Regulatory Notice 11-21

Fidelity Bonds

SEC Approves Consolidated FINRA Rule Governing Fidelity Bonds

Effective Date: January 1, 2012

May 2011

Notice Type
- Consolidated FINRA Rulebook
- Rule Approval

Suggested Routing
- Compliance
- Finance
- Legal
- Operations
- Senior Management

Key Topics
- Fidelity Bonds

Referenced Rules & Notices
- FINRA Rule 4360
- NASD Rule 3020
- NYSE Rule 319 and its Interpretation
- SEA Rule 15c3-1
- SEA Rule 17a-4

Executive Summary

The SEC approved FINRA's proposal to adopt a rule governing fidelity bonds[1] for the consolidated FINRA rulebook.[2] The new rule, FINRA Rule 4360, is based on NASD Rule 3020, taking into account certain requirements under NYSE Rule 319 and its Interpretation.[3]

The text of the new rule is set forth in Attachment A. The rule takes effect on January 1, 2012.

Questions regarding this *Notice* should be directed to:

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- Erika L. Lazar, Counsel, Office of General Counsel, at (202) 728-8013.

Background & Discussion

FINRA Rule 4360 (Fidelity Bonds) updates and clarifies the fidelity bond requirements in NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) and better reflects current industry practices. The requirements are set forth in detail below.

Financial Industry Regulatory Authority

General Provision

FINRA Rule 4360 requires each member firm that is required to join the Securities Investor Protection Corporation (SIPC) to maintain blanket fidelity bond coverage with specified amounts of coverage based on the firm's net capital requirement, with certain exceptions.[4] Such firms must maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability.[5] Firms may apply for this level of coverage with any product that meets these requirements, including the Securities Dealer Blanket Bond (SDBB) or a properly endorsed Financial Institution Form 14 Bond (Form 14).[6]

Most fidelity bonds contain a definition of the term "loss" (or "single loss"), for purposes of the bond, which generally includes all covered losses resulting from any one act or a series of related acts. A payment by an insurer for covered losses attributed to a single loss does not reduce a firm's coverage amount for losses attributed to other, separate acts. A fidelity bond with an aggregate limit of liability caps a firm's coverage during the bond period at a certain amount if a loss (or losses) meets this aggregate threshold. FINRA believes that per loss coverage without an aggregate limit of liability provides firms with the most beneficial coverage since the bond amount cannot be exhausted by one or more covered losses, which means it will be available for future losses during the bond period.

A firm that does not qualify for a fidelity bond with per loss coverage and no aggregate limit of liability must maintain substantially similar fidelity bond coverage in compliance with all other provisions of the rule, provided that the firm maintains written correspondence from two insurance providers stating that the firm does not qualify for such coverage.[7] The firm must retain such correspondence for the period specified by Exchange Act Rule 17a-4(b)(4).[8]

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.[9] These Insuring Agreements are defined in the fidelity bond forms available to firms. FINRA Rule 4360 modifies the descriptive headings for these Insuring Agreements, in part, from NASD Rule 3020(a)(1) and NYSE Rule 319(d) to align them with the headings in the current bond forms.[10] In addition, FINRA Rule 4360 replaces the specific coverage provisions in the NASD and NYSE rules that permit less than 100 percent of coverage for certain Insuring Agreements (*i.e.*, fraudulent trading and securities forgery)[11] so that coverage for all Insuring Agreements must be equal to 100 percent of the firm's minimum required bond coverage.[12]

A firm's fidelity bond must 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. FINRA Rule 4360 adopts the definition of "substantially modified" in NYSE Rule 319[13] and incorporates NYSE Rule 319.12's standard that a firm must *immediately* advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.[14]

Minimum Required Coverage

Each firm subject to the rule must maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee.[15]

A firm with a minimum net capital requirement that is less than $250,000 must maintain minimum coverage of the greater of 120 percent of its required minimum net capital under Exchange Act Rule 15c3-1 or $100,000.[16] The $100,000 minimum coverage requirement 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 their adoption more than 30 years ago. Although firms may experience a slight increase in costs for their premiums under the new rule, FINRA believes that the amendments to the fidelity bond minimum requirements are necessary to provide meaningful and practical coverage for losses covered by the bond.

Firms with a minimum net capital requirement of at least $250,000 must use a table in FINRA Rule 4360 to determine their minimum fidelity bond coverage requirement.[17] The table is a modified version of the tables in NASD Rule 3020(a)(3) and NYSE Rule 319(e)(i). The identical NASD and NYSE requirements for members that have a minimum net capital requirement that exceeds $1 million have been retained in FINRA Rule 4360; however, the rule adopts the higher requirements in NYSE Rule 319(e)(i) for a member with a net capital requirement of at least $250,000, but less than $1 million.

The entire amount of a firm's minimum required coverage must be available for covered losses and may not be eroded by the costs an insurer may incur if it chooses to defend a claim. Specifically, any defense costs for covered losses must be in addition to a firm's minimum coverage requirements.[18] A firm may include defense costs as part of its fidelity bond coverage, but only to the extent that it does not reduce its minimum required coverage under the rule.

Deductible Provision

FINRA Rule 4360 provides for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a firm. Any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the firm[19] must be deducted from its net worth in the calculation of its net capital for purposes of Exchange Act Rule 15c3-1.[20] Like the legacy NASD and NYSE rules, if the firm is a subsidiary of another FINRA member firm, 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.[21]

Annual Review of Coverage

A member firm (including a firm that signs a multi-year insurance policy) must review, annually as of the yearly anniversary date of the issuance of its fidelity bond, the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the rule.[22] 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 the basis for determining the firm's minimum required fidelity bond coverage for the succeeding 12-month period.[23] The "preceding 12-month period" includes the 12-month period that ends 60 days before the yearly anniversary date of a firm's fidelity bond to provide the firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

A firm 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 may not carry less minimum fidelity bond coverage in its second year than it carried in its first year.[24]

Exemptions

FINRA Rule 4360 exempts from the fidelity bond requirements firms in good standing with a national securities exchange that maintain a fidelity bond subject to the requirements of such exchange that are equal to or greater than the requirements set forth in the rule.[25] Additionally, consistent with NYSE Rule Interpretation 319/01, FINRA Rule 4360 exempts from the fidelity bond requirements any firm that acts solely as a Designated Market Maker (DMM), floor broker or registered floor trader and does not conduct business with the public.[26]

FINRA Rule 4360 does not maintain the exemption in NASD Rule 3020(e) for a one-person firm.[27] Historically, a sole proprietor or sole stockholder member 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 these 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. In addition, FINRA believes that each Insuring Agreement required by FINRA Rule 4360 has the potential to benefit a one-person firm.[28] Moreover, FINRA believes that requiring all SIPC member firms, regardless of size or structure, to maintain fidelity bond coverage promotes investor protection objectives and mitigates the effects of unforeseen losses.

Effective Date

FINRA Rule 4360 takes effect on January 1, 2012. Member firms subject to the rule (including a firm that signs a multi-year insurance policy) must have a fidelity bond in place as of January 1, 2012, that meets all of the requirements set forth in FINRA Rule 4360. Firms should contact their fidelity bond insurance providers in advance of the effective date of the rule to ensure that necessary updates to their policies are in place as of the effective date.

Endnotes

1 *See* Securities Exchange Act Release No. 63961 (February 24, 2011), 76 FR 11542 (March 2, 2011) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-059).

2 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 members 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 03/12/08* (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

3 FINRA Rule 4360 replaces NASD Rule 3020 and the corresponding provisions in NYSE Rule 319 and its Interpretation. Accordingly, effective January 1, 2012, NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) will be deleted from the Transitional Rulebook.

4 *See* FINRA Rule 4360(a)(1).

5 *See* FINRA Rule 4360(a)(3).

6 Since 1982, firms electing to acquire coverage through the FINRA-sponsored Insurance Program (Sponsored Program) have been provided with the SDBB. 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 SDBB.

7 *See* FINRA Rule 4360.02.

8 FINRA has been advised by insurance industry representatives that the alternative coverage requirement is necessary for firms that, for example, have had a covered loss paid by an insurer within the past five years or firms that may present certain risk factors that would prevent an insurer from offering per loss coverage without an aggregate limit of liability.

9 *See* FINRA Rule 4360(a)(1)(A)–(F).

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Endnotes continued

10 FINRA has been advised by insurance industry representatives that the rule change does not substantively change what is required to be covered by the bond. For example, previous versions of the SDBB and Form 14 included a separate Insuring Agreement for misplacement; however, in the current versions of the bonds, this coverage is included in both "on premises" and "in transit" coverage.

11 *See* NASD Rule 3020(a)(4) and (a)(5), and NYSE Rule 319(d)(ii)(B) and (C), and (e)(ii)(B) and (C).

12 Firms may elect to carry additional, optional Insuring Agreements not required by FINRA Rule 4360 for an amount less than 100 percent of the minimum required bond coverage.

13 FINRA Rule 4360.01 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 this Rule."

14 *See* FINRA Rule 4360(a)(2) and (e).

15 *See* FINRA Rule 4360(b)(2).

16 *See* FINRA Rule 4360(b)(1).

17 *See* FINRA Rule 4360(b)(1).

18 *See* FINRA Rule 4360(b)(3).

19 FINRA notes that a firm may elect, subject to availability, a deductible of less than 10 percent of the coverage purchased.

20 FINRA Rule 4360 eliminates the current concept of an "excess deductible" linked to a member firm's required *minimum* bond requirement in NASD Rule 3020 and bases such deduction from net worth on coverage purchased by the firm.

21 *See* FINRA Rule 4360(c).

22 *See* FINRA Rule 4360(d)(1).

23 *See* FINRA Rule 4360(d)(2).

24 *See* FINRA Rule 4360(d)(3).

25 *See* FINRA Rule 4360(f)(1)(A). 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 exemption is that such firm must maintain a fidelity bond subject to the same or greater requirements as in FINRA Rule 4360; however, such firm would be exempt from the requirement that FINRA be notified of changes to the bond and would alternatively comply with the notification provisions of the respective exchange.

26 *See* FINRA Rule 4360(f)(1)(B). *See also* Securities Exchange Act Release No. 58845 (October 24, 2008), 73 FR 64379 (October 29, 2008) (Order Approving File No. 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."

27 A one-person member (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.

Endnotes continued

28 Insuring Agreement A – Fidelity is premised on the acts of an "employee" of the insured, which is currently broadly defined in the SDBB to include, among others, an officer or other employee of the insured, while employed in, at or by any of the insured's offices or premises, an attorney retained by the insured while performing legal services for the insured and any natural person performing acts coming within the scope of the usual duties of an officer or employee of the insured, including any persons provided by an employment contractor. Based on this definition, FINRA believes that while a sole proprietor or sole stockholder may not have other associated persons or registered persons, it may have "employees" for purposes of a fidelity bond and therefore may benefit from Fidelity coverage (*e.g.*, outside counsel). Insuring Agreements B through F in FINRA Rule 4360 (*i.e.*, those covering property losses on premises or in transit, forgery and alteration, securities and counterfeit currency) are premised on losses suffered by the insured that are not limited to the acts of an "employee."

ATTACHMENT A

Below is the text of the new FINRA rule.

* * * * *

4360. Fidelity Bonds

(a) General Provision

(1) Each member required to join the Securities Investor Protection Corporation shall maintain blanket fidelity bond coverage which provides against loss and has Insuring Agreements covering at least the following:

(A) Fidelity

(B) On Premises

(C) In Transit

(D) Forgery and Alteration

(E) Securities

(F) Counterfeit Currency

(2) The fidelity bond must include a cancellation rider providing that the insurance carrier will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or substantially modified.

(3) A member's fidelity bond must provide for per loss coverage without an aggregate limit of liability.

(b) Minimum Required Coverage

(1) A member with a net capital requirement of less than $250,000 must maintain minimum fidelity bond coverage for all Insuring Agreements required by paragraph (a) of this Rule of the greater of (A) 120% of the member's required net capital under SEA Rule 15c3-1 or (B) $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:

Net Capital Requirement under SEA Rule 15c3-1	Minimum Coverage
250,000 – 300,000	600,000
300,001 – 500,000	700,000
500,001 – 1,000,000	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.

(3) Any defense costs for covered losses must be in addition to the minimum coverage requirements as set forth in paragraph (b)(1) of this Rule.

(c) Deductible Provision

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.

(d) Annual Review of Coverage

(1) A member, including a member that signs a multi-year insurance policy, shall, annually as of the yearly anniversary date of the issuance of the fidelity bond, review the adequacy of its coverage and make any required adjustments, as set forth in paragraphs (d)(2) and (d)(3) of this Rule.

(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.

(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.

(e) Notification of Change

A member shall immediately advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.

(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 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.

.02 Alternative Coverage. A member that does not qualify for blanket fidelity bond coverage as required by paragraph (a)(3) of this Rule shall maintain substantially similar fidelity bond coverage in compliance with all other provisions of this Rule, provided that the member maintains written correspondence from two insurance providers stating that the member does not qualify for the coverage required by paragraph (a)(3) of this Rule. The member must retain such correspondence for the period specified by SEA Rule 17a-4(b)(4).