and (a)(2)(A) and (c).

"business relationship outside of the broker-customer relationship."[14] Due to concerns expressed during the retrospective review of Rule 3240 that the personal relationship exception may be exploited—and to make more clear what kinds of personal relationships would be within the exception—FINRA proposes to narrow the personal relationship exception to arrangements that are based on a "bona fide, close personal relationship between the registered person and the customer maintained outside of, and formed prior to, the broker-customer relationship."[15] This language would replace the requirement 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" to narrow the scope of the exception and clarify the types of relationships that would be within the exception. For similar reasons, FINRA proposes to amend the business relationship exception to be limited to arrangements that are based on a "bona fide business relationship outside of the broker-customer relationship."[16]

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14 See Rule 3240(a)(2)(D) and (E). Although Rule 3240(a)(2)(D) and (E) refer to "the lending arrangement," and do not explicitly mention a "borrowing arrangement," these exceptions are not intended to exclude borrowing arrangements. FINRA therefore proposes a technical amendment to make clear that those exceptions apply to "borrowing or lending" arrangements based on a personal relationship or a business relationship.

15 Where appropriate in context, FINRA refers herein to proposed Rule 3240(a)(2)(D) as the "close personal relationship exception." See also supra note 3 (defining current Rule 3240(a)(2)(D) as the "personal relationship exception").

16 The term "bona fide" in the close personal relationship and business relationship exceptions was not included in the proposal in Notice 21-43. FINRA proposes to add the term "bona fide" to emphasize that for either of these exceptions to apply, the close personal relationship or business relationship must be legitimate. Adding the term "bona fide" would also align with language in proposed Rule 3240.04, discussed below.

In addition to narrowing the personal relationship and business relationship exceptions, FINRA is proposing to add Rule 3240.04 (Close Personal Relationships; Business Relationships), which 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 bona fide or was formed with the purpose of circumventing the purpose of Rule 3240. Proposed Rule 3240.04 is intended to help establish the scope of the close personal relationship and business relationship exceptions, focus on the most relevant factors when evaluating whether a close personal relationship or business relationship exists, and ensure that members consider meaningfully the potential issues involved in the proposed arrangement.

To provide even more guidance about the scope of the close personal relationship and business relationship exceptions, proposed Rule 3240.04 would also provide illustrative examples of these relationships. Specifically, it would provide that 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 relationships. Additionally, proposed Rule 3240.04 would provide that an example of a business relationship includes, but is not limited to, a loan from a registered person to a small outside business that the registered person co-owned for years for the sole purpose of providing the business with additional operating capital.[17]

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[17] The proposal in Notice 21-43 did not include an illustrative example of a business relationship in proposed Rule 3240.04. It has been added in response to

Notification and Approval Requirements

The proposed rule change would also amend Rule 3240's notification and approval requirements. Currently, Rule 3240(b) contains notification and approval requirements for borrowing or lending arrangements within the five exceptions, which vary depending on which exception applies. With respect to the personal relationship, business relationship, and registered persons exceptions, Rule 3240(b)(1) provides that a registered person shall notify the member of borrowing or lending arrangements prior to entering into such arrangements, and that the member shall pre-approve in writing such arrangements.[18] With respect to the immediate family member exception, Rule 3240(b)(2) provides, in pertinent part, that a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval. With respect to the financial institution exception, Rule 3240(b)(3) provides, in pertinent part, that a member's written procedures may indicate that registered persons are not required to notify the member or receive member approval, 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."

FINRA is proposing several amendments to all these notification and approval requirements. First, FINRA is proposing to amend Rule 3240(b)(1) to clarify that, although registered persons are required to obtain the member's prior approval of arrangements within the close personal relationship, business relationship, or registered

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comments to Notice 21-43 requesting examples of relationships within that exception.

[18] Rule 3240(b)(1) contains similar notification and approval requirements for modifications to borrowing or lending arrangements.

persons exceptions, the member is not required to approve such arrangements. As explained above, Rule 3240(b)(1) currently provides that the member "shall pre-approve" such arrangements, which could imply incorrectly that the member must approve the arrangement or modification and may not disapprove it. To preclude this incorrect interpretation, the proposed rule change would delete the "shall pre-approve" language and instead require the registered person to provide the member with notice of the arrangements or modifications "prior to entering into such arrangements" or "prior to the modification of such arrangements" and "obtain the member's approval."[19]

The proposed rule change would also amend the notification and approval requirements that apply to borrowing or lending arrangements within the registered persons, personal relationship and business relationship exceptions, to correspond with the proposed amendments that would clarify that the general prohibition applies to pre-existing arrangements. Specifically, proposed Rule 3240(b)(1)(B) would require registered persons, prior to the initiation of a broker-customer relationship at the member with a person with whom the registered person has an existing borrowing or lending arrangement, to notify the member in writing of existing arrangements within the registered persons, personal relationship and business relationship exceptions and obtain the member's approval in writing of the broker-customer relationship.[20]

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19 See proposed Rule 3240(b)(1)(A).

20 In such situations, if the member does not approve the formation of a broker-customer relationship with the registered person who provided such notice, the customer would still be permitted to seek to initiate a broker-customer relationship with another registered person at the same member.

Further, the proposed rule change would require that all notices required under Rule 3240 be in writing and retained by the member. Currently, Rule 3240 does not specify that notice must be given in writing, and the record-retention provision in Rule 3240.01 requires members only to preserve written approvals. The proposed rule change would require registered persons to give written notice and require members to preserve records of such written notice for at least three years.[21]

The proposed rule change would also amend the provisions that address notice and approval of arrangements within the immediate family and financial institution exceptions, to correspond with the proposed amendments that would clarify that the general prohibition applies to arrangements that pre-exist the broker-customer relationship. Currently, under Rule 3240(b)(2) and (3), the member's written procedures may indicate that registered persons are not required to notify the member or receive member approval of arrangements within the immediate family exception or arrangements within the financial institution exception that meet the additional conditions set forth in Rule 3240(b)(3). To extend these provisions to pre-existing arrangements, the proposed rule change would amend Rule 3240(b)(2) and (3) to provide that the member's procedures may also indicate that registered persons are not required to notify the

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[21] See proposed amendments to Rule 3240(b)(1)(A) and (b)(1)(B) and Rule 3240.01. Rule 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) requires notice and approval of arrangements that are within the personal relationship, business relationship, and registered persons exceptions. While Rule 3240(b)(2) and (3) do not expressly require notice and approval of arrangements within the immediate family member and financial institution exceptions, those subparagraphs imply that members may choose to require such notice and approval of those arrangements.

member or receive member approval of such arrangements either prior to or subsequent to initiating a broker-customer relationship.

Finally, in response to comments received in response to Notice 21-43, the proposed rule change would establish new obligations on a member when receiving notice of a borrowing or lending arrangement. Specifically, FINRA is proposing to add Rule 3240.06 (Obligations of Member Receiving Notice). Proposed Rule 3240.06 would provide that upon receiving written notice under Rule 3240, the member shall perform a reasonable assessment of the risks created by the borrowing or lending arrangement with a customer, modification to the borrowing or lending arrangement with a customer, or existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person. It would further provide that the member shall also make a reasonable determination of whether to approve the borrowing or lending arrangement, modification to the borrowing or lending arrangement, or, where there is an existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person, the broker-customer relationship. Proposed Rule 3240.06 would be similar to Rule 3241(b)(1), which requires members to perform a "reasonable assessment" and "reasonable determination" when receiving notice of a registered person being named a customer's beneficiary or holding a position of trust for a customer, and to supplementary material to FINRA Rule 3270 (Outside Business Activities of Registered Persons) that provides factors members must consider upon receiving written notice of an outside business activity.[22]

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[22] See Rule 3270.01 (Obligations of Member Receiving Notice).

FINRA intends that a member's "reasonable assessment" and "reasonable determination" for purposes of proposed Rule 3240.06 would be informed by guidance that FINRA has already provided to members in Notice 21-43.[23] Specifically, FINRA expects that a member's "reasonable assessment" would take into consideration several factors, such as:

(1) any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer;

(2) the length and type of relationship between the customer and registered person;

(3) the material terms of the borrowing or lending arrangement;

(4) the customer's or the registered person's ability to repay the loan;

(5) the customer's age;

(6) whether the registered person has been a party to other borrowing or lending arrangements with customers;

(7) whether, based on the facts and circumstances observed in the member'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;

(8) 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

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[23] FINRA has explained that this guidance was similar to general guidance that FINRA had published concerning the "reasonable assessment" and "reasonable determination" requirements in Rule 3241. See Notice 21-43, at n.21 (citing Rule 3241(b)(1), Regulatory Notice 20-38 (October 2020), and Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-020)).

(9) any indicia of customer vulnerability or undue influence of the registered person over the customer.

This list is not intended to be exhaustive. Moreover, while a listed factor may not be applicable to a particular situation, the factors that a member considers should allow for a reasonable assessment of the associated risks so that the member can make a reasonable determination of whether to approve the borrowing or lending arrangement, modification to the borrowing or lending arrangement, or, where there is an existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person, the broker-customer relationship. 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's assessment. If possible, as part of the member's reasonable assessment of the risks, FINRA would expect a member to try to discuss the arrangement with the customer.[24]

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice.

2. Statutory Basis

FINRA believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[25] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote

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24 FINRA notes that the proposed rule change would impact members that have elected to be treated as capital acquisition brokers ("CABs"), given that the CAB Rules incorporate the impacted FINRA rule by reference.

25 15 U.S.C. 78o-3(b)(6).

just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA believes that, by strengthening and modernizing Rule 3240, the proposed rule change would enhance investor protection. The proposed rule change would reduce risks to investors through incremental adjustments that strengthen the general prohibition against borrowing and lending arrangements and narrow the few exceptions to the rule. In addition, the proposed rule change would facilitate compliance by clarifying the scope of the general prohibition and the personal relationship and business relationship exceptions.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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.

(a) Regulatory Need

Rule 3240 generally prohibits registered persons from borrowing from or lending to their customers except when certain conditions are met, as specified in Rule 3240 and described above. Anecdotal evidence from member firms, law clinics, and previous

enforcement cases—as well as FINRA's experience in examining and enforcing for compliance with Rule 3240—suggests that there is some ambiguity about the scope of Rule 3240 and certain risks to investors due to conflicts of interest and the superior information that registered persons have about potential risks and returns. As discussed further below, the proposed rule change would reduce ambiguity and aim to mitigate these risks.

(b) Economic Baseline

The economic baseline for the proposed rule change is Rule 3240, members' 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 2022, there were 620,882 registered persons and 3,378 registered member firms that would be covered by the proposed rule change, in addition to the registered persons' customers.[26]

Absent Rule 3240, borrowing or lending arrangements between registered persons and their 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 establishes processes that may help mitigate the potential conflicts of interest in those arrangements that are within the exceptions. In this regard, registered persons may not enter into borrowing or lending arrangements that are within the rule's exceptions unless the registered person's member firm has written procedures allowing the borrowing or

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[26] See 2023 FINRA Industry Snapshot, https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf. There is no data of the number of customers of the registered member firms.

lending of money between such registered persons and their customers, and unless the registered person complies with any applicable notification and approval requirements. Members may adopt procedures that are stricter than Rule 3240. However, for purposes of conducting an economic analysis, FINRA does not have comprehensive information readily available about members' borrowing or lending policies or practices.

To understand the potential harm from impermissible borrowing or lending arrangements, FINRA reviewed final FINRA enforcement cases that involved findings of Rule 3240 violations. Between January 2018 and December 2021, there were an average of 15 such enforcement cases per year, totaling 58 cases over the four-year period.[27] The number of cases year over year did not display a noticeable trend. The customer was the borrower in only one of the cases, and the registered person was the borrower in the other 57 cases. The amounts of borrowed or lent money ranged from $1,800 to $1,350,000, with a mean of $163,509 and a median of $70,000.

Customer harm occurs if a loan from the customer is not repaid according to its terms,[28] or if the terms of the loan are substantially worse when compared to prevailing market terms for loans to comparable borrowers. In the enforcement cases in the review period, the customers were often repaid, though it is uncertain whether they were repaid according to the terms of the loan or how those terms would have compared to prevailing

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27 The number of enforcement cases includes the FINRA disciplinary actions that resulted in a Letter of Acceptance, Waiver, and Consent (AWC), an Order Accepting Settlement (OAS), or a decision issued by FINRA's Office of Hearing Officers, and that resulted in findings that the respondent violated Rule 3240. The number does not include matters resulting in Cautionary Action.

28 "Not repaid according to its terms" could include, but is not limited to, situations in which a customer is not repaid in full or not repaid at the interest rate or by the date agreed upon.

market terms. FINRA notes the number of enforcement cases does not represent all violations of Rule 3240 that may have occurred, and thus, does not provide a complete picture of the economic baseline of customer harm.

FINRA also reviewed disclosures on Forms U4 and U5 of consumer-initiated, investment-related arbitrations, civil litigation or customer complaints (written or oral) that included allegations related to a registered person (or former registered person) borrowing money from or lending money to a customer. This information complements the information from the enforcement cases regarding the potential harm caused by impermissible borrowing or lending arrangements, although the disclosures do not necessarily indicate whether or how Rule 3240 was violated. From 2018 to 2021, there was a total of 100 such disclosures over the four-year period, which averaged to 23 disclosures per year. The number of such disclosures declined from 38 in 2018 to 19 in 2021. In 28 of the total 100 identified disclosures, the amount of the compensatory damages claim was not known.[29] In the remaining 70 disclosures excluding two outliers,[30] the alleged compensatory damages claims ranged from $1,800 to $3.7 million, with a mean of $224,760 and a median of $94,600. Fifty-three of the 100 disclosures resulted in settlements, which ranged from $1,800 to $1.3 million. Five of the disclosures resulted in an arbitration award between $2,000 and $150,000. One disclosure resulted in a civil judgment of $85,000.

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29 For example, in one disclosure, a family member filed the complaint on behalf of a deceased customer without knowing the exact amount borrowed.

30 In two disclosures, the alleged compensatory damages were $20 million and $43 million, both of which are more than three standard deviations from the mean. FINRA removed these data points in calculating the mean and median to avoid biases caused by outliers.

The extent to which data concerning these consumer-initiated events may inform an economic baseline has some limitations. First, some disclosures allege harm caused by conduct in addition to borrowing from or lending to a customer, such as recommending unsuitable investments, so FINRA is unable to determine how much of the alleged harm derives from allegations related to borrowing or lending. Second, the alleged compensatory damages could be a poor proxy for measuring customer harm because the disclosures did not specifically mention the borrowed amounts or have details about whether the loan was repaid, and because nearly all alleged compensatory damages claims were not adjudicated. Nevertheless, to the extent some of the disclosures are of settlements, awards or judgments, those provide a better gauge of the potential customer harm than mere allegations of compensatory damages. Thus, the disclosure data provides a perspective, in addition to the enforcement data, on the prevalence and the scope of borrowing or lending arrangements between registered persons and customers.

To supplement the quantitative analysis above, FINRA also considered its own experience with examining and enforcing for compliance with Rule 3240. Specifically, FINRA is concerned that some registered persons attempt to circumvent the current rule, using tactics such as timing a borrowing or lending 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 bona fide. 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. These kinds of

arrangements present the same kinds of conflicts of interest that Rule 3240 is intended to address, and, as such, also inform the economic baseline.

(c) Economic Impact

By extending the coverage of the rule's general prohibition, narrowing some exceptions, and clarifying certain aspects of the rule, the proposed rule change would result in fewer attempts by registered persons to enter into impermissible arrangements. For example, the expected cost of attempting to enter into a borrowing or lending arrangement that is not within the exceptions would be higher, as the likelihood of getting caught would increase when members, registered persons and customers have better information about permitted arrangements. Further, by reducing ambiguity regarding permissible borrowing or lending arrangements, a registered person who currently avoids a permissible and mutually beneficial borrowing or lending arrangement may be more comfortable entering into such an arrangement because of the proposed rule change.

The proposed rule change would prohibit some arrangements that are allowed under the current rule. For example, the general prohibition does not currently extend to arrangements entered into within six months after a broker-customer relationship ends; under the proposed rule change, it would. Additionally, the proposed rule change would narrow the personal relationship exception, prohibiting some of the arrangements that are permissible under the current rule. FINRA recognizes, however, that the proposed rule change may preclude arrangements that could be mutually beneficial to customers and registered persons and superior to alternative opportunities for borrowing or lending. Furthermore, requiring members to make a reasonable assessment of the risks and a reasonable determination of whether to approve the arrangement or new broker-customer

relationship, as the case may be, may lead some members to disallow these arrangements altogether to avoid the cost of making the required assessments and determinations.

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

The proposed rule change requiring members that receive notice of an arrangement to perform a reasonable assessment of the risks created by the arrangement could also raise members' compliance costs in the long term to the extent that members are not currently conducting these assessments. While the current rule requires members, upon receiving notice of an arrangement, to approve the arrangement in writing, the current rule does not require members to conduct a reasonable assessment of the risks of

the arrangement prior to giving approval. Some members may already have a robust assessment process while some may have to adjust their process to comply with the proposed rule change. As a result, the compliance cost of the approval process for members that would have to make the adjustments could increase.

Members may also incur increased compliance costs in the short term. Specifically, members may need to update their written procedures in light of the proposed rule change given that Rule 3240 prohibits all arrangements unless the member has procedures permitting them. Members may also have to re-train their staff to become aware of the extended prohibitions, the modernized definition of "immediate family," the proposed factors to consider for arrangements based on close personal relationships and business relationships, and the "reasonable assessment" and "reasonable determination" requirements. While the proposed rule change would not apply retroactively, as discussed below, members may elect to re-evaluate previously approved arrangements under the proposed rule change. Additionally, members may choose to respond to the proposed rule change by reviewing their current registered persons' borrowing or lending arrangements with their current and previous customers, to the extent they have not already done so.

For members that are not already maintaining written notices and approvals of borrowing or lending arrangements that the proposed rule change would 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.

(d) Alternatives Considered

FINRA considered generally prohibiting all borrowing or lending arrangements between registered persons and customers and eliminating the existing exceptions. FINRA does not propose a complete prohibition for several reasons. As an initial matter, Rule 3240 already contains a general prohibition, and the proposed rule change would strengthen it, by clarifying that it applies to pre-existing arrangements, extending the time period over which the rule would apply, adopting supplementary material that addresses conduct by registered persons regarding arrangements with persons related to the registered person or to the customer, and narrowing some exceptions.

Moreover, as discussed below, FINRA determined that the enumerated exceptions in Rule 3240, with the proposed rule change described above, are for limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers. See discussion infra section C.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Notice 21-43. Six comments were received in response to Notice 21-43. A copy of Notice 21-43 appears in Exhibit 2a. Copies of the comment letters received in response to Notice 21-43 appear in Exhibit 2b. Of the six comment letters received, three were in favor of the proposed rule

change,[31] two were opposed,[32] and one raised issues that were beyond the scope of Rule 3240.[33]

The comments and FINRA's responses are set forth in detail below.

General Support for the Proposal

Three commenters expressed support for the proposal in Notice 21-43.[34] SIFMA noted that the proposal would provide greater clarity and guidance to members in assessing which arrangements may be permissible under the exceptions to the prohibition. PIABA specifically expressed support for applying Rule 3240 to arrangements that pre-exist the broker-customer relationship, extending the definition of customer to those who had accounts with a registered person in the previous six months, and making clear that the same or very similar conflicts of interest are present if a registered representative's close family member obtains a loan from a registered

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31 See Letter from Michael Edmiston, President, Public Investors Advocate Bar Association, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("PIABA"); letter from Bernard V. Canepa, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("SIFMA"); letter from Alice L. Stewart et al., Esquire, Director, University of Pittsburgh Securities Arbitration Clinic and Professor of Law, to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("University of Pittsburgh").

32 See Letter from Jenice L. Malecki, Malecki Law, to Marcia E. Asquith, Executive Vice President, Board and External Relations, FINRA, dated February 14, 2022 ("Malecki"); letter from Melanie Senter Lubin, President, North American Securities Administrators Association, Inc., to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, dated February 14, 2022 ("NASAA").

33 See Comment submission from Caleb Benore, dated December 29, 2021 ("Benore").

34 See PIABA, SIFMA and University of Pittsburgh.

representative's customer. University of Pittsburgh expressed support for nearly every change proposed in Notice 21-43.[35] PIABA, SIFMA and University of Pittsburgh all supported the proposed modernization of the "immediate family" definition.[36]

General Opposition to the Proposal

NASAA and Malecki did not support the proposal in Notice 21-43 because they both would favor an outright prohibition on borrowing from or lending to customers.[37] NASAA stated that the proposed changes would continue to subject registered persons to disparate regulatory requirements. In particular, NASAA noted that its model rule concerning Dishonest or Unethical Business Practices of Broker-Dealers and Agents, which lists acts and practices that are considered contrary to high standards of commercial honor and just and equitable principles of trade, prohibits agents from "[e]ngaging in the practice of lending or borrowing money or securities from a customer, or acting as a custodian for money, securities or an executed stock power of a customer."[38]

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35 While generally supporting the proposal, University of Pittsburgh had comments regarding the business relationship exception, and PIABA had comments regarding the definition of "customer." Those comments are discussed below.

36 NASAA, which generally opposed the proposal, also expressed support for the modernization of the definition of "immediate family."

37 In the alternative, NASAA and Malecki recommended various changes to Rule 3240, should it continue to permit any kinds of borrowing or lending arrangements. Those comments are discussed below.

38 See Dishonest or Unethical Business Practices of Broker-Dealers and Agents (adopted May 23, 1983), https://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf. NASAA also commented that its model rule concerning unethical business practices of investment advisers includes a similar prohibition. See NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered

During the retrospective review of Rule 3240, while some stakeholders also suggested that all borrowing and lending arrangements should be prohibited, others commented that the rule has appropriate exceptions or that the rule should have stronger controls short of a complete prohibition.[39] In evaluating this wide range of views, FINRA considered, as stated in Notice 21-43, whether the rule should generally prohibit all borrowing and lending arrangements between registered persons and customers with no exceptions. FINRA decided against this approach, however, for several reasons.

First, Rule 3240 already contains a general prohibition that the proposed rule change would strengthen by extending the period over which the rule would apply, clarifying that the prohibition applies to pre-existing arrangements, and narrowing some of the exceptions. Second, FINRA believes that all the exceptions are tailored to permit arrangements for which the potential benefits outweigh related potential risks. The exceptions allow for narrow situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced. Third, Rule 3240 also contains several protections that restrict a registered person's ability to enter into an arrangement within the five

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Advisers Model Rule 102(a)(4)-1 (2019), available at https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf (providing that an investment adviser, an investment adviser representative or a federal covered adviser shall not engage in unethical business practices, including, among other things, "[b]orrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds" or "[l]oaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser").

39 See Notice 21-43.

exceptions (i.e., that no arrangements within the exceptions are permitted absent a member's procedures allowing the borrowing or lending of money between registered persons and customers and absent the registered person's compliance with applicable notice and approval requirements). These protections would be further strengthened through the proposed rule change to require members, when receiving written notice of a borrowing or lending arrangement, to make a reasonable assessment of the risks created by a borrowing or lending arrangement and a reasonable determination of whether to approve it.

FINRA does not believe that NASAA's model rule concerning the unethical business practices of broker-dealers and agents warrants changing the general approach of Rule 3240 as a general prohibition with narrow exceptions and associated protections. As explained above, one of the paragraphs in the NASAA model rule prohibits broker-dealer agents from engaging in the practice of borrowing or lending money or securities from a customer. Although some states have adopted that paragraph of the NASAA model rule verbatim,[40] some states have laws or regulations concerning borrowing or lending that are, in many respects, more similar to Rule 3240,[41] or even incorporate Rule

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40 See, e.g., Georgia (Ga. Comp. R. & Regs. 590-4-5-.16(2)(b)(1) (2011)); Massachusetts (950 Mass. Code Regs. 12.204(1)(b)(1) (2020)); Pennsylvania (10 Pa. Code § 305.019(c)(2)(i) (2018)).

41 See, e.g., Connecticut (Conn. Agencies Regs. § 36b-31-15b(a)(1) (1995)); Michigan (Mich. Admin. Code r.451.4.27(3)(a) (2019)); New Jersey (N.J. Admin. Code § 13:47A-6.3(a)(43) and (44) (2017)); North Carolina (18 N.C. Admin. Code 6A.1414(c)(1) (1988)).

3240 by reference.[42] Moreover, FINRA has not identified any broker-dealer laws or regulations concerning borrowing or lending arrangements in several states that have high concentrations of FINRA-registered broker-dealer firms and branches.[43] Considering that Rule 3240 has a general prohibition on both borrowing arrangements and lending arrangements, limited tailored exceptions, and associated protections, including written-procedures requirements and notice-and-approval requirements, FINRA's rule—in its current form and as proposed—is as strong, if not stronger, than many states' laws.

In addition, NASAA commented that all borrowing and lending arrangements should be prohibited because the conflicts of interest that such arrangements create cannot be mitigated by member firm policies and procedures. NASAA contended that its position is consistent with the Commission's approach regarding certain other broker-dealer conflicts of interest. In this regard, NASAA wrote that the Commission recognized in the context of Regulation Best Interest ("Reg BI") that some conflicts are so pervasive that they cannot reasonably be mitigated and must be eliminated in their entirety. NASAA contended that the direct personal incentives inherent in borrowing and lending arrangements, and the desire to collect or the duty to pay a customer, are of equal if not greater concern.

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42 See, e.g., Colorado (Colo. Code Regs. 704-1 § 51-4.7(H)(2) (2019)); Florida (Fla. Admin. Code Ann. r.69W-600.013(2)(a) (2021)); Nevada (Nev. Admin. Code § 90.327(1)(d)(1) and Nev. Admin. Code § 90.321(1) (2008)).

43 Specifically, FINRA has not identified state broker-dealer laws or regulations prohibiting borrowing or lending with customers in New York, California, Illinois or Texas. See generally 2023 FINRA Industry Snapshot at 22-23, available at https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf.

FINRA believes that the regulatory approach used in Rule 3240 is generally consistent with the approach the Commission took with Reg BI. Reg BI establishes a standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any "securities transaction or investment strategy involving securities."[44] FINRA notes that Reg BI requires broker-dealers to address conflicts of interest associated with recommendations, including through mitigation, and in certain circumstances where the Commission determined that such conflicts cannot be reasonably mitigated, through elimination. Rule 3240 is generally consistent with the spirit of this regulatory approach. In this regard, Rule 3240 generally prohibits most borrowing and lending arrangements and, thus, eliminates the potential conflicts these arrangements would present. Moreover, the proposed rule change would strengthen the general prohibition, by clarifying that it applies to arrangements that pre-exist a broker-customer relationship, extending it to arrangements that arise within six months after a broker-customer relationship ends, and adding supplementary material concerning conduct by registered persons regarding arrangements with persons related to the registered person or to the customer. Furthermore, as discussed, the rule's tailored exceptions, which would be narrowed under the proposed rule change, are for situations where the potential benefits of the borrowing or lending arrangement—including the benefits of being able to enter into some arrangements without a notice and approval process—outweigh related potential risks. In addition, the rule has additional protections (i.e., the written-procedures requirement and the notice and approval requirements) that

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44 See 17 CFR 240.15l-1(a)(1).

would be further enhanced by requiring firms to make a reasonable assessment of the risks and a reasonable determination of whether to approve the arrangement.[45]

In addition, NASAA suggested that FINRA should clarify that members may impose more stringent controls up to and including a total prohibition of borrowing and lending arrangements. When FINRA proposed to adopt Rule 3240 as part of the consolidated FINRA rulebook, it indicated that members can choose to permit registered persons to borrow money from or lend money to their customers consistent with the requirements of the rule or may be more restrictive, including prohibiting borrowing or lending arrangements in whole or in part.[46] In light of NASAA's suggestion, if the proposed rule change is approved, FINRA would reiterate this guidance in the Regulatory Notice announcing the approval of the proposed rule change.

The Immediate Family Exception

NASAA recommended eliminating the immediate family exception because elder financial exploitation is often perpetrated by family members. NASAA also contended that, if the current rule framework is maintained, notification and approval should be required for arrangements with immediate family members, particularly where the customer is a senior or may otherwise be a vulnerable adult under applicable state law. Malecki also raised concerns regarding elder financial exploitation and noted that debt

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45 Moreover, the member's reasonable assessment and determination would be informed by guidance in Notice 21-43 that the member's reasonable assessment of the risks may include consideration of, among other factors, "any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer."

46 See Securities Exchange Act Release No. 61302 (January 6, 2010), 75 FR 1672, 1673 (January 12, 2010) (Notice of Filing of File No. SR-FINRA-2009-095).

situations can easily cause serious friction within family and friends. Malecki commented that the immediate family exception is too broad, and that only a narrow exception for educational debt for children should be permitted when brokers manage their own children's accounts.

Except for proposing to modify the definition of "immediate family," FINRA does not propose to amend the existing immediate family exception or require notice and approval of arrangements with immediate family members. As explained above, the narrow exceptions to the rule—including for arrangements with immediate family members—are for situations where FINRA believes the likelihood that the registered person has borrowed from or lent money to a customer by virtue of the broker-customer relationship is reduced, and the rule contains additional protections that restrict a registered person's ability to enter into an arrangement within the exceptions.

FINRA believes that Malecki's suggestion to limit the immediate family exception to educational debt for children would narrow the exception too much. There are numerous other examples of beneficial borrowing or lending arrangements between immediate family members, including senior family members.[47] Such loans may cover, for example, medical expenses, child care or elder care expenses, emergency home repair costs, or expenses in the wake of a job loss, or they may support a family member's small business at an interest rate lower than commercially available. Furthermore, FINRA continues to believe, as it did when it previously eliminated from the predecessor to Rule 3240 notice and approval requirements for arrangements with immediate family

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47 FINRA notes that the statements in this section that apply to senior family members also apply to other family members who may be vulnerable adults.

members, that such requirements may invade the legitimate privacy interests of customers and registered persons.[48] Thus, FINRA believes the potential risks are outweighed by the potential benefits of permitting immediate family members to privately borrow from and lend to each other.

FINRA also reiterates that a registered person is prohibited from entering into a borrowing or lending arrangement with a customer who is an immediate family member, including one who is a senior investor, unless the member adopts written procedures permitting such arrangements. As explained above, members may choose to prohibit all borrowing and lending arrangements, allow only some of the exceptions enumerated in Rule 3240(a)(2), or impose limitations on the exceptions. FINRA believes that, by strengthening the general prohibition and narrowing its exceptions, the proposed rule change would further protect all investors, including senior investors.[49]

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48 See Securities Exchange Act Release No. 49081 (January 14, 2004), 69 FR 3410 (January 23, 2004) (Notice of Filing of File No. SR-NASD-2004-05) (explaining, among other things, that such requirements may invade the legitimate privacy interests of customers and registered persons).

49 FINRA has maintained a longstanding commitment to protecting senior investors and continues to work to address risks facing this investor population as part of its regulatory mission, including by adopting rules that are intended to address risks related to possible financial exploitation of senior investors. See, e.g., FINRA, Protecting Senior Investors 2015-2020 (April 30, 2020); Regulatory Notice 20-34; Rule 2165 (Financial Exploitation of Specified Adults); Rule 4512.06 (Trusted Contact Person). FINRA further notes that Rule 2010 (Standards of Commercial Honor and Principles of Trade)—which provides that a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade—protects investors from unethical behavior and is broad enough to cover a wide range of unethical conduct.

The Personal Relationship and Business Relationship Exceptions

Several commenters addressed the personal relationship and business relationship exceptions. Malecki commented that these two exceptions are too broad. Likewise, University of Pittsburgh requested that Rule 3240 limit the business relationship exception to the financial industry and noted that a registered person getting regular haircuts from a hairstylist should not fit within the business relationship exception. University of Pittsburgh also requested that FINRA provide examples of qualifying business relationships and more information about whether a business relationship qualifies for the exception. On this last point, University of Pittsburgh suggested that useful factors may include (1) the financial risks for the parties; (2) the industry involved; and (3) any other factor that may help determine the trust established between the parties and the comparative risks of their past business practices and their potential borrower-lender agreements.

FINRA shares some of these concerns and accordingly has proposed to narrow the personal relationship exception and to provide factors that are relevant to assessing whether a relationship falls within the scope of either exception. Beyond what FINRA proposed in Notice 21-43—and in response to the comments—FINRA proposes additional amendments to expressly provide that the personal and business relationships must be "bona fide"[50] and provide that an illustrative example of a "business relationship" is a loan from a registered person to a small outside business that the

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50 See proposed Rule 3240(a)(2)(D) and (E).

registered person co-owned for years for the sole purpose of providing the business with additional operating capital.[51]

FINRA does not believe, however, that additional changes to the personal and business relationship exceptions are warranted. The personal relationship exception, as proposed to be amended, would not permit "virtually anyone" to enter into a borrowing or lending arrangement.[52] Rather, the proposed rule change would narrow the personal relationship exception significantly, to apply only to personal relationships that are "bona fide" and "close," and maintained outside of, and formed prior to, the broker-customer relationship. This narrower definition would reduce the risk that a registered person would concoct a personal relationship with a customer for the purpose of entering into a borrowing or lending arrangement with that customer, and it would address concerns expressed during the retrospective rule review that the exception can be exploited.

Likewise, FINRA believes that the business relationship exception, as proposed to be amended, is appropriately tailored. Rule 3240 currently requires that the qualifying business relationships be "outside of the broker-customer relationship." This language serves to separate the business relationship from the broker-customer relationship, and thus mitigate the potential conflict of interest. The proposed rule change would further narrow this exception by requiring that the business relationship be "bona fide." FINRA does not believe that the "business relationship" exception should be further limited to

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51 See proposed Rule 3240.04. FINRA agrees that a loan from a customer from whom the registered person purchases non-commercial consumer goods or services, such as hair styling services, would not fit within the business relationship exception.

52 See Malecki.

only the financial industry. There is no indication that the risks related to arrangements based on a bona fide business relationship turn on the industry or sector involved.

With respect to University of Pittsburgh's suggested factors, FINRA notes that the proposed rule change would require members, when receiving written notice under Rule 3240, to perform a reasonable assessment of the risks created and make a reasonable determination of whether to approve the arrangement or broker-customer arrangement, as the case may be. As explained above, a member's reasonable assessment and determination would be informed by the guidance already provided in Notice 21-43, which includes a non-exhaustive list of factors to consider when evaluating whether to approve a borrowing or lending arrangement. For example, these factors include, among others, any potential conflicts of interest, the length and type of relationship, the material terms of the arrangement, and the customer's or registered person's ability to repay the loan. These factors are broad enough to cover many of the kinds of specific considerations suggested by University of Pittsburgh, including its suggestion that members consider the industry that the loan involves.

Definition of "Customer"

Under the proposed rule change, the rule's prohibition would extend to arrangements with any customer who, within the previous six months, had a securities account assigned to the registered person at any member firm.[53] NASAA suggests that the period of time used in proposed Rule 3240.02 should be one year, instead of six

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53 See proposed Rule 3240.02.

months, because Rule 4111 (Restricted Firm Obligations) uses a one-year lookback period.[54]

The Rule 4111 lookback periods (including, among others, the one-year lookback period that pertains to "Registered Persons In-Scope"[55]) impact how Rule 4111 identifies firms with a significant history of misconduct. FINRA, however, has proposed a six-month period of time to align proposed Rule 3240.02 with the six-month period in the definition of "customer" in Rule 3241, because Rule 3241 addresses similar potential conflicts of interest as Rule 3240.[56] Moreover, FINRA believes the six-month lookback period in proposed Rule 3240.02 strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change and imposing requirements that are reasonable and appropriate, including reasonable requirements on members in tracking transfers of customers' accounts.[57]

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54 PIABA also suggests that the period of time used in proposed Rule 3240.02 should be one year or more, instead of six months, and cites the time it could take to "unwind some position a registered representative might recommend." It is unclear, however, what kinds of positions this comment pertains to or what would need to be unwound.

55 See Rule 4111(i)(13).

56 Like Rule 3240, Rule 3241 addresses situations that may create potential conflicts of interest between registered persons and their customers. Specifically, Rule 3241 addresses the potential conflicts that registered persons may face when they are named a customer's beneficiary, executor or trustee, or hold a power of attorney or similar position for or on behalf of a customer. It limits any registered person from being named a beneficiary, executor or trustee, or to have a power of attorney or similar position of trust for or on behalf of a customer, and protects investors by requiring members to affirmatively address registered persons being named beneficiaries or holding positions of trusts for customers. See Regulatory Notice 20-38 (Oct. 29, 2020).

57 Prior to the adoption of Rule 3241, many members "prohibit[ed] or impos[ed] limitations on being named as a beneficiary or to a position of trust when there is

Supervision and Customer-Disclosure Requirements

NASAA suggested that members should be required to incorporate specific supervisory procedures for assessing, and after approving, a borrowing or lending arrangement. Specifically, NASAA commented that the member should be required to document (1) the steps it undertook to assess the risk prior to approving the arrangement; (2) the steps it will take to minimize the conflict of interest; (3) how it communicated to the customer the risk created by the lending arrangement or repayment terms so that the customer appreciates the risk; and (4) an outline of the supervisory measures that it will take. Regarding the member's assessment of a borrowing or lending arrangement, NASAA contended that the rule should require members to evaluate borrowing and lending arrangements, and that the member's assessment should include an interview (preferably by a compliance officer) with the customer outside of the presence of the registered person or, where that is not possible, other verification that the customer

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not a familial relationship," but FINRA "observed situations where registered representatives tried to circumvent firm policies, such as resigning as a customer's registered representative [and] transferring the customer to another registered representative." See Regulatory Notice 20-38. "To address attempted circumvention of the restrictions (e.g., by closing or transferring a customer's account)," FINRA defined "customer" in Rule 3241 to include "any customer that has, or in the previous six months had, a securities account assigned to the registered person at any member firm." Id.; Rule 3241.01. When proposing Rule 3241, FINRA explained that the inclusion of the six-month look-back period "is important in addressing potential conflicts of interest and circumvention of the proposed rule change." See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41256 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-20). FINRA further explained, in response to a comment suggesting that the proposed definition of "customer" include a 12-month lookback provision, that it "believes the six-month period strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change by transferring the customer account to another representative and imposing reasonable requirements on member firms in tracking account transfers." Id.

benefits from and entered into the arrangement on his or her own volition and without pressure. Regarding supervision after approving an arrangement, NASAA commented that members should closely monitor the account of a customer who is a party to a borrowing or lending arrangement and impose formal conditions, apply heightened scrutiny to these accounts on an ongoing, annual review basis, place the registered person on heightened supervision, and conduct additional reviews on trades and transactions to ensure that recommendations are suitable. Similarly, Malecki commented that all loans except for educational debt for children should be supervised, and that "supervision of loans" should be aligned with FINRA rules regarding outside business activities and private securities transactions.[58]

The fundamental approach of FINRA's supervision rule is to require members to establish and maintain a system to supervise the activities of each associated person that is "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[59] Likewise, the written supervisory procedures required by FINRA's supervision rule must be "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[60] In guidance, FINRA has previously explained that written supervisory procedures should include a description of the controls and procedures used by members

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58 See Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person).

59 See Rule 3110(a); see also NASD Notice to Members 99-45 (June 1999).

60 See Rule 3110(a)(1) and (b)(1).

to deter and detect misconduct and improper activity.[61] Additionally, at a minimum, written supervisory procedures should include and describe (1) the specific identification of the individual(s) responsible for supervision; (2) the supervisory steps and reviews to be taken by the appropriate supervisor; (3) the frequency of such reviews; and (4) how such reviews shall be documented.[62] FINRA does not believe it is necessary or appropriate to further prescribe specific supervisory procedures that members should use when supervising for compliance with Rule 3240.

In response to the comments, however, FINRA is proposing stronger controls for when a member considers whether to approve a borrowing or lending arrangement or, where there is a pre-existing borrowing or lending arrangement, a new broker-customer relationship—specifically, the proposed requirement that a member, upon receiving written notice under Rule 3240, perform a "reasonable assessment" of the risks and a "reasonable determination" of whether to approve the arrangement or new broker-customer relationship, as the case may be.[63] As explained above, FINRA intends that a member's reasonable assessment and reasonable determination would be informed by the guidance that FINRA provided in Notice 21-43 concerning the factors members may consider when assessing whether to approve a borrowing or lending arrangement. FINRA believes this guidance would help members, when performing the reasonable assessments and determinations required under the proposed rule change, evaluate the

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61 See NASD Notice to Members 98-96 (December 1998); see also NASD Notice to Members 99-45, supra note 59.

62 See NASD Notice to Members 98-96, supra note 61; see also NASD Notice to Members 99-45, supra note 59.

63 See proposed Rule 3240.06.

key risks and conflicts and afford appropriate flexibility in evaluating which factors may apply to a particular situation.[64]

In a related comment, NASAA suggested that FINRA should require registered persons, at a minimum, to disclose to customers the factors listed in the guidance provided in Notice 21-43. Although NASAA refers to those factors as "the Proposal's recommended disclosures," the factors in Notice 21-43 are intended to help guide a member's assessment of whether to approve a loan; they were not designed or intended to be the basis of customer disclosures about a loan. Nevertheless, FINRA notes that that guidance states that FINRA expects a member, if possible and as part of the member's evaluation of whether to approve a borrowing or lending arrangement, to try to discuss the arrangement with the customer.

Retroactivity

NASAA commented that applying the proposed rule change retroactively could provide benefits to investors and recommended retroactive disclosure of pre-existing borrowing and lending arrangements.[65] FINRA seeks, however, to avoid creating

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64 With respect to Malecki's comment that "supervision of loans" should be aligned with FINRA rules regarding outside business activities and private securities transactions, FINRA notes that Rule 3270 does not require members to "supervise" outside business activities. However, if a loan constitutes a private securities transaction, then Rule 3280—and any applicable supervisory obligations—would apply. See Rule 3280(c)(2) (discussing supervisory requirements involving private securities transactions for compensation); 3280(d) (discussing private securities transactions not for compensation, where a member may "at its discretion" require the person to adhere to specified conditions); 3280(e)(1) (defining "private securities transaction" and several exclusions to that definition).

65 FINRA assumes that NASAA's comment about "pre-existing" arrangements concerns arrangements that were entered into before the effective date of the proposed rule change.

situations that would require registered persons and customers to terminate borrowing or lending arrangements or broker-customer relationships that, when entered into, were permissible under the current version of Rule 3240. In general, the proposed rule change would not apply retroactively to borrowing or lending arrangements that were entered into prior to the effective date of the proposed rule change and were permissible under the current version of Rule 3240.[66] Rather, the proposed rule change would apply only to (1) new arrangements and new broker-customer relationships that occur after the effective date of the proposed rule change; and (2) modifications that occur after the effective date of the proposed rule change of borrowing or lending arrangements that were entered into before the effective date.[67] Although FINRA is not proposing to require members to re-evaluate previously approved arrangements, members would have the discretion to do so.[68]

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66 For example, the proposed rule change to narrow the personal relationship exception would not apply retroactively to a borrowing or lending arrangement that was entered into prior to the effective date of the proposed rule change and that was permissible under the current personal relationship exception.

67 FINRA reiterates, however, that the current rule's general prohibition against borrowing and lending arrangements between registered persons and customers already applies to arrangements that pre-existed the formation of the broker-customer relationship, and that the proposed rule change would clarify that scope.

68 FINRA also notes that FINRA's supervision rule would require a member to follow-up on "red flags" indicating problematic activity related to borrowing or lending arrangements between registered persons and their customers, including arrangements that were entered into prior to the effective date of the proposed amendments. See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-20) (explaining that Rule 3110 (Supervision) includes the "longstanding obligation to follow-up on 'red flags' indicating problematic activity").

Harmonization of Regulatory Approaches to Financial Professionals' Borrowing and Lending Arrangements

In Notice 21-43, FINRA described some similarities and differences between Rule 3240 and the federal and state regulatory approaches for investment advisers and their supervised persons. FINRA sought to encourage and inform a broader dialogue about whether the similar risks presented when any financial professional borrows from or lends money to customers warrants a more uniform approach to regulating this activity. SIFMA commented that it welcomes a discussion on harmonizing the regulatory approaches, where appropriate.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2024-XXX on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2024-001. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. Do not include personal identifiable information in submissions; you should submit only information that you wish to make available publicly. We may redact in part or withhold entirely from publication submitted material

that is obscene or subject to copyright protection. All submissions should refer to File Number SR-FINRA-2024-001 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[69]

Jill M. Peterson
Assistant Secretary

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69 17 CFR 200.30-3(a)(12).

Exhibit 2a

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

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.

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

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.

* * * * *

Caleb Benore Comment On Regulatory Notice 21-43

Caleb Benore
N/A

As a layman, I find the practice of share lending to be disappointing. Many people trust their brokers and relevant institutions to act in ways that aren't detrimental to their portfolio. Lending shares (even from ETFs) to satisfy the borrowing needs of short sellers? This needs to end. Retail's confidence in US capital markets has all but evaporated at this point. So really, things couldn't be much worse if the practice continues. I suppose what this rule amendment depends on is this: do veteran or well-vested market participants care anymore?

sifma

February 14, 2022

SUBMITTED TO: pubcom@finra.org

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

Re: Regulatory Notice 21-43: Proposed Amendments to FINRA Rule 3240 (Borrowing from or Lending to Customers)

Dear Ms. Piorko Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposed amendments to Financial Industry Regulatory Authority ("FINRA") Rule 3240.[2] We appreciate FINRA's retrospective review of this and other rules to better protect seniors and vulnerable adults from financial exploitation, a shared goal of ours. We support the amendments that modernize the definition of "Immediate Family," align certain definitions with Rule 3241, and provide greater clarity and guidance in assessing which arrangements may be permissible under the exceptions to the prohibition. SIFMA looks forward to continuing to work with FINRA to address any practical supervisory challenges that may be created by the pre- and post- relationship aspect of the rule. We also welcome a discussion on harmonizing, where appropriate, FINRA, federal, and state investment adviser laws regulating borrowing and lending arrangements.

Respectfully submitted,

Bernard V. Canepa

Bernard V. Canepa
Managing Director and Associate General Counsel

[1] SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate for legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. With offices in New York and Washington, D.C., SIFMA is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] FINRA Regulatory Notice 21-43, *Prohibition on Borrowing From or Lending to Customers* (Dec. 16, 2021).

PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION
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February 14, 2022

Via email to: pubcom@finra.org
Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: **FINRA Regulatory Notice 21-43**
(FINRA proposed amendments to FINRA Rule 3240 and Retrospective Rule Review report)

Dear Ms. Piorko Mitchell:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that govern the practices of brokers and broker-dealer firms.

PIABA welcomes the opportunity to comment on the proposed amendments to FINRA Rule 3240 and the retrospective rule review report. In October 2019, PIABA commented on FINRA's retrospective review that, among other things, sought feedback on the effectiveness of FINRA Rule 3240 which is a prohibition on borrowing from or lending to customers. PIABA's position was, and largely remains what we previously described:

Rule 3240 has been effective in protecting investors and public interest, specifically by addressing potential misconduct relating to associated persons of broker-dealer firms borrowing from or lending money to customers. Specifically, the Rule has served to deter fraud and manipulative practices involving senior investors' retirement savings by prohibiting such conduct. PIABA believes that, in situations where one of the enumerated exceptions apply, the current rule is broad enough to cover those instances in which lending or borrowing money from customers may be

acceptable. Importantly, such situations first require appropriate disclosures and pre-approval by the broker-dealer firm, which is crucial to ensuring compliance with the Rule.

In this follow-up rule review, PIABA emphasizes that the obvious conflicts of interest and possibilities for abuse when registered representatives borrow or lend money to clients are major problems. FINRA Regulatory Notice 21-43 seemingly strengthens Rule 3240 and PIABA supports the effort. In fact, the simple step of changing the name of the rule from "Borrowing from or Lending to Customer" to "*Prohibition on* Borrowing from or Lending to Customers" makes FINRA's position on the topic very clear. (Emphasis added). There should be no doubt that these arrangements between registered persons and customers are not allowed in the financial services industry. The name change would leave no doubt. Violators of the rule have no excuse.

More specifically, strengthening the rule to broaden it and apply it to borrowing or lending arrangements that pre-exist the broker-customer relationship is a good amendment. Conflicts of interest would exist in the relationship irrespective of whether or not a lending arrangement existed before or after the broker-customer relationship is established. PIABA supports making clear that if a broker is already in a non-exempt lending relationship with a person that said person may not become a client.

Similarly, PIABA supports extending the definition of customer to those with existing accounts *and* those who had accounts with a registered person in the previous six months. In fact, based on the time it takes to unwind some position a registered representative might recommend, PIABA suggests that FINRA extend the proposed cooling off period to one year or more.

It is also a good idea to make clear that the prohibition extends to not just the registered person themselves but also to a person or entity related to the registered person. The same or very similar conflict of interest is present if a registered representative's close family member obtains a loan from a registered representative's client just as if the registered representative obtained it themselves. Knowing a relative or related entity stood to potentially benefit from a client's well-being creates the potential for a conflict to arise.

Finally, PIABA is in favor of modernizing the "immediate family" definition and limiting the "personal relationship" and "business relationship" exceptions. The risk of harm here is too great to leave the potential for abuse. PIABA commends any effort to limit the exceptions and make very clear that this conduct is not allowed.

PIABA acknowledges and appreciates the opportunity to comment on this important issue. PIABA applauds FINRA's effort to root out the problem that taking loans from clients or lending money to clients presents. We thank you for the opportunity to comment and urge FINRA to continue its efforts to curb this abusive conduct.

Sincerely,

Michael Edmiston
President, PIABA

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February 14, 2022

By email to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006

RE: Regulatory Notice 21-43: Prohibition on Borrowing from or Lending to Customers

Dear Ms. Mitchell:

I am writing on behalf of the North American Securities Administrators Association, Inc. ("NASAA")[1] in response to Financial Industry Regulatory Authority ("FINRA") *Regulatory Notice 21-43: Prohibition on Borrowing from or Lending to Customers – Proposed Amendments to FINRA Rule 3240 and Retrospective Rule Review Report* (the "Proposal"),[2] which would amend the current prohibition on borrowing from or lending to customers and would expand on exceptions to the prohibition. NASAA previously commented on proposed changes to Rule 3420 through Regulatory Notice 19-27.[3] While we applaud FINRA for taking steps toward protecting investors from borrowing and lending arrangements that may not be in their best interests, NASAA's positions have not changed since the October 2019 letter.

In brief, NASAA maintains that there should be an outright prohibition on borrowing from or lending to customers, including family members. The conflicts of interest for a registered person inherent in a lender-debtor relationship and the potential harm to investors outweigh any benefit to be gained under this rule. Should FINRA, however, decide to move forward with allowing borrowing and lending arrangements to exist between registered persons and their customers, the related accounts should be subject to, at a minimum, heightened supervision to ensure that any conditions and limitations imposed by the firm are followed. Additionally, the cooling off period before entering into a lending or borrowing arrangement with a former customer should be extended to at least 12 months.

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] The Proposal is available at https://www.finra.org/sites/default/files/2021-12/Regulatory-Notice-21-43.pdf.

[3] *See* Letter from Chris Gerold, NASAA President, to Jennifer Piorko Mitchell, FINRA Office of the Corporate Secretary, *Re: Regulatory Notice 19-27: Retrospective Rule Review* (Oct. 8, 2019) at 5-7, *available at* https://www.nasaa.org/wp-content/uploads/2019/10/NASAA-Comment-Letter-Re-Reg-Notice-19-27-10-8-19.pdf.

I. The Proposed Rule Would Continue to Subject Registered Persons to Disparate Regulatory Requirements.

The proposed amendments to Rule 3240 would allow registered persons to maintain pre-existing loan agreements or enter into new agreements with customers as long as certain criteria are met.[4] NASAA asserts that a registered person should simply be prohibited from these loan agreements with customers. In 1983, NASAA members adopted the Dishonest or Unethical Business Practices of Broker-Dealers and Agents model rule, which prohibits such conduct.[5] Since that time, 44 jurisdictions have enacted the model rule in part or in whole. The rule prohibits agents from "[e]ngaging in the practice of lending or borrowing money or securities from a customer, or acting as a custodian for money, securities or an executed stock power of a customer."[6] NASAA included similar provisions in a model rule applicable to investment advisers.[7] NASAA maintains that the conflicts of interest that exist when a registered person enters into a lending or borrowing arrangement cannot simply be mitigated by additional policies and procedures imposed by the registered person's firm.

NASAA's position is consistent with the approach of the Securities and Exchange Commission (the "Commission") with regard to certain other broker-dealer conflicts of interest.

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[4] Proposal at 3. Those criteria include:

- 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] NASAA Model Rule, *Dishonest or Unethical Business Practices of Broker-Dealer Agents*, May 23, 1983, *available at* https://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf.

[6] *Id.* at 3. *See also*, *e.g.*, 10 Pa. Code § 305.019 (1990, amended 2018); Tenn. Comp. R. & Regs. 0780-04-03-.02 (1983; amended 2016); Wis. Admin. Code DFI-Sec § 4.06 (1983; amended 2009); Wash. Admin. Code §460-22B-090(1).

[7] NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers Model Rule 102(a)(4)-1 (2019), *available at* NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf. Prohibiting investment advisers from:

- Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser or a financial institution engaged in the business of loaning funds.
- Loaning money or securities to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

As the Commission recognizes in the context of Regulation Best Interest – where it has required the elimination of sales contests, sales quotas and certain compensation arrangements – some conflicts of interest are "so pervasive such that they cannot be reasonably mitigated and must be eliminated in their entirety, as we believe they create too strong of an incentive for the associated person to make a recommendation that places their financial and other interest ahead of the interest of retail customers' interests …."[8] The direct personal incentives inherent in lending and borrowing arrangements, and the desire to collect or the duty to pay a customer, are of equal if not greater concern. Though the Proposal addresses the fiduciary duties of federally registered investment advisers, similar requirements and responsibilities under Regulation Best interest must be considered in context of the proposed amendments. Ultimately, we believe that these arrangements should be prohibited entirely.

We also note that the Proposal updates the definition of immediate family to align with the definition in Rule 3421. NASAA supports this modernization and appreciates the decision to narrow the inclusion of financially-supported persons as "immediate family" to those who live in the same household as the registered person. However, family members are not immune from, and may in fact be susceptible to, fraudulent activities and bad actors. While statistics on familial fraud are limited,[9] by focusing on the elderly and those at a higher risk of abuse we see that in almost 60% of elder abuse and neglect incidents the perpetrator is a family member.[10] Given the stakes at issue – namely investor protection from predatory lending or undue influence in a broker-customer relationship – it is not prudent to allow an exception to regulatory scrutiny based on assumptions about familial fidelity. For that reason, if FINRA retains the current framework for Rule 3240, NASAA recommends that even borrowing from or loaning to customers that are immediate family members should be subject to firm scrutiny and approval. This is particularly important where the customer is a senior or may otherwise be a vulnerable adult under applicable state law.

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[8] SEC Rel. No. 34-86031, *Regulation Best Interest: The Broker-Dealer Standard of Conduct* (June 5, 2019) at 352-53.

[9] *See* Strategic Finance, *Shattered Trust: Fraud in the Family*, Stephen Pedneault and Bonita Peterson Kramer (May 1, 2015), *available at* https://sfmagazine.com/post-entry/may-2015-shattered-trust-fraud-in-the-family/; *see also* AARP, *Older Americans Hit Hard by Financial Fraud*, Katherine Skiba (Feb. 28, 2019), *available at* https://www.aarp.org/money/scams-fraud/info-2019/cfpb-report-financial-elder-abuse.html (noting that nearly 40% of reported elder financial abuse came from a family member or fiduciary).

[10] National Council on Aging, *Elder Abuse Facts* (accessed Feb. 2, 2022), *available at* https://www.ncoa.org/public-policy-action/elder-justice/elder-abuse-facts/; *see also* Stephen Deane, SEC Office of the Investor Advocate, *Elder Financial Exploitation – Why it is a concern, what regulators are doing about it, and Looking Ahead* (June 2018) at 23, *available at* https://www.sec.gov/files/elder-financialexploitation.pdf (citing MetLife Mature Market Inst. et al, *The MetLife Study of Elder Financial Abuse: Crimes of Occasion, Desperation, and Predations Against America's Elders 5* (2011) (stating that data at that time showed that 55% of financial abuse in the United States is committed by family members, caregivers, and close friends).

II. FINRA Must Implement Stronger Guidelines, Disclosure Requirements, and Lockout Periods for the Proposed Rule to Protect Investors.

The Proposal provides a non-exclusive, non-exhaustive list of potential factors for a firm to consider as part of its written policy on loans between registered persons and customers. Yet, firms are not required to take any particular consideration into account. That is too lax. The rule should require a minimum amount of disclosure and required evaluation, from which the firms can elevate to a higher standard, to ensure adequate consideration among similar situations across similarly situated firms. Registered persons entering into these agreements should be required, at a minimum, to disclose the Proposal's recommended disclosures.[11] Likewise, NASAA believes that a robust documentation program should include, at a minimum, the firm's consideration of:

- the steps that the member firm undertook to assess the risk prior to the registered person being approved to enter into the loan agreement;
- the steps that the member firm will take to minimize the conflict of interest;
- how the member firm communicated to the customer the risk created by the loan agreement and repayment terms so that the customer appreciates the risk; and
- an outline of the supervisory measures that will be taken by the member firm.

These measures should be required in addition to the non-exclusive list of potential factors suggested by FINRA. Requiring defined disclosures and assessment considerations would allow regulators to assess and compare approval and supervision practices across firms. In guidance or

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[11] Proposal at 10-11. FINRA suggests that firms consider:

- 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.

NASAA strongly supports documentation and disclosure regarding age, mental capacity, or other arrangements the broker has entered that may show a pattern or practice of participating in loan agreements with customers.

otherwise, FINRA should make it clear that firms are free to impose more stringent controls up to and including a flat prohibition on such arrangements.

A reasonable assessment and determination process should also include an interview (preferably by a compliance officer in the firm) with the customer outside of the presence of the registered person. This practice would help ensure that the customer understands the terms of the loan agreement, has not been coerced, and does not show indicia of vulnerability or undue influence. Where it is not possible to interview the customer (either in person or online), the firm should at least be required to verify that the customer benefits from and entered into the loan of his or her own volition and did not feel pressure to do so.

The Proposal points out the similarities between Rule 3240 and Rule 3241 and similar potential conflicts of interest.[12] NASAA commented on Proposed Rule 3241 and FINRA Regulatory Notice 19-36, recommending heightened scrutiny of accounts where brokers hold a position of trust.[13] We believe a similar requirement, where firms must closely monitor the account where formal conditions are imposed by the firm, would significantly benefit investor protection. However, if the final rule does not require a firm to impose formal conditions, heightened scrutiny should be applied to these accounts on an ongoing, annual review basis.

In any situation where there is a loan agreement between a client and registered person, the firm should put the registered person on heightened supervision due to conflicts of interest and place additional reviews on trades and transactions in the account to ensure that the registered person is making suitable recommendations. As the senior population in the United States grows, instances of isolated senior investors will continue to increase. While these relationships can start with good intentions, they have the potential to become exploitative. In more malevolent cases, a registered person may "groom" a customer with the goal of exploitation.[14]

To that end, the proposal seeks comment on whether a six-month look-back period is sufficient for determining whether an individual was a registered person's "customer" prior to entering into a lending or borrowing arrangement.[15] Predatory lending practices or the inability to repay a loan could be detrimental to an investor's financial wellbeing. We believe that a 12-month period would significantly curtail attempts to circumvent the purpose of Proposed Rule 3240 and would inure to the benefit of investors. When accounting for the books and records requirements for much of the same data, which can run from three to six years, NASAA does not believe that a 12-month look-back period is overly burdensome. In a similar context, FINRA Rule 4111 uses a one-year lookback period for restricted firm obligations and "registered person[s] in scope." When

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12 *Id.* at 10.

13 Letter from Chris Gerold, NASAA President, to Jennifer Piorko Michelle, FINRA Office of the Corporate Secretary, *Re: Regulatory Notice 19-36: Rule to Limit a Registered Person from Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer* (Jan. 24, 2020), *available at* https://www.nasaa.org/wpcontent/uploads/2020/01/NASAA-Comment-Letter-re-Finra-Reg-Notice-19-36.pdf.

14 *Id.* at 4.

15 Proposal at 13.

attempting to protect investors from potential fraud or abuse, which could lead to Rule 4111 restrictions, a similar 12-month look-back provision would be appropriate.

Finally, the Proposal notes that FINRA does not plan to implement this rule with a retroactive application.[16] NASAA understands the argument that applying this rule to pre-existing loan agreements may constitute a significant undertaking.[17] We also appreciate that most agreements fall under the current, less stringent iteration of Rule 3420. However, the costs associated with applying the new rule retroactively could provide benefits to investors by identifying potential ongoing abuses, high-risk registered persons or firms that were close to the line under the old rule, and areas of concern for regulators. By requiring retroactive disclosure of these agreements, FINRA and regulators will be informed of the number of potentially problematic loan agreements and firms that may require further review. In those instances where brokers or firms have a high concentration of loan agreements, further action or requirements may be warranted.[18]

III. Conclusion

NASAA appreciates the opportunity to comment on the Proposal. In summary, NASAA believes that borrowing from or lending to customers should not be permitted. Should FINRA decide to move forward with allowing such arrangements as proposed, it should establish clear standards for firms by laying a foundation for the information that registered persons must provide and more specific guidelines on considerations for firm approval. In addition, the accounts in question should be subject to heightened supervision to ensure that the conditions and restrictions are met. Finally, the resulting final rule should be applied to both current and future customers.

Thank you for considering these views. NASAA looks forward to continuing to work with FINRA in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

Melanie Senter Lubin
NASAA President
Maryland Securities Commissioner

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[16] *Id.* at 7.

[17] Subject to the other concerns noted in this letter, NASAA generally supports the position that pre-existing loans when a broker joins a firm must be documented, disclosed, and remediated before entering the broker-customer relationship.

[18] *See, e.g.*, FINRA Rule 4111 – Restricted Firm Obligations.

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February 14, 2022

Marcia E. Asquith
Executive Vice President, Board and External Relations
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To Whom it May Concern,

Malecki Law files this comment in response to the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 21-43 and proposed amendments to FINRA Rule 3240 regarding the effectiveness and efficiency of FINRA's proposal to adopt a new and modified rule that addresses borrowing and lending arrangements between registered persons and customers.

Although the proposed amendments will better define the prohibitions to the exception, we suggest that borrowing and lending with brokerage customers should be eliminated. We believe that the exceptions proposed by FINRA should be more limited, and that these exceptions be supervised on an ongoing basis, just like outside business activities and private securities transactions under FINRA Rules 3270 and 3280, respectively.

The first exception we want to address is the immediate family exception. This articulates who qualifies as an immediate family member and provides that immediate family members will always be an exception. It is too broad.

Debt situations can easily cause serious friction within family and friends, as well as business associates. In my over thirty years of practice in the securities field, I have seen many cases where multiple siblings or partners within a business will question any borrowing, lending, and brokering transactions amongst one another. The friction only increases when the broker is involved and is also managing related assets. This is neither good for public investors or for the brokerage and advisor communities.

As the last Federal Reserve survey details, income and planning for repaying debt often involve financial forecasting in income and assets – income and assets that are often managed by the broker or advisor in the debt relationship with the customer:

> Debt Burden
>
> The ability of individual families to service their loans is a function of many factors, including the level of their loan payments and the income and assets they have available to meet those payments. In planning their borrowing, families make assumptions about their future ability to repay their loans. Problems may occur when events turn out to be contrary to those assumptions. If economic shocks are sufficiently large and prevalent, a broad pattern of default, restraint in spending, and financial distress in the wider economy might ensue.

https://www.federalreserve.gov/publications/2020-bulletin-changes-in-us-family-finances-from-2016-to-2019.htm. The Federal Reserve indicates that friends and family debt accounts for $89 billion annually, according to the most recent Federal Reserve Board Survey of Consumer Finances. https://www.federalreserve.gov/econres/scfindex.htm.

Certainly educational debt for children should be permitted at the same time a parent broker or advisor may manage their children's accounts (which in large part they typically fund). However, other scenarios are problematic, as we see in countless advisory pieces from regulators around the country. As FINRA has itself observed in the senior investor context:

> "a number of recent studies indicate that the vast majority of elder financial exploitation is perpetrated by strangers, **family members** and caregivers, rather than by brokerdealers or other financial services organizations. See, e.g., Consumer Financial Protection Bureau's Office of Financial Protection for Older Americans, Suspicious Activity Reports on Elder Financial Exploitation: Issues and Trends, at 18 (Feb. 2019); Statistics and Data on Elder Abuse, The National Center for Elder Abuse, Who are the Perpetrators?."

See FINRA Regulatory Notice 19-27, https://www.finra.org/rules-guidance/notices/19-27. (Emphasis added).

Lending and borrowing with a customer, even a family member, present potential problems when there are payment deficiencies. For example, just one area of conflict raises questions about whether what is happening in the investment account is best for the customer or best for repayment of the loan. As a result, ongoing monitoring of any lending, with the exception of a child's educational lending, would need to be closely supervised to insure that the "tail does not wag the dog." There is no justification for including supervision of loans in FINRA Rule 3270, only to then omit it from 3240. It is incongruous and confusing – although the purpose of supervision on both would be the same, i.e., to make sure the customer is protected.

FINRA's own website also details that supervision and oversight is critical with respect to FINRA Rule 3270:

> "Monitoring significant changes in or other red flags relating to registered representatives' or associated persons' performance, production levels, or lifestyle that may indicate involvement in undisclosed or prohibited OBAs and PSTs **(or other business or financial arrangements with their customers, such as borrowing or lending), including conducting regular, periodic background checks and reviews of**:
>
> - correspondence (including social media);
> - fund movements;
> - marketing materials;
> - online activities;
> - customer complaints; and
> - financial records (including bank statements and tax returns).

FINRA explanation of Rule 3270 https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/obas-and-psts (emphasis added).

There are thousands of brokers and advisors in America. If a public investor or broker/advisor needs a loan or gives a loan to a family member, there are plenty of other brokers/advisors available to take over the debtor or lender's investment account until the loan is repaid.

The fourth and fifth exceptions are the most problematic and arguably give the most leeway to open borrowing/lending arrangements to any customer and registered members. Under the fourth exception, lending arrangements can be permitted when such an 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 registered person did not maintain a relationship outside of the broker customer relationship."

This exception essentially states that anyone with a personal relationship outside the broker and customer context could meet the exception. This exception specifically is a very slippery slope. In theory and in practice, this exception could apply to virtually anyone because it would be easy to say that a broker and a customer have a personal relationship outside of the broker-customer context and allows virtually anyone to use that in an effort to get around the general prohibition. The same could be said of exception e.

With the exception of educational debt, all loans (including modifications and extensions) should be required to go through the approval and notification requirement, as well as ongoing monitoring and supervision. Without ongoing monitoring, the rule is "form over substance." The client is in a compromised and vulnerable position when the client has multiple financial relationships with the broker, inside and outside the firm.

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When brokers engage in outside business activity, that activity must be monitored. In the same vein, loans between clients and brokers should be similarly monitored to ensure that loans do not cause unwanted speculation to get ahead of loan debt.

Sincerely,

Jenice L. Malecki

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February 14, 2022

via email to pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
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RE: Regulatory Notice 21-43: Proposed Amendments to FINRA Rule 3240 and Retrospective Rule Review Report

Dear Ms. Mitchell:

The University of Pittsburgh Securities Arbitration Clinic (the "Clinic") appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") retrospective rule review on issues relating to the proposed amendments to FINRA Rule 3240. The Clinic, a University of Pittsburgh curricular offering, provides legal representation to investors with limited resources, often advocating for people whose claims represent much of their life savings. The Clinic offers the following commentary on the proposed amendments to Rule 3240.

General Effectiveness and Challenges of the Current Rule 3240 and the Benefits of Amendment

FINRA has drafted Rule 3240 to prohibit borrowing and lending arrangements between registered persons and their customers to decrease the chance that registered persons will solicit customers for abusive loan arrangements. The current rule has instances of language that leave the potential for misuse.

The importance of regulations that protect consumers from predatory lending actions has been evident since adopting the 1968 Truth in Lending Act.[1] The Truth in Lending Act "was the first federal consumer protection law and is considered a leading consumer protection statute" and features regulations requiring the use of standard terminology and uniform disclosure requirements.[2] While the Truth in Lending Act pertains to the regulation of credit loans, its purpose of protecting customers from predatory lending behaviors highlights the importance of tightening the language of Rule 3240 to ensure that customers are protected.

[1] 15 U.S.C. §§1601, *et seq.*
[2] Daniel Rothstein, Comment, *Truth in Lending: The Right to Rescind and the Statute of Limitations*, 14 Pace L. Rev. 633, 634 (1994).

Member firms have long recognized that registered persons accepting loans from customers is problematic.[3] FINRA has also recognized several instances where registered persons formed abusive lending arrangements with elderly investors in Regulatory Notice 19-27,[4] where FINRA initially asked for comment on Rule 3240. Additionally, there have been several other instances where registered persons formed such arrangements with senior customers within the past year.[5] Furthermore, in Regulatory Notice 19-27, FINRA also recognized attempts by registered persons to work around the rule "by having another registered person handle the account or by listing a spouse on loan documents."

We believe that the proposed amendments to Rule 3240 tighten the language and serve further to ensure the protection of consumers from predatory lending arrangements and thus that the proposed changes are beneficial, especially for elderly investors.

Financial Exploitation of Elderly Populations Is Prevalent

FINRA and the University of Pittsburgh School of Law's Securities Arbitration Clinic maintain a shared goal to protect elderly investors from financial exploitation. Despite rules such as 3240 being in place, financial exploitation of elders remains prevalent. Further tightening of Rule 3240 would help close loopholes that leave elders vulnerable to financial abuse.

In 2021, the Consumer Financial Protection Bureau released a report detailing the prevailing issue of elder financial exploitation in the United States.[6] Financial institutions filed over 62,000 elder financial exploitation suspicious activity reports in 2020, such reports implicating over $3.4 billion.[7] The 2021 report notes a steady increase in these suspicious activity reports and the amount of money implicated, up from 21,656 reports, totaling an estimated amount of $900 million in 2014.[8] Moreover, most of these reports are flagged and filed by financial institutions rather than the elderly customers themselves, showing their vulnerability and lower propensity to note these financial abuses themselves without these external protections.[9]

Reported elderly financial abuse will likely continue to grow as the elderly population increases in the United States. The National Center on Elder Abuse reports that as of 2018, there

[3] *See, e.g., McNabb v. SEC*, 298 F.3d 1126, 1129 (9th Cir. 2002) (where a broker-dealer was terminated from his member firm "in part on the grounds that he had violated the firm's policy against accepting loans from customers.").
[4] *See, e.g., Michael Mendenhall*, OHO Decision, Case ID 2009020489901 (July 25, 2012); *Katherine Ann White*, OHO Decision, Case ID 2015045601401 (April 7, 2017).
[5] *See, e.g., Alan Price*, FINRA Disciplinary Proceeding, Case ID 2020066136801 (January 25, 2022); *Steven Patrick Melen*, FINRA Letter of Acceptance, Waiver, and Consent, Case ID 2019062323801 (April 15, 2021); *Cynthia Kay Whitman*, FINRA Letter of Acceptance, Waiver, and Consent, Case ID 2020065709801 (April 26, 2021).
[6] Consumer Financial Protection Bureau, Suspicious Activity Reports on Elder Financial Exploitation (2020). https://www.consumerfinance.gov/consumer-tools/educator-tools/resources-for-older-adults/data-spotlight-suspicious-activity-reports-on-elder-financial-exploitation/ (Last accessed February 12, 2022).
[7] *Id.*
[8] *Id.*
[9] *Id.*

were 52.4 million adults aged 65 and over in the United States.[10] The organization estimates that by 2040, that number will have grown to 80 million, comprising almost 21% of the population.[11] Additionally, as of 2016, the population aged 85 was estimated to have nearly tripled, rising to 19 million from the reported 6.7 million.[12] The number of individuals left vulnerable to financial abuse, and the ever-growing economic impact of that abuse, provide a sufficient basis to further narrow rules, such as Rule 3240, which provide critical protections to vulnerable elderly investors.

The Center reported that financial abuse is the most prevalent among the various forms of elder abuse.[13] The Pennsylvania Department of Aging released a report in September 2020 detailing a case study of financial exploitation of older adults in Pennsylvania.[14] The report noted that 15% of the perpetrators were outside the family, friend, or caregiver categories.[15] Scams and loans made up 36% of the fraud reported, totaling an estimated loss of over $4 million.[16] Of those studied, only 4% of all losses were recovered.[17] A similar study in New York reflected a similar recovery percentage, with only 5% of those studied recovering their losses partially or fully.[18] Given the economic implications, the category of individuals outside of family and friends who commit the financial abuse, that scams and loans are two of the top three categories of abuse, and the low recovery rates, we agree that FINRA should narrow Rule 3240 to the greatest extent possible to prevent vulnerable elderly investors from prevalent and ever-growing financial abuse through loans.

Moreover, registered persons are vulnerable to growing punishments for financial abuse. Pennsylvania recently amended their criminal code to add financial exploitation of an older adult or care-dependent person by a person in a position of trust as a criminally punishable offense.[19] This creates a felony offense for financial exploitation that leads to a loss of property in the specified amounts.[20] The statute describes a person in a "position of trust" as "[a] person [who] has a fiduciary obligation to an older adult or care-dependent person, including through the power of attorney, guardianship, custodianship or conservatorship or as a trustee or personal representative."[21] Investment advisers could presumably be held criminally liable for offenses under this definition. Given the grave consequences of the statute, it is clear that the narrowing of exceptions of Rule 3240 is in line with a growing trend to protect against financial exploitation of elder adults.

For the preceding reasons, we make the following agreements or recommendations to the proposed amendments to Rule 3240.

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[10] National Center on Elder Abuse, Research, Statistics, and Data, (2020). https://www.consumerfinance.gov/consumer-tools/educator-tools/resources-for-older-adults/data-spotlight-suspicious-activity-reports-on-elder-financial-exploitation/ (Last accessed February 12, 2022).
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] Pennsylvania Department of Aging, Financial Exploitation of Older Adults: Study Report (September 2020).
[15] *Id.*, at 23.
[16] *Id.*, at 25.
[17] *Id.*, at 27.
[18] *Id.*
[19] Financial Exploitation of An Older Adult or Care-Dependent Person, 18 PA. C.S., § 3922.1 (2021).
[20] *Id.*
[21] 18 PA. C.S., §3922.1(f)(2)(3).

General Approval of Proposed Amendments:

Amendments that Strengthen the General Prohibition against Borrowing and Lending Arrangements

1. **Proposed change to the title of rule: "Borrowing from or Lending to Customers" → "Prohibition on Borrowing From or Lending to Customers"; Title of Rule 3240(a): "Permissible Lending Arrangements; Conditions" → "General Prohibition; Permissible Borrowing or Lending Arrangements; Conditions."**

We agree with these proposed changes to the titles of the rules as it increases clarity on the fact that forming borrowing or lending arrangements with customers is generally prohibited, with the exceptions stated in Rule 3240(a)(2)(A), (B), (C), (D), and (E).

2. **Proposed broadening of Rule 3240(a)'s "general requirements for borrowing and lending arrangements to apply to arrangements that pre-exist a new broker-customer relationship"; Proposed Supplementary Material 3240.02 that "would define "customer" to include . . . any customer that has, or in the previous six months had, a securities account assigned to the registered person at any member."; Proposed Supplementary Material 3240.05 extended the rule's requirements to "Arrangements with Persons Related to Either the Registered Person or the Customer."**

We agree with broadening the group as to whom this rule would apply. We believe that these changes would provide an adequate safeguard against the potential exploitation of customers by registered persons. If a registered person were allowed to form borrowing or lending arrangements immediately prior to the formation of a broker-customer relationship, a registered person who is not working in good faith might attempt to create an exploitative borrowing or lending arrangement prior to the formation of a broker-customer relationship to avoid the wording of the rules.

Likewise, proposed Supplementary Material 3240.02's expanded definition of "customer" to include any customer that has had a securities account assigned to the registered person within the past six months decreases the chance that a registered person acting in bad faith would terminate a broker-customer relationship specifically to form an exploitative borrowing or lending arrangement.

Proposed Supplementary Material 3240.05 also decreases the risk of exploitative borrowing or lending arrangements being formed by extending the rule's requirements so that registered persons or customers cannot include borrowing or lending arrangements with persons related to the other.

These proposed changes reduce the risk of a registered person succeeding in exploitative behavior and increase security in the member's handling of their customers.

3. **Proposed Supplementary Material 3240.03 that would state "borrowing and lending arrangements include owner-financing arrangements that do not involve borrowing or lending of money."**

We approve of this proposed amendment as it codifies a pre-existing interpretation of Rule 3240 and will simplify the interpretation process.

Amendments of the Definitions of "Immediate Family," "Personal Relationship," and "Business Relationship"

1. **Proposed modernization of Rule 3240(c)'s "Immediate Family" definition; Addition of "step and adoptive relationships"**

We approve of the modernization of the "Immediate Family" definition in the proposed change of "husband or wife" to "spouse or domestic partner" and the addition of step and adoptive relationships. These additions properly account for the changes in the modern social definition of "immediate family," mirroring the definition of "immediate family" as now defined in Rule 3241.

2. **Proposed narrowing of Rule 3240(a)(2)(D)'s "Personal Relationship" exception to require it to be a "close personal relationship between the registered person and the customer maintained outside of, and formed prior to, the broker-customer relationship"**

We agree with the proposed amendment to Rule 3240(a)(2)(D) and proposed Supplementary Material 3240.04, as it would serve to prevent relationships from being formed under false pretenses to take advantage of a customer. By requiring personal relationships to be "close" relationships formed prior to and maintained outside of the broker-customer relationship, the risk of a registered person successfully creating a close personal relationship in bad faith solely to exploit their customer is decreased. This narrows the rule's language so that it is not as open to such risks.

3. **Proposed Supplementary Material 3240.04's "factors for evaluating whether a borrowing or lending arrangement is based on a 'close personal relationship' or a 'business relationship," and examples of a close personal relationship**

We agree with the need to define and narrow "close personal relationship" and "business relationship" to prevent exploitation of these exceptions. Overall, the amendments provided specifically define "close personal relationship," leaving uncertainty around what types of business relationships qualify and what factors to consider when analyzing if a business relationship meets the exception's threshold. Additionally, the examples provided are tailored to "close personal relationships." We would request examples of qualifying "business relationships" be provided, as well as a narrower definition of the term.

First, we will analyze the amendments affecting the "close personal relationship" exception. We consider these amendments in light of the rule's stated aim: to guarantee 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." We agree that narrowing the "close personal relationship" definition aligns with FINRA's aim to protect customers. Restricting qualifying relationships to those formed prior to, and maintained outside of, the broker-customer relationship would prevent bad actors with exploitative intentions from forming personal relationships with customers outside of the broker-customer relationship to take advantage of the exception.

Moreover, each of the factors for analyzing if a relationship is a qualifying "close personal relationship" or "business relationship" for the purposes of the exception are necessary to analyze the relationship properly. While the factors are necessary to evaluate a "close personal relationship" or a "business relationship" for purposes of Rule 3240, we believe additional factors should be considered when analyzing if a business relationship qualifies under this exception.

The first factor, when the relationship began, is crucial. If the exception only bars relationships formed within the six months before a broker-customer relationship began and the relationship in question began seven months prior to the broker-customer relationship, there should be room for caution. The final factor, facts that indicate the relationship may not be a bona fide relationship under the exception, is perhaps the most important. Any indication that a relationship may have been formed to circumvent Rule 3240 should be investigated.

As stated above, we would request more information on defining "business relationship" and the factors for analyzing if a business relationship qualifies for the exception. Some factors that may be useful to consider would be: (1) what are the financial risks for the parties in this business relationship? (Ex.: is it nominal or is there already significant trust established between the parties based on the value of their business dealings); (2) what industry does the business relationship concern? (Ex.: is this a field unrelated to securities or a finance-based business); (3) any other factor that may help determine both the trust established between the parties and the comparative risks of their past business practices and their potential borrower-lender agreements.

We found one definition of "business relationship" on FINRA's website, in FINRA's Notice to Members 04-15[22]. This definition listed three specific ways a "business relationship" could be formed in the context of the Do-Not-Call Registry.[23] The "business relationship" defined seems to be narrowly tailored to the industry. Conversely, 15 U.S.C. § 1681s-3(d)(1) defined "business relationship" in a broad sense.[24] While this statute is not related to the FINRA rule at issue, it shows the potential for "business relationship" to be defined broadly.

We would ask FINRA to provide a narrow definition of "business relationship." Specifically, the most appropriate business relationships for this exception would be those in the financial industry. While perhaps proof of a relationship outside of the broker-customer

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[22] FINRA, Notice to Members 04-15, SEC Approves Amendments to NASD Rules Concerning Member Participation in the National Do-Not-Call Registry. https://www.finra.org/rules-guidance/notices/04-15 (Last accessed February 6, 2022).

[23] *Id.*

[24] 15 U.S.C. § 1681s-3(d)(1). https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=15-USC-1202457133-37152845 6&term_occur=1&term_src=title:15:chapter:41:subchapter:III:section:1681s%E2%80%933) (Last accessed February 6, 2022).

relationship, other business relationships may not provide the requisite knowledge or intimacy to prevent the exploitation of a vulnerable customer. Individuals may start a low-risk, nominal business relationship to take advantage of this exception. We imagine a scenario in which a broker finds a hairstylist and sees them every six weeks for a haircut and deems this a qualifying business relationship to meet the threshold of the exception. A narrower definition of "business relationship" and factors that help analyze the quality of a business relationship would help further Rule 3240's aim to prevent exploitation of customers by brokers.

Proposed Amendments to Notification and Approval Requirements

1. **Proposed amendment to Rule 3240(b)(1) to require a registered person to provide notice to a member firm of arrangement or modifications *prior* to entering such arrangements or modifications; removal of language that states that a member "shall pre-approve" such arrangements or modifications.**

We believe that this change will prevent the misinterpretation of the rule by registered members and disciplinary parties, and we approve of it. There are multiple disciplinary action reports where registered persons formed borrowing or lending arrangements with elderly customers without informing or receiving the approval of their member firm.[25] In the scenario that some did so under the impression that the "shall pre-approve" language required their firms to approve their request mandatorily, and thus neglected their duties to seek approval, this amendment will provide further clarity that their member must receive notification and may decide to approve the request or not.

2. **Proposed addition of Rule 3240(b)(1)(B) that would require registered persons to provide notice to and seek approval from a member firm before initiating a broker-customer relationship with a customer with whom the registered person has a pre-existing borrowing or lending arrangement.**

We agree with this proposed amendment as it would bring Rule 3240(b)(1)(B) in line with the proposed change to extend Rule 3240 to brokers that have pre-existing borrowing or lending arrangements with potential customers.

3. **Proposed amendments to Rule 3240(b)(1) and Supplementary Material 3240.01 that would require all notices and approval to be in writing and preserved for at least three years after the termination of the borrowing or lending arrangement "or at least three years after the registered person's association with the member has been terminated."**

We agree with these proposed amendments which require all notices and approval to be in writing and preserved for at least three years will provide records and documents that can be referred to if a registered member suffers a complaint or is subject to disciplinary action.

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[25] *See, e.g., Alan Price*, FINRA Disciplinary Proceeding, Case ID 2020066136801 (January 25, 2022); *Steven Patrick Melen*, FINRA Letter of Acceptance, Waiver, and Consent, Case ID 2019062323801 (April 15, 2021); *Cynthia Kay Whitman*, FINRA Letter of Acceptance, Waiver, and Consent, Case ID 2020065709801 (April 26, 2021).

4. **Proposed amendments to Rule 3240(b)(2) and (3) that would allow for a member firm's procedures to require a registered person to notify their member firm or receive approval to form a borrowing or lending arrangement prior or subsequent to forming a broker-customer relationship with a member of their immediate family.**

We agree with these proposed amendments as they would bring Rule 3240(b)(2) and (3) in line with the proposed change to extend the rule to brokers that have pre-existing borrowing or lending arrangements with potential customers.

Conclusion

Thank you for this opportunity to comment on the proposed amendments to Rule 3240, Prohibition on Borrowing from or Lending to Customers. It is important to our clinic at the University of Pittsburgh School of Law, as our clinic provides legal representation to investors with limited resources, often advocating for people whose claims represent much of their life savings. For the aforementioned reasons, we submit our approval of the proposed amendments and the above suggestions.

Respectfully Submitted,

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ALS/RTS/mkb

Exhibit 5

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

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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]or 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 borrowing or lending arrangement is based on a bona fide, 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 borrowing or lending arrangement is based on a bona fide 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 with a person with whom the registered person has an existing borrowing or lending arrangement, notify the member in writing of such existing arrangements 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 or lending arrangements include owner-financing arrangements.

.04 Close Personal Relationships; 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 bona fide or was formed with the purpose of circumventing the purpose of Rule 3240. Examples of close personal relationships

include, but are not limited to, a childhood or long-term friend or a godparent. An example of a business relationship includes, but is not limited to, a loan from a registered person to a small outside business that the registered person co-owned for years for the sole purpose of providing the business with additional operating capital.

.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.

.06 Obligations of Member Receiving Notice. Upon receipt of written notice under Rule 3240, a member shall perform a reasonable assessment of the risks created by the borrowing or lending arrangement with a customer, modification to the borrowing or lending arrangement with a customer, or existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person. The member shall also make a reasonable determination of whether to approve the borrowing or lending arrangement, modification to the borrowing or lending arrangement, or, where there is an existing borrowing or lending arrangement with a person who seeks to be a customer of the registered person, the broker-customer relationship.

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