

Notice to Members

OCTOBER 2003

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Registered Representatives
Senior Management

KEY TOPICS

Borrowing From and Lending
to Customers
Rule 2370

INFORMATIONAL

Borrowing From and Lending to Customers

SEC Approves NASD Rule Proposal To Govern
Lending Between Registered Persons and Customers;
Effective date: November 10, 2003

Executive Summary

On August 29, 2003, the Securities and Exchange Commission (SEC) approved the adoption of NASD Rule 2370, which prohibits registered persons from borrowing money from or lending money to a customer unless (1) the member has written procedures allowing such lending arrangements consistent with the rule; (2) the loan falls within one of five prescribed permissible types of lending arrangements; and (3) the member pre-approves the loan in writing.¹ The text of Rule 2370 is provided in Attachment A and is effective on November 10, 2003.

Questions/Further Information

Questions concerning this *Notice* may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8844.

Background

Loans between registered persons and their customers are of legitimate interest to NASD and member firms because of the potential for misconduct. NASD has brought disciplinary action against registered persons who have violated just and equitable principles of trade by taking unfair advantage of their customers by inducing them to lend money in disregard of the customers' best interests, or by borrowing funds from, but not repaying, customers.

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The potential for misconduct also exists when a registered person lends money to a customer. Rule 2370 provides the mechanism by which NASD and member firms can monitor lending arrangements between registered persons and their customers.

Discussion

First, under Rule 2370, lending arrangements between registered persons and customers are prohibited unless the member has written procedures allowing such lending arrangements. Second, if permitted by the member, the lending arrangement must fall within one of five permissible types of lending arrangements. The five types of permissible lending arrangements are:

- ◆ The customer is a member of the registered person's immediate family (as defined in the rule);
- ◆ The customer is in the business of lending money;
- ◆ The customer and the registered person are both registered persons of the same firm;
- ◆ The lending arrangement is based on a personal relationship outside of the broker-customer relationship; or
- ◆ The lending arrangement is based on a business relationship outside of the broker-customer relationship.

Third, the member must pre-approve the loan in writing.

This regulatory framework will give members control over, and supervisory responsibility for, lending arrangements between their registered persons and customers. Members can choose to permit their registered persons to borrow from or lend to customers consistent with the requirements of the rule or prohibit the practice in whole or in part. Members that permit lending arrangements between their registered persons and customers are required to have written procedures in place to monitor such lending arrangements. Registered persons who wish to borrow from or lend to customers will be required to provide prior notice of the lending arrangement to the member, and the member will be required to approve the loan in writing. Members will be permitted to approve loans only if the loan falls within one of the five types of permissible lending arrangements. These requirements will enhance members' ability to supervise the activities of registered personnel.

Rule 2370 gives members the ability to prohibit all lending arrangements between their registered persons and customers. However, if permitted, Rule 2370 establishes strict conditions under which such lending arrangements may take place. Under Rule 2370, firms are required to have written procedures in place evidencing their customer loan policy, and loans will be limited to five permissible types of arrangements that might not be problematic because of the relationship between the registered person and the customer. In addition, Rule 2370 provides additional safeguards by establishing a notice and approval requirement. These requirements will enable a member, to the extent it permits these loan arrangements, to assess the nature of each proposed arrangement and decide whether to approve it. These requirements also enhance NASD's ability to review these arrangements during the examination process. The safeguards provided under Rule 2370 are in addition to the general powers that NASD has to bring a disciplinary action against a registered person who has entered into an unethical lending arrangement with a customer under NASD Rule 2110.

It is important to note that this proposal does not change the application of Regulation T to lending activities by associated persons. Specifically, the definition of "creditor" under Regulation T extends to associated persons of broker/dealers and therefore, certain loans to customers by associated persons may require compliance with the provisions of Regulation T.

Effective Date

These amendments become effective on **November 10, 2003**.

Endnotes

- 1 See Release No. 34-48242 (Aug. 29, 2003), 68 FR 52806 (Sept. 5, 2003) (File No. SR-NASD-2003-92) ("SEC Approval Order").

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ATTACHMENT A – RULE TEXT

Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

2370. Borrowing From or Lending to Customers

(a) No person associated with a member in any registered capacity may borrow money from or lend money to any customer of the member 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 lending or borrowing arrangement meets one of the following conditions: (A) the customer is a member of such person's immediate family; (B) the customer 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; (C) the customer and the registered person are both registered persons of the same member firm; (D) 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 associated person not maintained a relationship outside of the broker/customer relationship; or (E) the lending arrangement is based on a business relationship outside of the broker-customer relationship; and (3) the member has pre-approved in writing the lending or borrowing arrangement.

(b) The term immediate family shall include 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 shall also include any other person whom the registered person supports, directly or indirectly, to a material extent.