OCTOBER 2004

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

KEY TOPICS

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

REQUEST FOR COMMENT

Subordination Agreements

NASD Seeks Comment on Enhanced Disclosure for Subordination Agreements; **Comment Period Expires November 26, 2004**

Executive Summary

In 2002, NASD adopted a requirement that firms submitting subordination agreements to NASD staff for approval provide each investor with a Subordination Agreement Investor Disclosure Document (Disclosure Document), a signed copy of which must be provided to NASD staff before the agreement will be approved.[1] The purpose of the Disclosure Document is to help investors understand what a subordination agreement is and what risks investors assume when they enter into such agreements.

While NASD continues to believe that the disclosures contained in the Disclosure Document help investors assess the general risks of subordination agreements, NASD is concerned that investors may still be entering into subordination agreements with firms without fully appreciating the specific risks that may be involved. Accordingly, NASD is seeking comment on a proposal to require firms to provide investors with detailed, specific disclosure focused on the firm and the particular loan before entering into a subordination agreement with an investor. These disclosures would augment the existing risk disclosures currently required to be provided by the firm to investors.

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by November 26, 2004. Members and other interested persons can submit their comments using the following methods:

- Mailing comments in hard copy to the address below; or
- E-mailing comments to *pubcom@nasd.com.*

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney

Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.[2]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.[3]

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight (RPO), at (202) 728-8104; or Brant K. Brown, Counsel, Office of General Counsel, RPO, at (202) 728-6927.

Background and Discussion

At times, a broker-dealer may borrow funds or securities from investors to enhance 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 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. Before a subordination agreement becomes effective for net capital purposes, it must be reviewed and approved by the broker-dealer's designated examining authority (DEA).[4]

SEC Rule 15c3-1d(a)(1) provides that NASD, as a DEA, may require that subordination agreements "include such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordination agreement to fail to meet the requirements of [Appendix D to Rule 15c3-1]." In 2002, the SEC approved an NASD rule change that requires firms, before entering into any subordination agreement with an investor, to deliver the Disclosure Document to the investor and receive a signed copy affirming that the investor has read it.[5] This rule became effective on July 15, 2002.

The Disclosure Document is intended to help investors understand what a subordination agreement is and what risks they assume when they enter into a subordination agreement. The Disclosure Document covers such topics as: (1) the two types of subordination agreements (subordinated loan agreements and secured demand note agreements); (2) the lack of SIPC protection; (3) the lack of private insurance protection; (4) the fact that any claim is subordinate or has no priority in payment over other lenders; (5) the lack of restrictions on the broker-dealer's use of a lender's funds or securities; and (6) the ability of a broker-dealer to force the sale of securities pledged as collateral. The Disclosure Document is a standard document that does not vary from firm to firm or from loan to loan; consequently, the disclosure is general and provides investors only with generic risk factors.

NASD is concerned that the general disclosures in the Disclosure Document alone may be insufficient to convey the specific risks of a particular subordination agreement and that, without some degree of detail about the specific subordination agreement and the broker-dealer firm, an investor is not able to assess accurately the appropriateness of the investment. Consequently, NASD is proposing that, in addition to the Disclosure Document, firms be required to provide an investor entering into a subordination agreement with specific, written disclosure concerning the proposed investment. Specifically, NASD is proposing to require firms to:

- provide the investor with a detailed statement concerning the intended use of proceeds;
- provide the investor with a detailed statement concerning the intended plan of financing;
- disclose the amounts, types, interest rates, and scheduled maturity dates of debt to which the intended loan will be subordinate;
- for any subordinated loans[6] with outstanding balances, disclose the outstanding balances, interest rates, and scheduled maturity dates of such loans and the number of investors involved; and
- provide the investor with a copy of the broker-dealer's most recent audited financial statement.

Firms would be required to provide these disclosures to the investor in writing before entering into any subordination agreement.[7] To the extent that the information does not appear in the subordination agreement itself, the firm would be required to provide the investor with a separate, stand-alone document containing the required information. NASD believes that these firm-specific and loan-specific disclosures will provide investors with useful information that will aid them in determining whether subordination agreements are appropriate investments.[8]

1. Detailed Statement Concerning the Intended Use of Proceeds

NASD proposes to require each firm to include in its disclosure a detailed statement concerning the firm's intended use of the proceeds from the subordinated loans. NASD recognizes that lenders are precluded from placing restrictions on how the broker-dealer may use the proceeds from a subordinated loan, and the Disclosure Document includes disclosure to this effect. Nevertheless, at the time a firm solicits or receives a subordination agreement, it is likely to have an *intended* use for those proceeds, and that use should be disclosed. For example, the broker-dealer would be required to disclose whether it is pursuing the funds to satisfy an arbitration award (and, if so, a description of such award) or to pay salaries (and, if so, a description of the persons receiving the salaries and the amounts). In short, the firm would be required to disclose the reason it is pursuing the loan.

2. Detailed Statement Concerning the Intended Plan of Financing

NASD also proposes to require firms to include in its disclosure a detailed plan of financing. This plan would include (1) the amount of the subordinated loan sought from the individual investor and its interest rate and scheduled maturity date (*i.e.*, the date that repayment by the firm to the lender is required); (2) the total amount of subordinated loans sought from other investors for the same purpose and their interest rates and scheduled maturity dates; (3) the number of investors from which the firm *intends* to borrow funds; and (4) the approximate percentage of the total loan expected from each investor. NASD recognizes that the intended number of investors may change over time. Accordingly, the firm would be required to disclose the intended number of investors as of the time the disclosure is made to the investor. For example, assume a firm initially intends to borrow $1 million by borrowing $100,000 from ten separate investors; however, after borrowing the intended $100,000 from one investor, the second investor decides to loan the firm $500,000. Under this scenario, the firm would be required to disclose to the first and second investors its original intention to borrow $1 million from ten investors equally; however, the firm would be required to disclose to subsequent investors its revised intention to borrow a total of $1 million from six investors, with one investor lending $500,000 and five investors lending $100,000.

3. Amounts, Types, Interest Rates, and Scheduled Maturity Dates of Debt to Which the Intended Loan Will be Subordinate

NASD also proposes to require firms to disclose the amounts, types, interest rates, and scheduled maturity dates of debt to which the intended loan will be subordinate. NASD believes that this information is important for investors in determining whether a subordination agreement is an appropriate investment and that without this information it is difficult for investors to assess the merits and risks of the investment.

4. For Any Subordinated Loans With Outstanding Balances, the Outstanding Balances, Interest Rates, and Scheduled Maturity Dates of Such Loans and the Number of Investors Involved

NASD also proposes to require firms to disclose, with respect to any subordinated loans with outstanding balances, the outstanding balances, interest rates, and scheduled maturity dates of those loans and the number of investors involved. NASD believes that it is important for investors to know about the broker-dealer's other outstanding subordinated loans and the current status of those loans to aid the investor in its determination of whether to loan funds or securities to the firm. Firms would be required to include only subordinated loans with outstanding balances at the time the investor enters into the subordination agreement.

5. Most Recent Audited Financial Statement

NASD believes that firms should be required to provide an investor with a copy of the firm's most recent audited financial statement before entering into a subordination agreement with that investor.[9] Because a subordination agreement is an investment in the broker-dealer firm, this requirement would provide the investor with a minimum amount of financial information about the firm before deciding whether to invest.

Request for Comment

NASD requests comment on the following questions:

(1) Is there additional information NASD should require firms to disclose to help an investor understand the risks of a subordinated loan and whether the loan is an appropriate investment? Are any of the items NASD proposes to require firms to disclose unnecessary?

(2) For those items requiring firms to disclose intentions (*i.e.*, intended use of proceeds and intended number of investors), should firms have an obligation to inform investors that have already invested of any change?

(3) Should certain classes of persons be prohibited from entering into subordination agreements with firms? Should firms be obligated to ensure that investors entering into subordination agreements have a certain minimum level of sophistication or net worth? If so, what level would be appropriate?

(4) The current proposal would not require firms to make the disclosures if the investor were an "institutional account." Is this exclusion appropriate? Are there other classes of persons that should also be excluded?

(5) Should NASD require firms to receive a signed acknowledgement from the investor that it has received, read, and understands the disclosures similar to the requirement for the Disclosure Document?

(6) The current proposal would require firms to disclose only previously provided subordinated loans if those loans have outstanding balances. Should firms be required to disclose all previously provided subordinated loans within a certain timeframe, including loans that have been paid off? If so, what would be an appropriate timeframe?

In addition to the questions listed above, NASD is interested in any other issues that commenters may wish to address relating to the proposal.

Endnotes

1 See *Notice to Members* (NtM) 02-32 (June 2002).

2 *See* NtM 03-73 (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.

3 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.

4 For firms for which NASD is the DEA, the local District Office reviews and approves subordination agreements. NASD approval of subordination agreements is a regulatory function. It does not include an opinion regarding the viability or suitability of the investment.

5 67 Fed. Reg. 36281 (May 23, 2002); *see also* NtM 02-32 (June 2002).

6 References to "subordinated loans" in this *Notice* include arrangements under both subordinated loan agreements and secured demand note agreements.

7 This proposal would only apply to those firms for which NASD is the DEA. Firms would not be required to file these additional disclosures with NASD as part of the subordination agreement review process. Rather, NASD would require firms to maintain copies of these disclosures and make them promptly available to NASD staff in the ordinary course of examinations or upon request.

8 NASD proposes to exempt institutional accounts from this requirement. Thus, firms would not be required to provide these disclosures to investors that meet the definition of "institutional account" in NASD Rule 3110(c)(4).

9 This requirement would be separate from existing requirements under other rules addressing the disclosure of financial information. *See, e.g.*, SEC Rule 17a-5(c); NASD Rule 2270.