

Fidelity Bonds

FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Fidelity Bonds

Comment Period Expires: September 14, 2009

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on a proposed consolidated FINRA rule governing fidelity bond requirements.

The text of the proposed rule is set forth in Attachment A. Examples of estimated fidelity bond premiums for different-sized firms under the proposed rule are set forth in Attachment B.

Questions concerning this *Notice* may be directed to:

- Susan DeMando Scott, Associate Vice President, Financial Operations Policy, at (202) 728-8411; or
- Erika L. Lazar, Senior Attorney, Office of General Counsel, at (646) 315-8512.

Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by September 14, 2009.

Members and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

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

July 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topic(s)

- Fidelity Bonds

Referenced Rules & Notices

- NASD Rule 3020
- NYSE Rule 319 and Its Interpretation
- SEA Rule 15c3-1

To help FINRA process and review comments more efficiently, persons should only use one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider 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 FINRA Web site. Generally, FINRA will post comments on its 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 SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.³

Background & Discussion

NASD Rule 3020 and NYSE Rule 319⁴ (and its Interpretation) require member firms to maintain minimum amounts of fidelity bond coverage for officers and employees, and that such coverage address losses incurred due to certain specified events. The purpose of a fidelity bond is to protect a firm against certain types of losses, including, but not limited to, those caused by the malfeasance of its officers and employees, and the effect of such losses on the firm's capital.

FINRA proposes adopting NASD Rule 3020 as FINRA Rule 4360, taking into account requirements under NYSE Rule 319 (and its Interpretation). The proposed FINRA rule updates the fidelity bond requirements to clarify the rule and reflect current industry practices. Unless otherwise noted below, the provisions in NASD Rule 3020 would transfer, subject only to non-substantive changes, as part of the consolidated FINRA rule.

Proposed FINRA Rule 4360 (Fidelity Bonds)

General Requirements

Proposed FINRA Rule 4360 requires each firm that is required to join the Securities Investor Protection Corporation (SIPC) to maintain a blanket fidelity bond with specified amounts of coverage based on its net capital requirement, with certain exceptions. The proposed rule requires each firm to maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees of a firm who are not performing acts within the scope of the usual duties of an officer or employee.

Proposed FINRA Rule 4360 requires all firms to maintain fidelity bond coverage with the Securities Dealer Blanket Bond (securities blanket bond), unless the firm is unable to obtain this coverage. Today, firms that carry \$5 million or more in fidelity bond coverage, or that have had an insurance claim paid out by the insurance company within the past five years, cannot obtain the securities blanket bond, so they use the Financial Institution Form 14 Bond (Form 14 bond). The securities blanket bond provides “per event” coverage and the Form 14 bond provides “per year” coverage.⁵ FINRA believes that all firms required to maintain fidelity bond coverage should carry “per event” coverage offered by the securities blanket bond, unless they are unable to secure such coverage, in which case, they may carry the Form 14 bond as long as it offers coverage that is otherwise consistent with the requirements of the proposed rule. If a firm is unable to obtain either the securities blanket bond or the Form 14 bond, the firm must maintain coverage with a bond that is substantially similar to the securities blanket bond and is otherwise consistent with the requirements of the proposed rule.

Like NASD Rule 3020, proposed FINRA Rule 4360 requires that a firm’s fidelity bond include a cancellation rider providing that the insurer will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or “substantially modified.” Also, the proposed rule adopts the definition of “substantially modified” in NYSE Rule 319⁶ and incorporates NYSE Rule 319’s standard that a firm must *immediately* advise FINRA in writing if its insurance is cancelled, terminated or substantially modified.

Minimum Required Coverage

Proposed FINRA Rule 4360 increases the minimum required fidelity bond coverage for firms, while continuing to base the coverage on their net capital requirement.⁷ To that end, the proposed rule requires a firm with a net capital requirement that is less than \$250,000 to maintain minimum coverage of the greater of 120 percent of the firm’s required net capital under SEA Rule 15c3-1 or \$100,000. The increase to \$100,000 modifies the present minimum requirement of \$25,000. FINRA believes this increase is warranted since the NASD and NYSE fidelity bond rules have not been materially modified since adoption—over 30 years ago—and \$25,000 in 1974 (the year the NASD rule was adopted) is equal to approximately \$124,000 today (adjusted for inflation).

Historically, firms that have maintained minimum coverage of \$25,000 have had claims that exceed this amount. Although firms may experience a slight increase in costs for their premiums under the proposal, FINRA believes that the proposed changes to the fidelity bond minimum requirements are necessary to provide meaningful and practical coverage for losses covered by the bond.

Under proposed FINRA Rule 4360, firms with a net capital requirement of at least \$250,000 will use a table in the rule to determine their minimum fidelity bond coverage requirement. The table is a modified version of the table in NASD Rule 3020, incorporating aspects of NYSE Rule 319. The identical NASD and NYSE requirements for firms that have a minimum net capital requirement that exceeds \$1 million are retained in proposed FINRA Rule 4360. However, the proposed rule adopts the higher requirements in NYSE Rule 319 for a firm with a net capital requirement of at least \$250,000, but less than \$1 million.⁸

Insuring Agreements

The securities blanket bond provides the same level of coverage (100 percent) for all Insuring Agreements required by the NASD and NYSE rules. To reflect this industry practice, proposed FINRA Rule 4360 eliminates the specific coverage provisions in the NASD and NYSE rules that permit less than 100 percent of coverage⁹ for certain Insuring Agreements (*i.e.*, fraudulent trading and securities forgery) to require that coverage for all Insuring Agreements be equal to 100 percent of the bond coverage. Firms may elect to carry optional Insuring Agreements not required by proposed FINRA Rule 4360 for an amount less than 100 percent of the bond coverage.

Also, proposed FINRA Rule 4360 aligns the Insuring Agreements required by the rule with the securities blanket bond that is offered to FINRA member firms. Under the proposed rule, a firm's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency. These areas of coverage are modified, in part, from NASD Rule 3020; however, the proposal does not substantively change what is required to be covered by the bond.

Deductibles

Proposed FINRA Rule 4360 provides for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a firm. Similar to NASD Rule 3020, any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the member is deducted from the firm's net worth in the calculation of its net capital for purposes of SEA Rule 15c3-1.¹⁰ FINRA notes that a firm may elect, subject to availability, a deductible less than 10 percent of the coverage purchased.

Annual Review and Adjustments

Consistent with NASD Rule 3020 and NYSE Rule 319, proposed FINRA Rule 4360 requires each firm—including a firm that signs a multi-year insurance policy—annually as of the yearly anniversary date of the issuance of the fidelity bond to review the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the rule. Under the proposed rule, a firm’s highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), is used as the basis for determining the firm’s required minimum fidelity bond coverage for the succeeding 12-month period. The “preceding 12-month period” includes the 12-month period that ends 60 days before the yearly anniversary date of a member’s fidelity bond. This gives a firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

Exemptions

Proposed FINRA Rule 4360 provides an exemption from the fidelity bond requirements for firms in good standing with a national securities exchange that maintain a fidelity bond subject to requirements of such exchange that are equal to or greater than the requirements set forth in the proposed rule.¹¹

Additionally, consistent with NYSE Rule Interpretation 319/01, proposed FINRA Rule 4360 continues to exempt from the fidelity bond requirements any firm that acts solely as a Designated Market Maker (DMM),¹² floor broker or registered floor trader and does not conduct business with the public.

Proposed FINRA Rule 4360 does not maintain the exemption in NASD Rule 3020 for a one-person firm.¹³ Historically, a sole proprietor or sole stockholder member firm was excluded from the fidelity bond requirements based upon the assumption that such firms were one-person shops and, therefore, could not obtain coverage for their own acts. FINRA has determined that sole proprietor and sole stockholder firms can and often do acquire fidelity bond coverage, even though it is currently not required, since all claims (irrespective of firm size) are likely to be paid or denied on a facts-and-circumstances basis. Also, certain provisions of the fidelity bond benefit a one-person shop (*e.g.*, those covering customer property lost in transit).

Implementation Date

FINRA understands that changes to a firm’s fidelity bond policy, in coordination with insurance providers, may be impacted by bond renewal cycles and changes required by the insurance industry. As such, FINRA will work with firms to establish a reasonable implementation date for the proposed rule change upon approval by the SEC.

Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or 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 SEA Section 19 and rules thereunder.
- 4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 5 Since 1982, firms electing to acquire coverage through the FINRA-sponsored Insurance Program (Sponsored Program) have been provided with the securities blanket bond. It is the “default” insurance for FINRA member firms in that when a firm completes the application for the Sponsored Program, they are applying for the securities blanket bond.
- 6 NYSE Rule 319 defines the term “substantially modified” as any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of the rule.
- 7 See Attachment B for examples of estimated premiums for different sized firms under the proposed rule.
- 8 For example, NASD Rule 3020 permits a small clearing and carrying firm (*i.e.*, one subject to a \$250,000 net capital requirement) to obtain \$300,000 in coverage. The same firm, had it been designated to NYSE, would have needed \$600,000 in coverage. FINRA believes the increased coverage requirements are appropriate given the larger number/amount of claims that can be satisfied at these levels.
- 9 See NASD Rule 3020(a)(4) and (a)(5); NYSE Rule 319(d)(ii)(B) and (C), and (e)(ii)(B) and (C).
- 10 NASD Rule 3020 bases the deduction from net worth for an excess deductible on a firm’s minimum required coverage while proposed FINRA Rule 4360 bases such deduction from net worth on coverage purchased by the firm.

- 11 In general, the notification provisions of the corresponding exchange rules (*i.e.*, cancellation rider and notification upon cancellation, termination or substantial modification of the bond) require notification to the respective exchange rather than to FINRA. Accordingly, the practical effect for a firm that avails itself of the proposed exemption is that such firm must maintain a fidelity bond subject to the same requirements as in Proposed FINRA Rule 4360; however, such firm is exempt from the requirement that FINRA be notified of changes to the bond and will alternatively comply with the notification provisions of the respective exchange.
- 12 See Exchange Act Release No. 58845 (October 24, 2008), 73 FR 64379 (October 29, 2008) (Approval Order; SR-NYSE-2008-46). In this rule filing, the role of the specialist was altered in certain respects and the term “specialist” was replaced with the term “Designated Market Maker.”
- 13 A one-person firm (that is, a firm owned by a sole proprietor or stockholder that has no other associated persons, registered or unregistered) has no “employees” for purposes of NASD Rule 3020, and therefore such a firm currently is not subject to the fidelity bonding requirements. Conversely, a firm owned by a sole proprietor or stockholder that has other associated persons has “employees” for purposes of NASD Rule 3020, and currently is, and will continue to be, subject to the fidelity bonding requirements.

Attachment A

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

* * * * *

Text of Proposed New FINRA Rule

(Marked to Show Changes from NASD Rule 3020; NASD Rule 3020 and NYSE Rule 319 (and Its Interpretation) to Be Deleted in Their Entirety from the Transitional Rulebook)

* * * * *

[3020]4360. Fidelity Bonds

(a) [Coverage Required]General Provision

(1) Each member required to join the Securities Investor Protection Corporation [who has employees and who is not a member in good standing of the American Stock Exchange, Inc.; the Boston Stock Exchange; the Midwest Stock Exchange, Inc.; the New York Stock Exchange, Inc.; the Pacific Stock Exchange, Inc.; the Philadelphia Stock Exchange, Inc.; or the Chicago Board Options Exchange] shall[:]

[(1) M] maintain [a] blanket fidelity bond coverage[, in a form substantially similar to] with the [standard form of] Securities Dealer [Brokers] Blanket Bond, [promulgated by the Surety Association of America, covering officers and employees] which provides against loss and has insuring [a] Agreements covering at least the following:

- (A) Fidelity
- (B) On Premises
- (C) In Transit
- [(D) Misplacement]
- [(E) D] Forgery and Alteration [(including check forgery)]
- [(F) E] Securities [Loss (including securities forgery)]
- [(G) E] [Fraudulent Trading] Counterfeit Currency

[(H) 2] The fidelity bond must include a [C] cancellation [R] rider providing that the insurance carrier will use its best efforts to promptly notify [the National Association of Securities Dealers, Inc.] FINRA in the event the bond is cancelled, terminated or substantially modified.

(b) Minimum Required Coverage

([2]1) A member with a net capital requirement of less than \$250,000 must [M]maintain minimum fidelity bond coverage for all [i]Insuring [a]Agreements required [in this] by paragraph (a) of this Rule of [not less than \$25,000;] the greater of (1) 120% of the member's required net capital under SEA Rule 15c3-1 or (2) \$100,000. A member with a net capital requirement of \$250,000 or more must maintain minimum fidelity bond coverage for all Insuring Agreements required by paragraph (a) of this Rule in accordance with the following table:

(3) Maintain required minimum coverage for Fidelity, On Premises, In Transit, Misplacement and Forgery and Alteration insuring agreements of not less than 120% of its required net capital under SEC Rule 15c3-1 up to \$600,000. Minimum coverage for required net capital in excess of \$600,000 shall be determined by reference to the following table:]

Net Capital Requirement under SE[C]A Rule 15c3-1	Minimum Coverage
\$250,000–300,000	\$600,000
300,001–500,000	700,000
[\$6]500,00[0]1–1,000,000	[75]800,000
1,000,001–2,000,000	1,000,000
2,000,001–3,000,000	1,500,000
3,000,001–4,000,000	2,000,000
4,000,001–6,000,000	3,000,000
6,000,001–12,000,000	4,000,000
12,000,001[–]and above	5,000,000

(2) At a minimum, a member must maintain fidelity bond coverage for any person associated with the member, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee.

[(4) Maintain Fraudulent Trading coverage of not less than \$25,000 or 50% of the coverage required in paragraph (a)(3), whichever is greater, up to \$500,000;]

[(5) Maintain Securities Forgery coverage of not less than \$25,000 or 25% of the coverage required in paragraph (a)(3), whichever is greater, up to \$250,000.]

[(b)c] Deductible Provision

[(1) A deductible provision may be included in the bond of up to \$5,000 or 10% of the minimum insurance requirement established hereby, whichever is greater.]

[(2) If a member desires to maintain coverage in excess of the minimum insurance requirement then a deductible provision may be included in the bond of up to \$5,000 or 10% of the amount of blanket coverage provided in the bond purchased, whichever is greater. The excess of any such deductible amount over the maximum permissible deductible amount described in subparagraph (1) above must be deducted from the member's net worth in the calculation of the member's net capital for purposes of SEC Rule 15c3-1. Where the member is a subsidiary of another Association member the excess may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.]

A provision may be included in a fidelity bond to provide for a deductible of up to 25% of the coverage purchased by a member. Any deductible amount elected by the member that is greater than 10% of the coverage purchased by the member must be deducted from the member's net worth in the calculation of its net capital for purposes of SEA Rule 15c3-1. If the member is a subsidiary of another FINRA member, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

[(c)d] Annual Review of Coverage

(1) [Each]A member, including a member that signs a multi-year insurance policy,[other than members covered by subparagraph (2),] shall, annually [review,] as of the yearly anniversary date of the issuance of the fidelity bond, review the adequacy [thereof] of its coverage and make any required adjustments, as set forth in paragraphs (d)(2) and (d)(3) of this Rule. [by reference to the highest required net capital during the immediately preceding twelve-month period, which amount shall be used to determine minimum required coverage for the succeeding twelve-month period pursuant to subparagraphs (a)(2), (3), (4) and (5).]

(2) A member's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), shall be used as the basis for determining the member's required minimum fidelity bond coverage for the succeeding 12-month period. For the purpose of this paragraph, the "preceding 12-month period" shall include the 12-month period that ends 60 days before the yearly anniversary date of a member's fidelity bond. [Each member which has been in business for one year shall, as of the first anniversary date of the issuance of its original bond, review the adequacy thereof by reference to an amount calculated by dividing the highest it experienced during its first year by 15. Such amount shall be used in lieu of required net capital under SEC Rule 15c3-1 in determining the minimum required coverage to be carried in the member's second year pursuant to subparagraphs (a)(2), (3), (4) and (5). Notwithstanding the above, no such member shall carry less minimum bonding coverage in its second year than it carried in its first year.]

[(3) Each member shall make required adjustments not more than 60days after the anniversary date of the issuance of such bond.]

(3) A member that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement may use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member shall not carry less minimum bonding coverage in its second year than it carried in its first year.

[(4) Any member subject to the requirements of this paragraph (c) may apply for an exemption from the requirements of this paragraph (c). The application shall be made pursuant to Rule 9610 of the Code of Procedure. The exemption may be granted upon a showing of good cause, including a substantial change in the circumstances or nature of the member's business that results in a lower net capital requirement. The NASD may issue an exemption subject to any condition or limitation upon a member's bonding coverage that is deemed necessary to protect the public and serve the purposes of this Rule.]

[(d)e) Notification of Change

Each member shall report the cancellation, termination or substantial modification of the fidelity bond to [the Association] FINRA within ten business days of such occurrence.

[(e) Definitions]

[For purposes of fidelity bonding the term "employee" or "employees" shall include any person or persons associated with a member firm (as defined in Article I, paragraph (q) of the By-Laws) except:]

[(1) Sole Proprietors]

[(2) Sole Stockholders]

[(3) Directors or Trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.]

[(f) Exemptions]

(1) The requirements of this Rule shall not apply to:

(A) members that maintain a fidelity bond as required by a national securities exchange, registered with the SEC under Section 6 of the Exchange Act, provided that the member is in good standing with such national securities exchange and the fidelity bond requirements of such exchange are equal to or greater than the requirements of this Rule; and

(B) members whose business is solely that of a Designated Market Maker, Floor broker or registered Floor trader and who does not conduct business with the public.

(2) Any member may apply for an exemption, pursuant to the Rule 9600 Series, from the requirements of paragraphs (d)(2) and (d)(3) of this Rule. An exemption may be granted, at the discretion of FINRA, upon a showing of good cause, including a substantial change in the circumstances or nature of the member's business that would result in a lower net capital requirement.

• • • Supplementary Material: -----

.01 Alternative Coverage. Where a member is unable to obtain the Securities Dealer Blanket Bond, the member shall maintain fidelity bond coverage with the Financial Institution Form 14 Bond that is otherwise consistent with the requirements of this Rule. Where a member is unable to obtain either the Securities Dealer Blanket Bond or the Financial Institution Form 14 Bond, the member shall maintain fidelity bond coverage with a bond that is substantially similar to the Securities Dealer Blanket Bond and is otherwise consistent with the requirements of this Rule.

.02 Definitions. For purposes of this Rule, the term "substantially modified" shall mean any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of this Rule.

Attachment B

Examples:¹

Firm with four employees, no branches.	Estimated Premiums
Present coverage of \$25,000 with \$5,000 deductible.	\$364
Proposed coverage of \$100,000 with \$10,000 deductible.	\$598
Proposed coverage of \$100,000 with \$25,000 deductible.	\$569
Firm with 18 employees, three branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$790
Proposed coverage of \$100,000 with \$10,000 deductible.	\$1,140
Proposed coverage of \$100,000 with \$25,000 deductible.	\$1,085
Firm with 100 employees, 45 branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$3,278
Proposed coverage of \$100,000 with \$10,000 deductible.	\$4,168
Proposed coverage of \$100,000 with \$25,000 deductible.	\$3,964
Firm with 375 employees, 150 branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$9,823
Proposed coverage of \$100,000 with \$10,000 deductible.	\$12,346
Proposed coverage of \$100,000 with \$25,000 deductible.	\$11,743

¹ Branch charges have been factored into the estimated premiums. The above examples do not include the 10 percent discount available to FINRA member firms electing a two-year policy.