Financial Industry Regulatory Authority

February 23, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2010-059 – Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing,[1] a proposed rule change to adopt new FINRA Rule 4360 (Fidelity Bonds). The Commission received three comment letters in response to the proposal.[2]

The proposed rule change would update and clarify the fidelity bond requirements and better reflect current industry practices. Proposed FINRA Rule 4360 would require each member that is required to join SIPC to maintain blanket fidelity bond coverage, including sole proprietors and sole stockholders who were previously exempted from the fidelity bond requirements.[3] The proposed rule would increase the minimum required fidelity bond coverage for members and would require members to maintain a fidelity bond that provides for per loss coverage without an aggregate limit

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1 See Securities Exchange Act Release No. 63331 (November 17, 2010), 75 FR 72850 (November 26, 2010) (Notice of Filing of SR-FINRA-2010-059) (the "Proposing Release").

2 Letter from Richard M. Garone, Underwriting Director, Travelers Bond & Financial Products, to Elizabeth M. Murphy, Secretary, SEC, dated December 16, 2010 ("Travelers"); letter from Robert J. Duke, Director of Underwriting/ Assistant Counsel, The Surety & Fidelity Association of America, to Elizabeth M. Murphy, Secretary, SEC, dated December 17, 2010 ("SFAA"); and letter from Albert Kramer, President, Kramer Securities Corporation, to Elizabeth M. Murphy, Secretary, SEC, dated December 31, 2010 ("Kramer").

3 Proposed FINRA Rule 4360 would exempt from the fidelity bond requirements members 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 proposed rule and any firm that acts solely as a Designated Market Maker, floor broker or registered floor trader and does not conduct business with the public.

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of liability. Supplementary material to proposed FINRA Rule 4360 would require members that do not qualify for a bond with per loss coverage without an aggregate limit of liability to secure alternative coverage. The proposed rule change would provide for a deductible amount of up to 25% of the coverage purchased by a member, subject to specified conditions.

The comments received by the Commission on proposed FINRA Rule 4360 and FINRA's responses to the comments are discussed in detail below.

A. Elimination of the Exemption in NASD Rule 3020 for Sole Proprietors and Sole Stockholders

Generally, NASD Rule 3020 requires any member that has employees and is required to join SIPC to maintain a blanket fidelity bond covering officers and employees, which provides against loss and has certain insuring agreements. For the purpose of fidelity bonding, NASD Rule 3020 excludes from the definition of "employee" sole proprietors, sole stockholders and directors or trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.[4] FINRA Rule 4360 would eliminate this definition and the exemption from the fidelity bond requirements for sole proprietors and sole stockholders. The proposed rule would require each member, at a minimum, to 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.

All three commenters[5] oppose the proposed elimination of the exemption from the fidelity bond requirements in NASD Rule 3020 for sole proprietors and sole stockholders. One commenter[6] believes that it is irresponsible to require one-person shops to maintain a fidelity bond that would provide little, if any, true coverage and that a one-person shop should be allowed to decide if they want to self insure in other areas that would not invoke the alter ego concept. Another commenter[7] requests that the proposed rule change not be approved without an exemption for sole proprietors and sole stockholders and notes that maintaining a fidelity bond will be a great financial burden for small firms. One commenter[8] agrees with the premise, as stated by FINRA in the rule filing, that sole proprietors and sole stockholders may rely on

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4 See NASD Rule 3020(e).

5 Kramer, SFAA and Travelers.

6 Travelers.

7 Kramer.

8 SFAA.

certain Insuring Agreements in a fidelity bond; however, two commenters[9] are concerned that Insuring Agreement A - Fidelity, required by paragraph (a)(1)(A) of the proposed rule, is not available in the market for a sole proprietor or sole stockholder because the sole owner is considered the alter ego of the company, and dishonesty of a sole owner cannot be underwritten prudently. One such commenter[10] suggests language that would explicitly exclude sole proprietors and sole stockholders from Insuring Agreement A - Fidelity coverage, and believes that the rule filing inaccurately describes Insuring Agreement A - Fidelity because it uses the term "malfeasance."

FINRA does not intend to amend the proposed rule change to retain the NASD Rule 3020 exemption for sole proprietors and sole stockholders. First, FINRA finds the commenters' concerns regarding the requirement to subject sole proprietors and sole stockholders to the fidelity bond requirements to be overstated. As noted in the rule filing, under NASD Rule 3020, 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 the rule, 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. Also as noted in the rule filing, FINRA has determined that sole proprietors 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 or structure) are likely to be paid or denied on a facts-and-circumstances basis.

FINRA understands that while the insured, in this case a sole owner, cannot be covered under any of the Insuring Agreements included in a fidelity bond for his or her own intentional acts, each such Agreement has the potential to benefit a one-person shop, including Insuring Agreement A - Fidelity. Insuring Agreements B through F in the proposed rule (i.e., those covering property loss on premises or in transit, forgery and alteration, securities and counterfeit currency) are all premised on losses suffered by the insured based on the acts of another person; such persons do not have to be an "employee" of the firm. Insuring Agreement A - Fidelity, however, is premised on the acts of an "employee" of the insured, which seems to be what raised concerns among the commenters, because such firms may not have what would typically be considered employees or other associated persons. The commenters argue that firms without employees can neither attain nor use Fidelity coverage.

FINRA notes that the term "employee" currently is defined in the Securities Dealer Blanket Bond to include, among others, an officer or other employee of the

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9 SFAA and Travelers.

10 SFAA.

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 broad 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). A member's fidelity bond may, based on the facts-and-circumstances, pay a claim for Fidelity based on the acts of one of these "employees." Moreover, FINRA believes that requiring all SIPC member firms, regardless of size or structure, to maintain fidelity bond coverage promotes investor protection objectives and protects firms from unforeseen losses.

Second, with respect to the comment that the rule filing imprecisely describes Insuring Agreement A - Fidelity, FINRA notes that the rule filing did not specifically address, or attempt to describe, any of the Insuring Agreements required by the proposed rule. The filing states that "[t]he purpose of a fidelity bond is to protect a member 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 member's capital." The statement in the rule filing that includes the term "malfeasance" is part of a description of the purpose of a fidelity bond in general, and does not address a particular Insuring Agreement. FINRA purposefully did not attempt to define the Insuring Agreements since these items are defined in the fidelity bonds themselves. However, FINRA notes that the statement regarding the general purpose of a fidelity bond does not aim to impose requirements beyond what is required under the provisions of the proposed rule.

B. Requirement for Per Loss Coverage Without an Aggregate Limit of Liability

One commenter[11] notes that the proposed rule change, which would require members subject to the proposed rule to maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability, will so significantly modify the Financial Institution Form 14 Bond ("Form 14") (i.e., removing the "industry standard" aggregate limit of liability) that it will create a competitive disadvantage to underwriters that do not offer this type of coverage. The commenter states only two underwriting firms offer this type of coverage and that this provision will pose a significant underwriting challenge to underwriters and increase costs for members. The commenter notes that the current NASD and NYSE rules reference forms that have an aggregate limit of liability.

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[11] Travelers.

As stated in the rule filing, FINRA believes that a member's fidelity bond coverage should not include an aggregate limit of liability because it is important that a member's coverage not be eroded by covered losses within the bond period, thus exposing a member to future losses with a reduced or exhausted bond limit. FINRA was advised by industry representatives active in drafting the revised Form 14 bond form that it could be modified to provide this type of coverage and that it could be offered by any firm that offers the Form 14. It would be up to the underwriter to decide how to establish appropriate premiums for members based on this type of coverage. FINRA does not intend to amend the proposed rule change with respect to this provision and believes that taking steps to prevent inadequate coverage for members' fidelity claims outweighs potential increases in premiums that may result from the proposed rule change.

C. Proposed Changes to the Deductible Provision

One commenter[12] opposes the provision in paragraph (c) of the proposed rule requiring a deduction from net capital in the case of certain deductible levels. While the commenter is pleased to see an increased maximum permissible deductible of 25% of the coverage purchased by a member, the commenter believes that the fact that an insured will have to take a deduction in their net capital computation for the difference over any deductible that is greater than 10% of their fidelity bond limit is going to provide strong disincentive for any firm to consider a higher deductible. The commenter states that it could lead to higher premium costs for members if an underwriter cannot obtain an adequate deductible versus exposure balance.

In response, FINRA notes that the proposed rule eliminates the current concept of an "excess deductible" linked to a member's required *minimum* bond requirement.[13] Rather, under proposed FINRA Rule 4360, a member would only be subject to a deduction from net capital in the amount of any deductible over 10% of the coverage *purchased* by the member. As such, FINRA does not believe that the proposed deductible provision will result in higher premium costs than the current rule. The

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12 Travelers.

13 Under NASD Rule 3020(b), a deductible provision may be included in a member's bond of up to $5,000 or 10% of the member's minimum insurance requirement, whichever is greater. 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 based on the member's minimum required coverage must be deducted from the member's net worth in the calculation of the member's net capital for purposes of SEA Rule 15c3-1.

proposed rule simply offers the option for a deductible of up to 25% of the coverage purchased and any deductible amount elected by the member that is greater than 10% of the coverage purchased must be deducted from the member's net worth in the calculation of its net capital for purposes of SEA Rule 15c3-1. FINRA believes that any member electing a deductible over 10% of the coverage purchased should make such a net capital adjustment in light of the increased "self-insurance" on the part of the member and the need to further ensure the financial soundness of the member. Accordingly, FINRA does not intend to amend this provision.

FINRA believes that the foregoing, along with the discussion in the Proposing Release, fully responds to the issues raised by the commenters. If you have any questions, please contact me at (202) 728-8013 or at erika.lazar@finra.org.

Very truly yours,

Erika L. Lazar
Counsel
FINRA Office of General Counsel