

Regulatory Notice

14-05

Consolidated Financial and Operational Rules

SEC Approves Consolidated FINRA Rules 4314 (Securities Loans and Borrowings), 4330 (Customer Protection – Permissible Use of Customers’ Securities) and 4340 (Callable Securities)

Effective Date: May 1, 2014

Deadline for Notification to FINRA of Existing Programs under Rule 4330.06: May 30, 2014

Effective Date for FINRA Rule 4330(b)(2)(B): October 28, 2014

Executive Summary

The SEC approved FINRA’s proposed rule change¹ to adopt additional financial and operational rules for the consolidated FINRA Rulebook (the Consolidated Rulebook).² FINRA Rules 4314, 4330 and 4340 are new consolidated rules governing securities loans and borrowings, permissible use of customers’ securities and callable securities. The new rules are based in part on, and replace, provisions of the NYSE and NASD rules³ and include new provisions.

The text of the new rules is available at www.finra.org/notices/14-05.

Questions regarding this *Notice* should be directed to:

- ▶ Kris Dailey, Vice President, Risk Oversight & Operational Regulation (ROOR), at (646) 315-8434 or by [email](#); or
- ▶ Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-6903 or by [email](#).

Background & Discussion

The SEC recently approved new FINRA Rules 4314, 4330 and 4340 relating to securities loans and borrowings, permissible use of customers’ securities and callable securities.

February 2014

Notice Type

- ▶ Consolidated Rulebook

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Margin
- ▶ Operations
- ▶ Risk
- ▶ Senior Management

Key Topics

- ▶ Margin Lending
- ▶ Operational Rules
- ▶ Partial Redemption of Securities
- ▶ Securities Lending and Borrowing

Referenced Rules & Notices

- ▶ FINRA Rule 2111(b)
- ▶ FINRA Rule 4314
- ▶ FINRA Rule 4330
- ▶ FINRA Rule 4340
- ▶ NASD Rule 2330
- ▶ NYSE Rule 296 and its interpretations
- ▶ NYSE Rule 402
- ▶ NYSE Rule 402.30
- ▶ SEA Rule 15c3-3
- ▶ SEA Rule 17a-3
- ▶ SEA Rule 17a-4



Financial Industry Regulatory Authority

FINRA Rule 4314 (Securities Loans and Borrowings)

FINRA Rule 4314, based on NYSE Rule 296, sets forth the obligations of a firm that engages in lending and borrowing securities and establishes consistent disclosure and record keeping requirements relating to a firm's securities lending activities. The rule, among other things, requires a firm that acts as agent in a loan or borrow transaction to disclose its capacity. In cases where the firm lends securities to or borrows securities from a counterparty that is acting in an agency capacity, the firm must maintain books and records to reflect the details of the transaction with the agent and each principal(s) on whose behalf the agent is acting.

Specifically, Rule 4314(a) requires a firm that lends or borrows securities in the capacity of agent to disclose its capacity to the other party to the transaction, and prior to lending securities to or borrowing securities from a person that is not a FINRA member firm, to determine whether the other party is acting as principal or agent in the transaction. When the other party (which may or may not be a member firm) is acting as agent in the transaction, the member firm is required to maintain books and records that reflect: (1) the details of the transaction with the agent; and (2) each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

Supplementary Material .02 allows a firm to satisfy its disclosure obligation under Rule 4314(a) by, among other things, providing specific disclosure of its capacity as agent in the written agreement between the parties or in the individual confirmations of each loan and borrow transaction. Supplementary Material .03 clarifies the books and records requirements imposed by Rule 4314(a) and requires firms to create and maintain records for each security loan or borrow transaction in accordance with Securities Exchange Act (SEA) Rules 17a-3 and 17a-4. It further provides that when a firm enters into a security loan or borrow transaction with a party that is acting as agent on behalf of another principal(s), the firm must maintain a record of the transaction with the agent, including identifying the specific security and quantity loaned or borrowed, the contract value and the type and description of the security collateral provided to the agent, and the identity of each underlying principal and the amount and description of the collateral allocated to each such principal.

Rule 4314(b), based on NYSE Rule 296(a), continues to provide each firm that is a party to an agreement with another firm for the loan and borrowing of securities with the right to liquidate the transaction whenever the other party becomes subject to one of the liquidation conditions specified in the rule. Rule 4314(c) requires all firms that lend or borrow any security to or from any person that is not a FINRA member firm, including any customer, to have a written agreement, which may consist of the exchange of contract confirmations, that confers upon the member firm the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in Rule 4314(b).

Supplementary Material .04 reminds firms of their obligations under Rule 4330(b) to provide written disclosures to customers regarding the risks and financial impact associated with the customer's loan(s) of securities, and requires that firms disclose in the written notice their right to liquidate the borrow transactions with customers under the conditions specified in Rule 4314(b). In addition, Supplementary Material .05 requires, for purposes of Rule 4314(c), that each firm that is subject to the provisions of SEA Rule 15c3-3 and that borrows fully paid or excess margin securities from a customer comply with the provisions of SEA Rule 15c3-3 relating to the requirements for a written agreement between the borrowing firm and the lending customer.

Rule 4330 (Customer Protection – Permissible Use of Customers' Securities)

FINRA Rule 4330, based on NYSE Rule 402 and NASD Rule 2330, sets forth requirements applicable to a firm's use of customers' securities.

a. FINRA Rule 4330(a) (Authorization to Lend Customers' Margin Securities)

FINRA Rule 4330(a) requires a firm to obtain a customer's written authorization prior to lending securities that are held on margin for a customer and that are eligible to be pledged or loaned. Supplementary Material .02 permits a firm to use a single customer account agreement/margin agreement/loan consent signed by the customer as written authorization under Rule 4330(a), provided such customer account agreement/margin agreement/loan consent includes clear and prominent disclosure that the firm may lend either to itself or others any securities held by the customer in its margin account.

b. FINRA Rule 4330(b) (Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities)

1. Notification to FINRA

Rule 4330(b) establishes new requirements to address the borrowing and lending of customers' fully paid or excess margin securities. Specifically, Rule 4330(b)(1) requires a firm that borrows fully paid or excess margin securities carried for the account of any customer to:

- ▶ comply with the requirements of SEA Rule 15c3-3;
- ▶ comply with the requirements of SEA Section 15(e) (Notices to Customers Regarding Securities Lending) to provide notices to customers regarding securities lending; and
- ▶ notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to first engaging in such securities borrows.

Supplementary Material .06 (Notification to FINRA of Pre-existing Fully Paid or Excess Margin Securities Borrows and Disclosures to Customers) requires firms that have any existing fully paid or excess margin securities borrows with customers as of May 1, 2014 (*i.e.*, the effective date of the rule) to notify FINRA in writing, in such manner and format as FINRA may require, of such borrows. Firms must provide such notice to FINRA on or before May 30, 2014.

The notifications required under Rule 4330(b) for new programs and Supplementary Material .06 for pre-existing programs must be provided by a firm to its Regulatory Coordinator in writing, either in hard copy or electronically. The written notification must include the following:

- ▶ name and CRD number of the firm;
- ▶ name of individual contact at firm;
- ▶ type(s) and number of customers that are parties to the fully paid or excess margin securities borrow arrangement(s);
- ▶ type(s) of collateral provided to customers in connection with such securities borrow arrangements and how collateral is held (*e.g.*, in broker-dealer's custody, delivered to customer);
- ▶ for a new program, the proposed start date of the program; and
- ▶ for an existing program, the date the program commenced.

Pursuant to Supplementary Material .03 (Notification to FINRA), FINRA may request additional information to evaluate compliance with SEA Rule 15c3-3, SEA Section 15(e) and other applicable FINRA rules or federal securities laws or rules. FINRA is considering alternative methods of notification, such as through Firm Gateway, and will announce any changes to the notification procedures in a future *Regulatory Notice*.

2. Appropriateness Determination

FINRA Rule 4330(b)(2) requires a firm to make an appropriateness determination prior to first entering into a securities borrow with a customer and to provide specified written disclosures to customers with respect to the customer's securities loan transactions. Rule 4330(b)(2)(A) requires a firm to have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the firm must exercise reasonable diligence to ascertain the essential facts relative to the customer, including, but not limited to:

- ▶ the customer's financial situation and needs;
- ▶ tax status;
- ▶ investment objectives;

- ▶ investment time horizon;
- ▶ liquidity needs;
- ▶ risk tolerance; and
- ▶ any other information the customer may disclose to the firm or associated person in connection with entering such securities loans.

Supplementary Material .04 (Appropriateness of Customer's Loan(s) of Securities), provides that in making the appropriateness determination, when the firm has entered into a carrying agreement with an introducing firm pursuant to Rule 4311, the firm may rely on the representations of the introducing firm that has a customer relationship with the lender.

Supplementary Material .05 (Appropriateness Determination for Institutional Customers) provides that a firm may fulfill the obligation set forth in Rule 4330(b)(2)(A) for an institutional account, as defined in Rule 4512(c), by complying with the requirements of Rule 2111(b). FINRA reminds firms that they also are required to comply with FINRA Rule 2111 (Suitability) when recommending a securities lending program, individual transactions within such program, or an investment strategy that includes a securities lending program to a customer.⁴

3. Disclosure Documents and Delayed Implementation Date

FINRA Rule 4330(b)(2)(B) requires a firm, prior to first entering into securities borrowing arrangement with a customer, to provide the customer, in writing (which may be electronic), with a clear and prominent notice stating that the provisions of the Securities Investor Protection Act of 1970 (SIPA) may not protect the customer with respect to the customer's securities loan transaction and that the collateral delivered to the customer may constitute the only source of satisfaction of the member firm's obligation in the event the member firm fails to return the borrowed securities.

Rule 4330(b)(2)(B) further requires a firm to provide the customer with disclosures regarding the customer's rights with respect to the loaned securities, and the risks and financial impact associated with the customer's loan(s) of securities. These disclosures include, but are not limited to:

- ▶ the loss of voting rights;
- ▶ the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable;
- ▶ the factors that determine the amount of compensation received by the member firm and its associated persons in connection with the use of the securities borrowed from the customer;

- ▶ the factors that determine the amount of compensation (*e.g.*, interest rate) to be paid to the customer and whether or not such compensation can be changed by the firm under the terms of the borrow agreement;
- ▶ the risks associated with each type of collateral provided to the customer;
- ▶ that the securities may be “hard-to-borrow” because of short-selling or may be used to satisfy delivery requirements resulting from short sales;
- ▶ the potential tax implications, including payments deemed cash-in-lieu of dividend paid on securities while on loan; and
- ▶ the firm’s right to liquidate the transaction because of a condition of the kind specified in Rule 4314(b) (Securities Loans and Borrowings-Right to Liquidate Transaction).

Firms must provide customers with the written disclosures no later than October 28, 2014.

Rule 4330(b)(3) requires a firm to create and maintain books and records showing compliance with Rule 4330(b)(2). Such records must be maintained in accordance with the requirements of SEA Rule 17a-4(a).

Rule 4340 (Callable Securities)

FINRA Rule 4340, based in part on NYSE Rule 402.30 (Securities Callable in Part), requires a firm that has in its possession or control bonds or preferred stocks that are callable in part, whether specifically set aside or otherwise, to identify such securities and establish an impartial lottery system by which it will allocate among its customers the securities to be redeemed or selected as called in the event of a partial redemption or call. The rule applies to any security that by its terms may be called or redeemed prior to maturity.

The rule allows a firm to establish and make available on its website procedures by which it will allocate among its customers, on a fair and impartial basis, the securities to be redeemed or selected as called in the event of a partial redemption or call. In addition, the rule requires the firm to provide written notice (which may be electronic) to new customers at the opening of an account, and to all customers at least once every calendar year, of the manner in which they may access the allocation procedures on the firm’s website and that, upon a customer’s request, the firm will provide hard copies of the allocation procedures to the customer.

In addition, Rule 4340(b) and (c) set forth allocation restrictions firms must follow in the event of a favorable or unfavorable redemption of callable securities. Where a redemption of callable securities is made on terms favorable to the called parties, a firm must not allocate the securities to any account in which it or its associated persons have an interest until all other customers’ positions in such securities have been satisfied.⁵ Similarly, where the redemption of callable securities is made on terms unfavorable to the called parties, the rule provides that a firm cannot exclude its positions or those of its associated persons, including the accounts of clerical and ministerial associated persons, from the pool of securities eligible to be called.

Supplementary Material .02 (Allocations of Partial Redemptions or Calls) provides that a firm's allocation procedures may include the use of an impartial lottery system, acting on a pro-rata basis, or such other means as will achieve a fair and impartial allocation of the partially redeemed or called securities. Supplementary Material .03 (Accounts of an Introducing Member and its Associated Persons) provides that where an introducing firm is a party to a carrying agreement with another firm that is conducting an allocation pursuant to the rule, any accounts in which the introducing firm or its associated persons have an interest shall be subject to the provisions regarding participation in favorable and unfavorable calls or redemptions. In addition, the introducing firm must identify such accounts to the firm conducting the allocation.

Endnotes

1. See Securities Exchange Act Release No. 70958 (November 27, 2013) (*Order Approving Proposed Rule Change*; File No. SR-FINRA-2013-035); 78 FR 72951 (December 4, 2013).
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 members, 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 members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice March 12, 2008](#) (Rulebook Consolidation Process).
3. Effective May 1, 2014, NASD Rule 2330, NASD IM-2330, Incorporated NYSE Rule 296, including Supplementary Material .10 and .20, Incorporated NYSE Rule 402, including Supplementary Material .30, and NYSE Rule Interpretations 296(b)/01 and 402(b)/01 will be eliminated from the Transitional Rulebook.
4. FINRA previously has provided guiding principles that firms and registered representatives could consider when determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule. See, e.g., [Regulatory Notice 12-25](#) (discussing the term “recommendation” and citing various resources that explain the guiding principles that firms could use when analyzing whether a communication constitutes a recommendation); [Regulatory Notice 11-02](#) (discussing FINRA’s guiding principles); [Regulatory Notice 10-06](#), at 3-4 (providing guidance on recommendations made on blogs and social networking websites); [Notice to Members 01-23](#) (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *21-27 (Oct. 6, 2008) (applying the guiding principles to the facts of the case to find a recommendation), *aff’d in relevant part*, 592 F.3d 147 (D.C. Cir.), *cert. denied*, 130 S.Ct. 3333 (2010).
5. Supplementary Material .01 (Definition of Associated Person; Clerical and Ministerial Functions) to FINRA Rule 4340 clarifies that the term “associated person” as used in the rule has the same meaning as provided in SEA Section 3(a)(18), which expressly excludes, for certain purposes, any persons associated with the member whose functions are solely clerical or ministerial (referred to as “clerical and ministerial associated persons”).