

Notice to Members

JUNE 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Appendix D to the Net Capital Rule
Net Capital
Operations
SEC Rule 15c3-1
Subordination Agreements
Subordinated Loans

INFORMATIONAL

Subordinated Loan Agreements

SEC Approves NASD Rule Requiring Members to Require Investors to Sign a Disclosure Document as Part of a Subordinated Loan Agreement; **Effective Date: July 15, 2002**

Executive Summary

On May 17, 2002, the Securities and Exchange Commission (SEC) approved a rule change requiring members to obtain a signed Subordination Agreement Investor Disclosure Document (Disclosure Document) from each investor before entering into a subordination agreement with that investor.

The Disclosure Document requirement, the text of which is provided in Attachment A, becomes effective on July 15, 2002.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan DeMando, Director, Financial Operations, at (202) 728-8411, or Shirley H. Weiss, Associate General Counsel, at (202) 728-8844.

Discussion

At times, broker/dealers borrow funds or securities from investors or customers for the purpose of enhancing the firm's net capital position. To receive benefit under the SEC's net capital rule (Rule 15c3-1), funds or securities loaned by an investor to a broker/dealer, including a loan to a broker/dealer made by a customer of the broker/dealer, must be the subject of a satisfactory subordination agreement. The subordination agreement sets forth the rights and obligations of the lender (*i.e.*, the investor) and the borrower (*i.e.*, the broker/dealer), and it provides that any claims by the lender must be subordinate to claims by other parties, including customers and employees of the firm.

This rule requires members to deliver a Disclosure Document to each investor and receive a signed copy of the Disclosure Document affirming that the investor has read it before entering into any subordination agreement.¹ The purpose of the Disclosure Document is to help investors understand what a subordination agreement is and what risks they assume when they enter into a subordination agreement. NASD staff will require a copy of the signed Disclosure Document as part of its review of all subordination agreements and, in its discretion, may contact investors regarding subordination agreements. The Disclosure Document provides information that NASD believes is essential for an investor to understand prior to entering into a subordination agreement. In addition to understanding what a subordination agreement is and how it operates, retail brokerage customers especially need to understand the risks associated with subordination agreements. Investors who enter into subordination agreements will be able to obtain the following basic information from the Disclosure Document.

There Are Two Types of Subordination Agreements. Under a Subordinated Loan Agreement (SLA), the investor lends cash to the firm. Under a Secured Demand Note Agreement (SDN), the investor agrees to give cash to the firm on demand (*i.e.*, without prior notice) during the term of the note. The investor also must provide cash or securities as collateral for the SDN. If the investor uses securities as collateral, these securities must be deposited with the firm and registered in the firm's name, and the investor cannot sell or otherwise use them unless the investor substitutes securities of equal or greater value for the deposited securities.

There Is No SIPC Protection. When an individual enters into a subordination agreement, he or she is making an investment in a broker/dealer, and any cash or securities that are subject to the subordination agreement are not protected by SIPC. If the broker/dealer defaults on the loan, the customer can lose his or her entire investment, including any cash, securities, or accounts loaned or pledged as collateral.

There Is No Private Insurance Protection. Subordination agreements generally are not covered by any private insurance policy held by the broker/dealer. Thus, if the broker/dealer defaults on the loan, the customer can lose all of his or her investment.

There Is No Priority In Payment Over Other Lenders. Subordination agreements cause the lender to be subordinate to other parties if the broker/dealer goes out of business, *i.e.*, the lender under a subordination agreement is paid after the other parties are paid, assuming the broker/dealer has any assets remaining after the satisfaction of obligations to other parties.

There Are No Restrictions on the Broker/Dealer's Use of a Lender's Funds or Securities. A lender cannot place additional restrictions on the use of proceeds of a subordination agreement beyond those contained in Appendix D of the SEC's Net Capital Rule. In other words, funds or securities lent to a broker/dealer under a subordination agreement can be used by the broker/dealer almost entirely without restriction, including paying salaries to the broker/dealer's personnel.

A Broker/Dealer Can Force the Sale of Securities Pledged as Collateral. Broker/dealers are required to discount the market value of securities that are pledged as collateral for an SDN. If these securities decline in value so that their discounted value is less than the face amount of the SDN, the investor must deposit additional securities with the firm to keep the SDN at the proper collateral level. If the investor does not deposit additional collateral with the firm, the firm may sell some or all of the investor's securities. In addition, if the firm makes a demand for cash under an SDN, and the investor does not provide the firm with cash, the firm may sell some or all of the investor's securities.

Effective Date

As of July 15, 2002, each subordinated loan agreement submitted to NASD staff for approval must contain a Disclosure Document signed by the investor.

ENDNOTES

1 Pending adoption of this requirement, NASD in *Notice to Members 02-04* strongly urged all members entering into subordination agreements to adopt immediately, as a "best practice," procedures to deliver a Disclosure Document to, and obtain a signed copy from, each investor as part of the subordinated loan process.

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ATTACHMENT A

SUBORDINATION AGREEMENT

INVESTOR DISCLOSURE DOCUMENT

Please read this document carefully before deciding to enter into a subordination agreement with a broker/dealer. Subordination agreements are an investment. These investments can be risky and are not suitable for all investors. An investor should never enter into a subordination agreement with a broker/dealer unless he/she can bear the losses of the total investment.

Subordination agreements are complicated investments. A subordination agreement is a contract between a broker/dealer (the borrower) and a lender (the investor), pursuant to which the lender lends money and/or securities to the broker/dealer. The proceeds of this loan can be used by the broker/dealer almost entirely without restriction. The lender agrees that if the broker/dealer does not meet its contractual obligations, his/her claim against the broker/dealer will be subordinate to the claims of other parties, including claims for unpaid wages. Lenders may wish to seek legal advice before entering into a subordination agreement.

Key Risks

All investors who enter into subordination agreements with broker/dealers should be aware of the following **key risks**:

Money or securities loaned under subordination agreements are not customer assets and are not subject to the protection of the Securities Investor Protection Corporation (SIPC). In other words, your investment in the broker/dealer is **not** covered by SIPC. Nor are subordination agreements generally covered by any private insurance policy held by the broker/dealer. Thus, if the broker/dealer defaults on the loan, the investor can lose all of his/her investment.

- ✦ The funds or securities lent to a broker/dealer under a subordination agreement can be used by the broker/dealer almost entirely without restriction.
- ✦ Subordination agreements cause the lender to be subordinate to other parties if the broker/dealer goes out of business. In other words, you, as an investor, would be paid after the other parties are paid, assuming the broker/dealer has any assets remaining.
- ✦ NASD approval of subordination agreements is a regulatory function. It does **not** include an opinion regarding the viability or suitability of the investment. Therefore, NASD approval of a subordination agreement does not mean that NASD has passed judgment on the soundness of the investment or its suitability as an investment for a particular investor.

SIPC Coverage

Q. In general, what is SIPC coverage?

A. SIPC is a non-profit, non-government, membership corporation created to protect customer funds and securities held by a broker/dealer if the broker/dealer closes because of bankruptcy or other financial difficulties. SIPC defines customers as persons who have securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions.

Q. Is an investor who enters into a subordination agreement covered by SIPC?

A. No. SIPC considers these agreements to be investments in the broker/dealer. Once a customer signs a Subordinated Loan Agreement (SLA) or Secured Demand Note Agreement (SDN), he or she is no longer considered a customer of the broker/dealer relative to this investment. (These agreements are explained in further detail below.) For example, Mr. Jones has an IRA rollover account and a separate investment account with a broker/dealer. Mr. Jones enters into a subordination agreement with the broker/dealer and uses the investment account as collateral. This action would cause Mr. Jones to lose SIPC coverage for the investment account but not for his IRA account. If Mr. Jones pledges physical shares (*i.e.*, certificates) as collateral for his subordination agreement, as opposed to pledging an account, he will lose SIPC coverage for the shares pledged.

Other Insurance Coverage

Q. If my broker/dealer tells me that the firm has Fidelity Bond Coverage, will this coverage insure my investment?

A. Fidelity Bond Coverage provides limited protection that generally would not benefit a subordinated lender (investor) under an SLA or SDN. In addition, NASD is not aware of any other insurance product that will protect an investor in this situation. If a broker/dealer claims that an SLA or SDN is covered by any type of insurance, the investor should insist on receiving that representation in writing from the insurance company.

General Information About Subordination Agreements

Q. Why would a broker/dealer ask an investor to enter into a subordination agreement?

A. Subordination agreements add to the firm's capital and thereby strengthen the broker/dealer's financial condition.

- Q. What are the advantages and disadvantages for an investor to enter into a subordination agreement with a broker/dealer?**
- A. An investor may be able to obtain a higher interest rate than from other investments. There are, however, key disadvantages. If the broker/dealer goes out of business, the investor's claims are subordinated to the claims of other parties, *i.e.*, customer and creditor claims will be paid before investors' claims. Thus, the subordinated investor may or may not get his/her funds or securities back, depending on the financial condition of the broker/dealer. **Finally, money or securities loaned under subordination agreements are not customer assets and are not covered by SIPC, or in general, any other private insurance.**
- Q. Per the Lender's Attestation, the broker/dealer is required to give the prospective lender copies of various financial documents, including a certified audit. Why is this necessary?**
- A. A subordination agreement is an investment in the broker/dealer. Therefore, the investor, as a prospective lender, should assess the firm's financial condition to determine whether the loan makes good business sense. Financial documents can be complicated and the investor should consider consulting with an attorney or accountant.
- Q. Outside counsel can be expensive. What if my broker/dealer provides an attorney for me at its expense?**
- A. It may not be desirable to use a broker/dealer's attorney to assist you in the transaction. To ensure independent, objective representation, an investor should retain his/her own attorney.
- Q. How many types of subordination agreements are there?**
- A. In general, there are only two, the Subordinated Loan Agreement and the Secured Demand Note Agreement.

Subordinated Loan Agreements (SLA)

- Q. What is an SLA?**
- A. If an investor lends cash to a broker/dealer, the investor will usually do this as part of an SLA. The SLA discloses the terms of the loan, including the identities of the broker/dealer and investor, the amount of the loan, the interest rate, and the date on which the loan is to be repaid.
- Q. Can the lender restrict the broker/dealer's use of the loan?**
- A. No. Language in the SLA precludes the lender from placing restrictions on how the broker/dealer may use the funds. Therefore, lenders should not rely on side agreements with a broker/dealer that purport to limit the use of the loan proceeds. These agreements are inconsistent with the SLA and may not be enforceable.

Secured Demand Note Agreements (SDN)

Q. What is an SDN?

- A. An SDN is a promissory note, in which the lender agrees to give cash to the broker/dealer on demand during the term of the SDN. This "promissory note" must be backed by collateral, generally the lender's securities. The lender retains his/her status as beneficial owner of the collateral, but the securities must be in the possession of the broker/dealer and registered in its name. As securities can fluctuate in value, the lender must give sufficient securities to the broker/dealer so that when the securities are discounted, the net value of the securities will be equal to or greater than the amount of the SDN. This "discounting" is required by regulation. The rate of the discount varies and can be as high as 30 percent in the event common stock is used as collateral.

For example, assuming common stock is used as collateral, for every \$1,000 of face amount of the SDN, the investor must give the broker/dealer collateral that has a market value of at least \$1,429. Therefore, collateral for a \$15,000 SDN would require common stock that has a current market value of at least \$21,435.

Q. What happens to the securities that I pledge as collateral under an SDN?

- A. + The investor gives up the right to sell or otherwise use the securities that have been pledged to the broker/dealer under an SDN. Once securities are pledged as collateral for an SDN, the broker/dealer has exclusive use of the securities.
- + The investor may exchange or substitute the securities that have been pledged to the broker/dealer with different securities, but the value of the new securities (after applying the appropriate discount) must be sufficient to collateralize the SDN.
- + The broker/dealer may use them as collateral, *i.e.*, the broker/dealer may borrow money from another party using the securities the investor has pledged as collateral under the SDN as collateral for the new loan.
- + If the securities pledged as collateral decline in value so that their discounted value is less than the face amount of the SDN, the investor must deposit additional securities with the broker/dealer to keep the SDN at the proper collateral level. If the investor does not give the broker/dealer additional collateral, the broker/dealer may sell some or all of the investor's securities.
- + If the broker/dealer makes a demand for cash under an SDN, and the investor does not provide the broker/dealer with the cash, the broker/dealer has discretion to sell some or all of the investor's collateral (or securities). The SDN gives the broker/dealer the discretion to choose which of the investor's collateral to sell.

- ✦ All securities pledged as collateral for the SDN, including excess collateral, are subordinated to the claims of the broker/dealer's customers and creditors. Thus, if the firm becomes insolvent, the investor's ability to retrieve his/her collateral may be at risk.

NASD Approval Process

Q. What is involved in the NASD approval process?

- A. NASD will review the subordination agreement to ensure that it meets all technical requirements of Appendix D of SEC Rule 15c3-1 and to verify and that the broker/dealer has actually received the investor's funds or securities. This review is done to enable the borrower broker/dealer to use the subordination agreement as part of its regulatory capital. As previously stated, NASD does not review subordination agreements to determine whether the investment is viable or suitable for the investor (lender). The investor must make this determination.

By signing below, the investor attests to the fact that he/she has read this Subordination Agreement Investor Disclosure Document.

Investor Name

Investor Signature

Date

FOR NASD USE ONLY

Effective Date:

LOAN Number:

NASD ID Number:

Date Filed: