SIFMA
Securities Industry and
Financial Markets Association

March 8, 2010

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: Regulatory Notice 10-03: FINRA Request for Comment on Proposed Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities.

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on three proposed consolidated rules discussed in FINRA Regulatory Notice 10-03: (i) Proposed FINRA Rule 4330 – setting forth requirements applicable to a member firm's borrowing or lending of a customer's margin securities that are eligible to be pledged or loaned; (ii) Proposed FINRA Rule 4314 – setting forth requirements applicable to a member firm that is party to an agreement for the loan or borrowing of securities; and (iii) Proposed FINRA Rule 4340 – setting forth obligations applicable to any callable securities a member firm has in its possession or control.

I. Introduction

The proposed FINRA rules are designed to address certain aspects of the securities lending market, an increasingly integral component of the U.S. securities markets overall. The proposed FINRA rules build upon the current extensive regulatory framework applicable to securities lending by adding certain additional disclosure obligations and other requirements in securities lending transactions, with a particular focus on increased disclosure with respect to borrowing from fully-paid customers. The proposed rules are also designed to incorporate recent developments in securities lending, including the Agency Lending Disclosure Initiative ("ALD"). SIFMA supports FINRA's goals of enhancing the current safeguards within the securities lending market to further address investor protection concerns, and promote the fundamental goal of lenders – incremental income with limited risk. At the same time, SIFMA also is cognizant of the need to mitigate any confusion or unintended consequences associated with FINRA's proposed requirements. The comments provided herein are primarily designed to address these aspects, and raise certain

[1] The Securities Industry and Financial Markets Association (SIFMA) bring together the shared interests of hundreds of securities firms, bank and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global financial Markets Association (GFMA). For more information visit www.sifma.org.

interpretive issues that SIFMA believes should be clarified by FINRA in its rule filing to the Commission.

II. Background

As the Staff is aware, securities may be borrowed for a number of different purposes, including to facilitate delivery for timely trade settlement, to meet segregation requirements, or to allow the borrowing broker-dealer to on-lend securities to others. The ability of broker-dealers to borrow securities plays a critical role in supporting market liquidity[2] and mitigating counterparty settlement and market risk. Furthermore, the need to borrow securities expeditiously has been emphasized due to the implementation of Rule 204 (and its predecessor Rule 204T), which imposes requirements on clearing firm participants to take prompt action to resolve settlement failures in all equity securities. In short, without the ability to efficiently borrow and loan securities the trading markets would experience less liquidity and the settlement infrastructure would experience increased capital expenditures, elongated fails, and greater systemic risk.

The securities lending market in the U.S. operates on a well-established base of legal principles and business practices, supported by an infrastructure that has evolved significantly over time through a combination of industry efforts and commercial technology developments. Such advances have also allowed broker-dealers and lending agents to automate securities lending transactions, which has been critical in allowing borrowers and lenders of securities to keep pace with the growth and expansion that has taken place in the capital markets over the past 40 years.

The securities lending market today is subject to extensive regulatory requirements and oversight, including but not limited to: (i) Federal Reserve Board Regulation T, which generally specifies the conditions under which a U.S. broker-dealer may engage in securities lending transactions (including the "permitted purpose requirement"); (ii) Exchange Act Rule 15c3-3, which contains the requirements for how a U.S. broker-dealer documents and collateralizes securities borrows from customers, including extensive requirements applicable to borrows from "fully-paid" customers; (iii) Exchange Act Rule 15c3-1, containing provisions that relate to how a U.S. broker-dealer must adjust the minimum net capital it is required to maintain based on its securities borrowing and lending activities; and (iv) various FINRA rules imposing other specific requirements with respect to securities borrowing and lending transactions. Other regulations, such as the Investment Company Act of 1940 and ERISA, directly impact the supply side by setting conditions on securities lending for investment fiduciaries. In addition, with the advent of ALD, SIFMA believes that the last remaining credit and capitalization gaps have been closed.

[2] Liquidity is facilitated not only in the equities markets but also in the options and futures markets where short selling may be used as a hedge to options and futures trading strategies.

III. Proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities)

A. Fully-Paid Securities

The proposed rule requires member firms, prior to entering into securities borrow transactions with customers, to provide certain information on risks. FINRA has enumerated certain disclosures in Rule 4330(b)(2)(A)(ii), but has also indicated that this is not intended to be an exclusive list.

SIFMA firms support further disclosure of potential risks to investors, however believe that the best means to accomplish this goal is through the development of an industry-standard form of risk disclosure. This form could be provided to FINRA for comments, with the aim of establishing mutually-agreeable standards between the regulators and the industry. SIFMA believes that such an approach has worked well in other contexts (*e.g.*, the options disclosure document, portfolio margining, prime brokerage 150 and 151 agreements), and would greatly help to alleviate confusion and establish uniformity across the industry.

With respect to the frequency of disclosure, SIFMA believes that it should be sufficient to provide the required information to customers at the outset of the securities lending relationship. If FINRA believes that more frequent disclosures would be beneficial, firms could provide an annual disclosure notice to customers. SIFMA further urges FINRA to clarify in its rule filing to the Commission that for those principal lenders utilizing lending agents the recipient of the required disclosures should be lending agents in their capacity as such, and not the underlying principals.

SIFMA believes that FINRA should provide further clarification in its rule filing regarding certain of the proposed disclosures. For example, 4330(b)(2)(A)(ii)(d) discusses disclosure regarding "limitations on customer's ability to sell the loaned securities." Firms understand that intent of this disclosure is to notify customers of any situations where securities may be subject to an actual restriction on sale due to the loan[3], and is not intended to provide guidance on the marking of customers' sales as "long" or "short," or otherwise provide guidance concerning Regulation SHO. To avoid any doubt, and ensure consistency with current regulatory requirements, SIFMA recommends that FINRA eliminate the proposed disclosure concerning the limitation on the ability to sell the loaned securities or clarify that such orders to sell may be marked "long," provided there is compliance with any applicable guidance from the SEC on this issue.[4]

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[3] Please note that SIFMA is not aware of any such applicable restrictions.

[4] In the Adopting Release on Rule 204, the Commission repeated its position taken in a prior FAQ and the Release on Interim Final Temporary Rule 204T, specifically stating that the sale of a security on loan may be treated as a long sale for purposes of Regulation SHO, as follows: "We note that if a person that has loaned a security to another person sells the security and a bona fide recall of the security is initiated within two business days after trade date, the person that has loaned the security will be 'deemed to own' the security for purposes of Rule 200(g)(1) of Regulation SHO, and such sale will not be treated as a short sale for purposes of temporary Rule 204T. In addition, a broker-dealer may mark such orders as 'long' sales provided such marking is also in compliance with Rule 200(c) of Regulation SHO. Thus, the close-out requirement of Rule 204(a)(1) applies to sales of such securities." Securities Exchange Act Release No. 60388, 74 FR 38266, 38270 (July 31, 2009). While not specifically addressed in the Releases or prior FAQ, SIFMA notes that

In addition, SIFMA notes that the proposed disclosures would require information concerning the "economics of the transaction." There are a variety of different factors that may go toward determining the price for a securities lending transaction. These may include, among others, the size of the transaction, the expected stability of the borrow, and the collateral posted. As a result, different than the market for securities transactions, there may be different prices for securities loans/borrows involving the same security (*i.e.*, there is no NBBO with respect to the securities lending market). SIFMA believes that FINRA should clarify in its rule filing that firms will be expected to provide adequate disclosure to customers that price can be impacted by the existence of these different factors.

FINRA has proposed certain suitability requirements in 4330(b)(2)(B). While the Regulatory Notice did not identify criteria for suitability, we understand FINRA considers that the following may be factors in determining whether a customer's participation in a securities lending program is suitable for the particular customer: the type of collateral posted for the loan, potential impacts on customers associated with the loss of voting rights on securities loaned, and tax consequences associated with the receipt of manufactured versus actual dividends. SIFMA believes that FINRA should clarify that firms' suitability obligations should apply with respect to customers' overall participation in a securities lending program, and not on a transaction-by-transaction basis, which would otherwise be unduly burdensome and negatively impact the efficiency of securities loans and borrows. Furthermore, the proposed Supplementary Material to Rule 4330(b)(2) permits the member firm to rely on any representations made by another member firm that has a customer relationship with the lender. This is consistent with the general understanding that suitability determinations are the responsibility of the introducing broker, with such allocation of responsibility generally set forth in the Clearing Agreement between clearing and introducing brokers. SIFMA requests that FINRA clarify that a clearing firm can meet its requirements through reliance on a representation by the introducing broker that, with respect to any customer it introduces into a securities lending program, the introducing broker has determined the program to be suitable for that customer.

Finally, with respect to FINRA's proposed 30-day notification provision in 4330(b)(1), SIFMA recommends that FINRA confirm that the 30-day notification provision applies prior to a broker-dealer's initiation of a fully-paid customer securities lending program, and does not impose a separate requirement prior to entering into agreements with specific customers. With respect to existing securities lending programs, notification could be provided to FINRA within a certain period of time after the new rules become effective.

B. Margin Securities

In the Supplementary Material relating to proposed Rule 4330(a), FINRA has set forth the language for a "legend" to be incorporated in customer agreements. SIFMA recommends revising

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when a customer who has lent securities out of its broker-dealer custody securities account sells those securities, it does not issue a recall to its broker. Instead, the customer generally notifies the broker of its need for the securities through the long sale itself. As this achieves the same objective as a recall, SIFMA submits that it therefore should be treated as a recall for the purpose of the Release and FAQ.

the legend to make clear that this language is only meant to apply to margin securities (*i.e.*, not excess margin securities or fully-paid securities) in customer margin account agreements. Therefore, the recommended revised legend would read as follows:

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

Furthermore, to the extent that language in firms' existing customer margin account agreements is sufficiently comparable to the proposed language, SIFMA requests existing customer margin account agreement be grand-fathered from the requirement for broker-dealers to re-paper existing agreements to incorporate the exact wording of the stated "legend" or to adjust its placement in the agreement.

IV. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

Regulatory Notice 10-03 indicates that certain of the proposed requirements in new Rule 4314 are designed to address and maintain consistency with ALD. While it is true that disclosure of capacity and determination of whether the other party is acting as principal or agent are not new concepts, firms believe that FINRA needs to explicitly recognize in the rule the ALD initiative and that transfer of data between the agent lender and broker-dealer under the ALD regime is sufficient to meet the books and records requirements. In this regard, firms strongly recommend that FINRA work with the SEC to adopt the final version of the SEC's ALD no-action letter prior to or simultaneous with the adoption of Rule 4314. Due to the procedural nature of the no-action letter, firms believe it could prove unwieldy to incorporate all of the detailed requirements of the no-action relief into the proposed rule, but rather believe that an interpretation to the rule (set forth in the Supplementary Material) could reference the fact that firms should structure their operations in a manner consistent with the cited SEC no-action letter.

Finally, SIFMA urges FINRA to clarify that, with respect to certain "anonymous loan markets," where the actual counterparty to securities loans and borrows is a central counterparty, it is expected that the required disclosures of Rule 4314 be made to the central counterparty, and not any underlying counterparty.

V. Proposed FINRA Rule 4340 (Callable Securities)

Proposed Rule 4340(a) eliminates the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system, in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member firm. Instead, the proposed rule would allow member firms to establish procedures that require the allocation to be conducted on a fair and impartial basis, but also require a member firm to post the allocation procedures on its web site, as well as provide notice to new and existing customers explaining how the procedures may be accessed.

SIFMA firms would like clarification on the requirement that a member post its allocation procedures on its website. If FINRA's intent is that firms provide detailed, granular procedures,

firms clearing through third parties and self-clearing firms using Service Bureau systems likely will not be able to comply with this requirement, in that such procedures would constitute proprietary information belonging to the third-party, and the third-party would likely be disinclined to make such proprietary information publicly available via the member's website. If FINRA believes that disclosure of allocation procedures would provide benefits to customers, it should be sufficient for firms to provide a general statement describing the allocation procedures and to post such on the member firms' internet site, but FINRA should not require the actual procedures to be disclosed.

If you have any questions or require additional information, please do not hesitate to contact the undersigned, Rob Toomey at 212-313-1124 or Tom Tierney at 212-313-1237. Thank you for your attention to this matter.

Sincerely,

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