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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2013 - * 035
Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☑ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☑ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Rule

- 19b-4(f)(1)
- 19b-4(f)(2)
- 19b-4(f)(3)
- 19b-4(f)(4)
- 19b-4(f)(5)
- 19b-4(f)(6)

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) Section 806(e)(2)

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934

Section 3C(b)(2)

Exhibit 2 Sent As Paper Document

Exhibit 3 Sent As Paper Document

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Adopt FINRA Rules 4314 (Securities Loans and Borrowings), 4330 (Customer Protection – Permissible Use of Customers' Securities) and 4340 (Callable Securities) in the Consolidated FINRA Rulebook

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Kosha Last Name * Dalal

Title * Associate Vice President and Associate General Counsel

E-mail * kosha.dalal@finra.org

Telephone * (202) 728-6903 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 08/14/2013

By Patrice Gliniecki

(Name *)

(Title *)

Senior Vice President and Deputy General Counsel

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Patrice Gliniecki,

Required fields are shown with yellow backgrounds and asterisks.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information *

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change *

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Exhibit Sent As Paper Document

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

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Exhibit Sent As Paper Document

☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "SEA"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities, and callable securities as FINRA Rules in the consolidated FINRA rulebook. Specifically, the proposed rule change would adopt with amendments the following as FINRA Rules: (1) Incorporated NYSE Rule 296 (Liquidation of Securities Loans and Borrowings) and Supplementary Material paragraphs .10 and .20 regarding requirements applicable to a member that is a party to an agreement for the loan or borrowing of securities as FINRA Rule 4314 (Securities Loans and Borrowings); (2) Incorporated NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities) regarding requirements applicable to a member borrowing or lending a customer's securities that are eligible to be pledged or loaned as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities); and (3) Incorporated NYSE Rule 402.30 (Securities Callable in Part) regarding requirements applicable to a member that has in its possession or under its control any callable securities as FINRA Rule 4340 (Callable Securities).

The text of the proposed rule change is attached as Exhibit 5 to this rule filing.

(b) Upon Commission approval and implementation by FINRA of the proposed rule change, NASD Rule 2330, NASD IM-2330, Incorporated NYSE Rule 296, including Supplementary Material .10 and .20, Incorporated NYSE Rule 402, including

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[1] 15 U.S.C. 78s(b)(1).

Supplementary Material .30, and NYSE Rule Interpretations 296(b)/01 and 402(b)/01 will be eliminated from the current FINRA rulebook.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meetings on July 15, 2009 and September 23, 2009, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following Commission approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[2] FINRA is proposing to amend and adopt the following as FINRA Rules in the Consolidated FINRA Rulebook: (1) NYSE Rule 296 (Liquidation of Securities Loans and Borrowings)[3] and Supplementary Material paragraphs .10 and .20

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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 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

as FINRA Rule 4314 (Securities Loans and Borrowings); (2) NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities) as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities); and (3) NYSE Rule 402.30 (Securities Callable in Part) as FINRA Rule 4340 (Callable Securities).

I. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

a. Background

NYSE Rule 296 (Liquidation of Securities Loans and Borrowings) sets forth the obligations of a member that is party to an agreement with another member for the loan and borrowing of securities. Specifically, the rule provides that a member that is party to an agreement with another member for the loan and borrowing of securities has the right to liquidate such transaction whenever the other party to the transaction: (1) applies for or consents to a receiver, custodian, trustee or liquidator of itself or its property; (2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due; (3) makes a general assignment for the benefit of its creditors; or (4) files, or has filed against it, a petition for a Chapter 11 bankruptcy filing or a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA") ("liquidation conditions").

The rule further provides that no member may lend or borrow any security to or from any non-member of the NYSE, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon the member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified above.

NYSE Rule 296.10 defines the term "agreement for the loan and borrowing of securities," for purposes of NYSE Rule 296. NYSE Rule 296.20 provides that each member that is subject to SEA Rule 15c3-3 (Customer Protection – Reserves and Custody of Securities) and that borrows securities from a customer (as the term is defined in SEA Rule 15c3-3) must comply with SEA Rule 15c3-3's provisions requiring a written agreement between the borrowing member and the lending customer.

NYSE Rule 296 has been the basis for provisions incorporated in the industry standard Master Securities Lending Agreement ("MSLA"). The rule provides protection to members that may enter into a securities lending transaction without a duly signed MSLA with a counterparty. Should one of the counterparties become insolvent, the rule allows the other counterparty to liquidate immediately against collateral received. For these reasons, FINRA is proposing to adopt NYSE Rule 296 as FINRA Rule 4314 (Securities Loans and Borrowings) into the Consolidated FINRA Rulebook with the changes described below.

b. Proposed FINRA Rule 4314

In 2006, the industry began to adopt voluntary books and records and disclosure practices relating to securities lending, as a result of an industry-wide initiative to address the risks associated with agency lending (the Agency Lending Disclosure Initiative ("ALD Initiative")). Consistent with the industry-wide initiative, FINRA is proposing a new requirement to make clear whether parties are acting as principals or agents when entering into an agreement to loan or borrow securities. The proposed rule would require a member that acts as agent in a loan or borrow transaction to disclose its capacity and, in cases where the member lends securities to or borrows securities from a counterparty that

is acting in an agency capacity, require that the member 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 and the details of each transaction therewith.

Specifically, proposed new FINRA Rule 4314(a) would require a member that lends or borrows securities in the capacity of agent to disclose such capacity to the other party (or parties) to the transaction. The provision would further require a member, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction. When the other party (who may or may not be a member) is acting as agent in the transaction, the member would be 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. FINRA believes this requirement will help address concerns regarding the level of transparency and information disclosure in agency lending transactions. The new requirement would improve transparency by disclosing the name of the underlying principal(s) to the member and thereby give the member the ability to assess its creditworthiness, which is needed given the member's ongoing exposure in the lending transaction. In addition, the proposal establishes uniform books and records requirements.

Proposed FINRA Rule 4314(b), based on NYSE Rule 296(a), would continue to provide each member that is a party to an agreement with another member for the loan and borrowing of securities with the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions specified in the rule. FINRA is proposing to add the words "to liquidate such

transaction" to the last sentence of proposed paragraph (b)(1) to clarify the meaning of the provision. FINRA believes a member's right to liquidate the transaction under the specified circumstances would assist the member in managing the risk associated with such transactions and maintaining compliance with its net capital requirements. In addition, the liquidation conditions have largely been incorporated into the industry standard MSLA developed as part of the ALD Initiative.

In addition, NYSE Rule 296(b) requires a member to have a written agreement with any non-member of the NYSE to whom it lends, or from whom it borrows, securities. FINRA is proposing to adopt this requirement so that all FINRA members that engage in such transactions with non-members of FINRA must have the written agreement as required in NYSE Rule 296(b). Specifically, proposed FINRA Rule 4314(c) would require that no member shall lend or borrow any security to or from any person that is not a member of FINRA, including any customer, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon such member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in proposed FINRA Rule 4314(b). FINRA believes that applying this requirement to all FINRA members is appropriate for the adoption of the rule into the Consolidated FINRA Rulebook, protects the member's interests in the event of a liquidation condition specified in proposed FINRA Rule 4314(b) and supports the member's compliance with net capital requirements.

FINRA is proposing to transfer NYSE Rule 296.10, which defines the term "agreement for the loan and borrowing of securities," as Supplementary Material .01 to proposed FINRA Rule 4314, without substantive change. In addition, FINRA is

proposing to add new Supplementary Material .02 through .05 to the proposed FINRA rule. FINRA believes the new Supplementary Material provides clarity and guidance by describing how a member firm can meet its disclosure obligations under the proposed rule, and clarifying the proposed rule's books and records requirements. Specifically, proposed Supplementary Material .02 clarifies the methods by which a member may satisfy its disclosure obligation in new paragraph (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 security exchanged between the parties for each loan and borrow transaction. Proposed Supplementary Material .03 clarifies the books and records requirements imposed by new paragraph (a) and requires members to create and maintain records for each security loan or borrow transaction in accordance with SEA Rules 17a-3 and 17a-4. It also provides that when a member enters into a security loan or borrow transaction with a party that is acting as agent on behalf of another principal(s), the member must maintain a record of details 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. FINRA believes proposed Supplementary Material .03 will establish consistent industry standards regarding the types of information firms must maintain for each security loan or borrow transaction with an agent and the underlying principal(s) on whose behalf the agent is acting. Such detailed records will evidence that firms, when entering into security loan or borrow transactions,

have knowledge of the parties involved to enable them to assess, among other things, the creditworthiness of the underlying principal(s).

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

c. Eliminated Rules and Requirements

FINRA is proposing to eliminate NYSE Rule Interpretation 296(b)/01, which addresses transactions with non-member organizations and the written agreements required in regard to repurchase and reverse repurchase transactions not subject to SEA Rule 15c3-3, as the interpretation is beyond the scope of proposed FINRA Rule 4314.

II. Proposed FINRA Rule 4330 (Customer Protection - Permissible Use of Customers' Securities)

a. Background

NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities), NASD Rule 2330(b)-(d) (Customers' Securities or Funds) and NASD IM-2330 (Segregation of Customers' Securities) set forth the requirements applicable to a

member's use of customers' securities. Specifically, NYSE Rule 402 and NASD Rule 2330 prohibit a member from lending, either to itself or others, securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless the firm first obtains a written authorization from the customer permitting the lending of the customer's securities. NYSE Rule Interpretation 402(b)/01 (Agreements for Use of Customers' Securities/Application) permits a member to use a single customer signed margin agreement/loan consent in lieu of obtaining separate written documents. Both the NYSE and NASD rules contain similar provisions requiring members to comply with SEA Rule 15c3-3 in obtaining custody and control of securities and maintaining appropriate cash reserves.

FINRA is proposing to adopt NYSE Rule 402 as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities), subject to certain significant changes, and eliminate NASD Rule 2330 and NASD IM-2330 as duplicative or otherwise unnecessary.[4] The proposed rule adds new disclosure requirements and establishes the need for members to conduct appropriateness determinations before engaging in the borrowing and lending of customers' fully paid and excess margin securities.

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

Proposed FINRA Rule 4330(a) would require a member 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. FINRA believes continuing the requirement to have written customer consent protects customers. FINRA is also proposing to delete

[4] NASD Rule 2330(a), (e) and (f) are now marked "Reserved." The substantive provisions of these paragraphs were deleted in prior rule filings.

the phrase "either to itself as a broker-dealer or to others" currently contained in NYSE Rule 402(b) that in relevant part provides that "[n]o member organization shall lend, either to itself as a broker-dealer or to others, securities which are held on margin for a customer and which are eligible to be pledged or loaned, unless ….," because FINRA does not believe the language adds to the meaning of the sentence and may be confusing. Proposed FINRA Rule 4330(a) instead would clearly provide that "[n]o member shall lend securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless such member shall first have obtained a written authorization from such customer permitting the lending of such securities."

Proposed Supplementary Material .02 (Authorization to Lend Customers' Margin Securities) retains and codifies NYSE Rule Interpretation 402(b)/01, thereby continuing to permit a member to satisfy the written authorization requirement by using a single customer-signed margin agreement/loan consent, in lieu of obtaining a separate written authorization, provided that it contains a legend in bold type face placed directly above the signature line that states substantially the following:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

Consistent with NYSE Rule 402(a) and NASD Rule 2330(b), proposed Supplementary Material .01 (Definitions) would provide that the definitions contained in SEA Rule 15c3-3 would apply to proposed FINRA Rule 4330. However, the proposed rule does not include the requirement contained in both the NYSE and NASD rules for members to maintain cash reserves as prescribed by SEA Rule 15c3-3 because members continue to be subject to SEA Rule 15c3-3.

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

In addition, FINRA is proposing new requirements to address the borrowing and lending of customers' fully paid or excess margin securities. Specifically, proposed FINRA Rule 4330(b)(1) would require a member that borrows fully paid or excess margin securities carried for the account of any customer to: (A) comply with the requirements of SEA Rule 15c3-3; (B) comply with the requirements of Section 15(e) (Notices to Customers Regarding Securities Lending) of the Exchange Act to provide notices to customers regarding securities lending; and (C) notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to first engaging in such securities borrows.

Proposed Supplementary Material .03 (Notification to FINRA) would provide that upon FINRA's receipt of such written notification, FINRA may request such additional information as it may deem necessary to evaluate compliance with SEA Rule 15c3-3, Section 15(e) of the Exchange Act and other applicable FINRA rules or federal securities laws or rules. Examples of additional information would include, but would not be limited to:

(a) the written agreement authorizing such borrowing of securities, which shall reflect the material terms of the arrangement;

(b) the types of customers that are parties to such securities borrows;

(c) the types of accounts used to effect the securities borrows (i.e., whether the subject securities are maintained in customers' cash or margin or other accounts);

(d) the types of collateral provided to customers in connection with such securities borrows, the frequency of marking to market of the collateral and the custody arrangements for such collateral;

(e) the operational and recordkeeping processes related to such securities borrows;

(f) the rebates paid/received in connection with such securities borrows and any other compensation arrangements related thereto;

(g) the procedures for handling customers' requests to sell the securities subject to such borrows; and

(h) disclosures made to customers.

Proposed FINRA Rule 4330(b)(2) also imposes two new requirements that a member must satisfy prior to first entering into securities borrows with a customer. FINRA believes that these proposed new requirements will strengthen customer protection and increase investor confidence. First, proposed FINRA Rule 4330(b)(2)(A) would require that a member have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the member shall 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 member or associated person in connection with entering such securities loans. Accordingly, where a member has a securities borrow program, the member would be required to determine the appropriateness of such activity for the customer prior to the customer entering into the first securities borrow. In addition, proposed Supplementary Material .04

(Appropriateness of Customer's Loan(s) of Securities), clarifies that the member borrowing a customer's fully paid or excess margin securities is responsible for making the determination regarding the appropriateness of such borrow from a customer. The proposal would provide, however, that in making the determination, when the member has entered into a carrying agreement with an introducing member pursuant to FINRA Rule 4311, the member may rely on the representations of the introducing member that has a customer relationship with the lender.

Second, proposed FINRA Rule 4330(b)(2)(B) would require a member, prior to first entering into securities borrows with a customer, to provide the customer, in writing (which may be electronic), with a clear and prominent notice stating that the provisions of 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's obligation in the event the member fails to return the securities.

FINRA believes that providing customers with clear and prominent disclosure of potential risks associated with customers' loans of securities will allow customers to make more informed investment decisions. In addition, proposed FINRA Rule 4330(b)(2)(B) would require a member 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: (i) loss of voting rights; (ii) the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable; (iii) the factors that determine the amount of compensation received by the member and its

associated persons in connection with the use of the securities borrowed from the customer; (iv) 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 member under the terms of the borrow agreement; (v) the risks associated with each type of collateral provided to the customer; (vi) that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales; (vii) potential tax implications, including payments deemed cash-in-lieu of dividend paid on securities while on loan; and (viii) the member's right to liquidate the transaction because of a condition of the kind specified in FINRA Rule 4314(b) (Securities Loans and Borrowings-Right to Liquidate Transaction) (discussed above).

Proposed FINRA Rule 4330(b)(3) would require that a member create and maintain books and records evidencing compliance with proposed FINRA Rule 4330(b)(2). Such records must be maintained in accordance with the requirements of SEA Rule 17a-4(a).

Proposed Supplementary Material .05 (Notification to FINRA of Pre-existing Fully Paid or Excess Margin Securities Borrows and Disclosures to Customers) would require members that have any existing fully paid or excess margin securities borrows with customers as of the effective date of proposed Rule 4330 to notify FINRA in writing, in such manner and format as FINRA may require, of such borrows within 30 days from the effective date of the rule. Notifications may be provided to a member's FINRA Regulatory Coordinator in writing, either in hard copy or electronically. FINRA will specify the manner and format of such notification in a Regulatory Notice announcing the effectiveness of the rule. In addition, such members would be required to

provide such customers with the disclosures required by proposed FINRA Rule 4330(b)(2)(B) within 90 days from the effective date of the rule. FINRA believes that the requirement to provide notice to FINRA of existing programs is necessary for it to have a more complete picture of members' activities in this area when the rule becomes effective, and that the proposed timeframes for notice to FINRA and providing disclosures to existing customers are reasonable.

d. Eliminated Rules and Requirements

Proposed FINRA Rule 4330 would not retain the provisions in NYSE Rule 402 that are duplicative of the requirements in SEA Rule 15c3-3 or the outdated provisions regarding the physical segregation of securities. In addition, the proposed rule change would eliminate NASD Rule 2330 and NASD IM-2330, which also contain duplicative provisions relating to SEA Rule 15c3-3 and outdated provisions relating to the physical segregation of securities.

III. Proposed FINRA Rule 4340 (Callable Securities)

a. Background

NYSE Rule 402.30 (Securities Callable in Part) requires a member that has in its possession or control securities that are callable in part to identify each such security so that its records clearly show for whose account it is held. The following securities are exempt from this requirement:

(1) certain bonds that have not paid interest for at least two interest periods;

(2) Euro-dollar bonds deposited in a central clearing facility for such bonds, provided that customers are notified of the deposit into the central clearing facility

and also that the member has the right to withdraw uncalled bonds from the facility at any time; and

(3) bonds or preferred stocks, provided that the member has satisfied certain requirements, including adopting an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member.

NYSE Rule 402.30 also requires that a member provide written disclosure to all customers of the systems and the manner in which securities are held and their rights to withdraw uncalled securities, as described above, prior to: (1) the member depositing the securities in bulk; or (2) the customer purchasing such securities, except in the case of a new account, provided that such notice was sent to the customer prior to the settlement date. The rule further requires that in the event of a favorable call of the securities, the member shall not allocate any securities to any account in which it or its general, limited, or special partners, officers, directors, approved persons or employees have an interest until all other customers' positions in the securities have been satisfied. There is no comparable NASD rule.

FINRA is proposing to adopt FINRA Rule 4340 (Callable Securities), based in part on NYSE Rule 402.30. The proposed rule changes are detailed further below.

b. Proposed FINRA Rule 4340(a): Allocation Procedures and Customer Notice

Proposed FINRA Rule 4340(a) would retain in substance the provision in NYSE Rule 402.30 requiring each member that has in its possession or under its 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. However, proposed FINRA Rule 4340(a) would apply this provision to any security that by its terms may be called or redeemed prior to maturity. FINRA believes firms should establish allocation procedures for all securities that may be partially redeemed, not just securities designated as callable securities. The proposed rule change also would eliminate the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member. Instead, proposed FINRA Rule 4340(a)(1) would adopt a more flexible approach that would allow a member to establish and make available on the member's 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. Proposed Supplementary Material .02 (Allocations of Partial Redemptions or Calls) would clarify that such 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.

Proposed FINRA Rule 4340(a)(2) would require the member 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 member's website and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

FINRA believes the proposed periodic notice to customers of the firm's allocation procedures will allow customers to be better informed regarding their rights in the event of a partial redemption or call of securities in their accounts.

c. Proposed FINRA Rule 4340(b) and (c): Favorable and Unfavorable Redemptions

Proposed FINRA Rule 4340(b) would retain in substance the restriction in NYSE Rule 402.30 prohibiting a member from allocating securities to any of its accounts or those of its "employees, partners, officers, directors, and approved persons" in a redemption offered on terms favorable to the called parties until all other customers' positions have been satisfied. However, proposed FINRA Rule 4340(b) would apply the restriction to a member and its "associated persons," rather than to a member's "employees, partners, officers, directors, and approved persons." Accordingly, the proposed rule would provide that, where redemption of callable securities is made on terms favorable to the called parties, a member shall 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.

Proposed Supplementary Material .01 (Definition of Associated Person; Clerical and Ministerial Functions) would clarify that the term "associated person" as used in the proposed rule would have the meaning provided in Section 3(a)(18) of the Exchange Act, 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").[5] The proposed supplementary material also would make clear that,

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[5] 15 U.S.C. 78c-3(a)(18).

in the event of a redemption made on terms favorable to the called parties, a member may include the accounts of clerical and ministerial associated persons in the pool of securities eligible to be called. FINRA believes the proposed change strikes the proper balance by prohibiting firms from favoring the member and its associated persons in any allocation. However, FINRA believes permitting firms to include clerical and ministerial associated persons of the firm in the pool of securities eligible to be called for a redemption favorable to the called parties is reasonable because such allocation does not present the same potential for conflicts of interest as positions held by the firm and its non-clerical and non-ministerial associated persons, and does not unduly burden associated persons engaged in clerical and ministerial functions.

Similarly, where the redemption of callable securities is made on terms unfavorable to the called parties, proposed FINRA Rule 4340(c) and proposed Supplementary Material .03 would make clear that a member 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. FINRA believes that requiring a firm to include the positions of the firm and all its associated persons (including those engaged in clerical and ministerial functions) when a redemption is on terms unfavorable to the called parties is reasonable because the provision ensures that all parties are on parity. In addition, proposed Supplementary Material .03 (Accounts of an Introducing Member and its Associated Persons) would codify that where an introducing member is a party to a carrying agreement with another member that is conducting an allocation pursuant to proposed FINRA Rule 4340(a), any accounts in which the introducing member 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 member must identify such accounts to the member conducting the allocation.

d. Eliminated Rules and Requirements

Finally, the proposed rule change would eliminate as unnecessary NYSE Rule 402.30 in its entirety, including eliminating the rule's provision permitting customers to withdraw uncalled fully paid securities at any time prior to a partial call, and also to withdraw excess margin securities, provided that the customers' accounts are not subject to restrictions under Regulation T, or such withdrawals will not cause an under-margined condition.

As noted above, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[6] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will clarify and streamline the financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities and callable securities for adoption as FINRA Rules in the

6 15 U.S.C. 78o–3(b)(6).

new Consolidated FINRA Rulebook. FINRA notes that the proposed rule change transfers provisions from NASD Rule 2330 and NYSE Rules 296, 402 and 402.30 unchanged into the Consolidated Rulebook and, as such, those transferred provisions do not impose any new requirements for the industry and member firms engaging in securities loans and borrows that are already subject to the requirements of the current rules. FINRA believes the proposed changes to the current rules address concerns regarding transparency and disclosure under various borrowing and lending arrangements, both among members and with customers. Specifically, FINRA believes the new disclosure and recordkeeping requirements in proposed FINRA Rule 4314 adopt industry practices consistent with industry-wide initiatives that were developed in 2006, through the ALD Initiative. FINRA further believes that the new requirements in proposed FINRA Rule 4330 that a member, prior to first entering into a securities borrow with a customer, have reasonable grounds to believe the customer's loans of securities are appropriate, and send certain specified disclosures to the customer regarding the possible risks associated with securities loan transactions, are reasonable investor protections given the increasing number of retail customers involved in these types of transactions. In general, FINRA believes that the proposed rule change will provide consistency with respect to disclosures and recordkeeping in the marketplace to members, customers and other parties under various borrowing and lending arrangements. Similarly, FINRA believes that proposed FINRA Rule 4340, which adds new disclosure requirements to make the process of partial redemption of callable securities more transparent to customers, provides enhanced investor protection to the market.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA believes that the proposed rule change is necessary because clarifying and streamlining the financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities and callable securities for adoption as FINRA Rules in the new Consolidated FINRA Rulebook will provide consistency with respect to disclosures to customers and other parties and to the recordkeeping requirements of members, under various borrowing and lending arrangements. Specifically, FINRA believes the new disclosure and recordkeeping requirements proposed in FINRA Rule 4314 adopt industry practices consistent with industry-wide initiatives that were developed in 2006, through the ALD Initiative. FINRA further believes that the new requirements in proposed FINRA Rule 4330 that a member, prior to first entering into a securities borrow with a customer, have reasonable grounds to believe the customer's loans of securities are appropriate, and send certain specified disclosures to the customer regarding the possible risks associated with securities loan transactions, are reasonable investor protections given the increasing number of retail customers involved in these types of transactions. Similarly, FINRA believes proposed FINRA Rule 4340, which adds new disclosure requirements to make the process of partial redemption of callable securities more transparent to customers, provides enhanced investor protection to the market. FINRA notes that the proposed rule change transfers certain provisions from NASD Rule 2330 and NYSE Rules 296, 402 and 402.30 unchanged into the Consolidated Rulebook and, as such, those transferred provisions do

not impose any new requirements for the industry and member firms engaging in securities loans and borrows that are already subject to the requirements of the current rules.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In January 2010, FINRA published Regulatory Notice 10-03 soliciting comment on proposed FINRA Rules 4314, 4330 and 4340. FINRA received four comment letters in response to the Notice,[7] which are discussed below. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

One commenter had a general comment on the proposed rules.[8] The commenter strongly supported FINRA's efforts to streamline and add clarity to the new consolidated rulebook. Specifically, the commenter noted that "[t]he proposed consolidation of the rules governing securities loans and borrowing seems to be an example of a simplified rule that eliminates duplicative and/or outdated provisions. Furthermore, the elimination

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7 See Letter from Peter J. Chepucavage, Executive Director, CFAW General Counsel Plexus Consulting LLC, received January 20, 2010 ("Plexus"); letter from Erica M. Vaters, Vice President - Fidelity Institutional Compliance, Fidelity Brokerage Services LLC, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 5, 2010 ("Fidelity"); letter from Daniel C. Rome, Executive Consultant, Accounting and Compliance International, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 8, 2010 ("ACI"); and letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 8, 2010 ("SIFMA").

8 See ACI letter.

of specific allocation requirements will allow members to establish procedures more tailored to their unique operation."[9]

A. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

As discussed above, proposed FINRA Rule 4314(a) requires a member that enters into a transaction to lend or borrow securities as agent to disclose its capacity to the other party (or parties) to the transaction. In addition, the paragraph would require a member, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction.

Only one of the four commenters commented on this proposed rule.[10] The commenter "supports FINRA's goals of enhancing the current safeguards within the securities lending market to further address investor protection concerns, and promote the fundamental goal of lenders – incremental income with limited risk." However, the commenter would like FINRA to explicitly recognize in the proposed rule the ALD Initiative and that transfer of data between the agent lender and broker-dealer under the ALD regime is sufficient to meet the books and records requirements. In addition, the commenter strongly recommends that FINRA work with the SEC to adopt the final version of the SEC's ALD no-action letter prior to or simultaneous with the adoption of proposed Rule 4314. The commenter further notes that "[d]ue to the procedural nature of the no-action letter, firms believe it could prove unwieldy to incorporate all of the detailed requirements of the no-action relief into the proposed rule." The commenter

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9 See ACI letter.

10 See SIFMA letter.

suggests that firms would rather FINRA adopt an "interpretation to the rule (set forth in the Supplementary Material) that references the fact that firms should structure their operations in a manner consistent with the cited SEC no-action letter."[11]

FINRA recognizes the work of the ALD Initiative and has been actively involved for several years with SIFMA, industry participants, the SEC and other regulators regarding the procedures that broker-dealers borrowing securities through intermediaries should follow in order to have adequate information regarding the principals on whose behalf the securities are being loaned. Based on FINRA's involvement with the ALD no-action letter initiative to date, FINRA believes proposed Rule 4314 is consistent with the ALD Initiative. In addition, FINRA believes that it is appropriate to move forward with the proposed rule to address concerns regarding transparency and disclosure under these lending arrangements. If the Commission approves proposed FINRA Rule 4314 and thereafter an ALD no-action letter were to be issued by the SEC staff, and there were inconsistencies between the two, FINRA would carefully review the rule at that time and consider amendments as necessary to eliminate such inconsistencies.

The commenter also urges FINRA to clarify that, with respect to certain "anonymous loan markets," where the actual counterparty to securities loans and borrows is a central counterparty, that the required disclosures of Rule 4314 would be made to the central counterparty, and not any underlying counterparty.[12] FINRA understands that with respect to such "anonymous loan markets" the borrower's and lender's transactions are matched by an electronic borrow/loan system in a manner that does not disclose the

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11 See SIFMA letter.

12 See SIFMA letter.

borrowing and lending parties' identity to each other and the only known counterparty to both the borrower and the lender is the central counterparty, which acts as principal in the transactions with both the borrower and lender. In such cases, the disclosures required by Rule 4314 would be required to be made to the central counterparty

B. Proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities)

i. Comments on Proposed FINRA Rule 4330(a)

As described above, proposed FINRA Rule 4330(a) would retain the requirement in NYSE Rule 402(b) that a member obtain a customer's written authorization prior to lending the customer's margin securities. In addition, proposed Supplementary Material .02 would retain and codify NYSE Rule Interpretation 402(b)/01, which permits a member to satisfy the written authorization requirement by using a single customer signed margin agreement/loan consent, provided that it contains a legend in bold type face directly above the signature line substantially stating the following: "BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

One commenter generally supports the retention of NYSE Rule 402(b) and NYSE Rule Interpretation 402(b)/01.[13] However, that commenter and another commenter believe that firms currently have similar, but not identical language in the legends of their customer margin agreements, and they request that, to avoid substantial repapering costs for firms, existing customer margin agreements be grandfathered and the new language in the legend of proposed Supplementary Material .02 be required only for new margin

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13 See Fidelity letter.

customer agreements.[14] In response, FINRA notes that, since the legend in proposed Supplementary Material .02 is identical to the legend required by NYSE Rule Interpretation 402(b)/01, and since that legend, as explained in the interpretation, applies to "margin eligible securities," any existing customer margin account agreements containing such legend that includes the words "margin securities" would be deemed in compliance with the NYSE Rule Interpretation 402(b)/01 legend requirement and would continue to comply with proposed Supplementary Material .02. However, FINRA would expect firms to review existing customer margin account agreements for compliance and if, upon finding any non-compliant customer margin account agreements, have customers sign new customer margin account agreements.

In addition, one of the commenters requests that the proposed legend refer to "margin securities" to clarify that "the language is only meant to apply to margin securities (i.e., not excess margin securities or fully-paid securities) in customer margin account agreements."[15] FINRA notes that proposed FINRA Rule 4330(a) and Supplementary Material .02 specifically address a member's obligation to obtain a customer's written authorization prior to lending the customer's *margin* securities. As such, while the legend does not specify "margin securities," FINRA believes that its inclusion in the section of the rule that is specific to the requirements for borrowing customer's margin securities, clarifies its applicability to margin securities. Accordingly, FINRA does not believe the change recommended by the commenter is necessary.

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14 See Fidelity letter and SIFMA letter.

15 See SIFMA letter.

ii. Comments on Proposed FINRA Rule 4330(b)(1)(C) –Notification to FINRA

As discussed further above, FINRA Rule 4330(b)(1)(C), as required in the Notice, would require a member borrowing a customer's fully paid or excess margin securities carried for the account of any customer, to notify FINRA in writing at least 30 days prior to engaging in such borrow activities.

One commenter recommends that FINRA clarify that the 30-day notification period applies only to a firm's initiation of a fully-paid customer securities lending program and does not impose a separate requirement prior to entering into securities borrows with specific customers.[16] In addition, the commenter recommends that with respect to existing securities lending programs, notification could be provided to FINRA within a certain period of time after the new rules become effective.[17] Another commenter generally agrees with FINRA Rule 4330(b)(1)(C) as applied going forward to members that currently do not have programs in place to borrow customer fully-paid or excess margin securities, but does not believe that there is any benefit to imposing this requirement on firms with existing programs that FINRA already reviews during both routine and "sweep" FINRA examinations.[18]

In response to comments, FINRA seeks to clarify that the notification requirement in proposed FINRA Rule 4330(b)(1)(C) applies prior to the time a firm first enters into either a fully paid or excess margin securities borrow program or if it has no program,

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16 See SIFMA letter.

17 See SIFMA letter.

18 See Fidelity letter.

prior to first entering into such fully paid securities borrows with one or more customers, and is proposing to amend the rule text accordingly. A notice is not required for each new customer that enters an established program. FINRA also is replacing the terms "borrow activities," "transaction" and "program" with the term "securities borrows" to make the terminology consistent throughout the provision. In addition, FINRA is adding proposed Supplementary Material .05 to address fully paid or excess margin securities borrows with customers that exist as of the effective date of this proposed rule, either as part of a program or outside of a program. In such cases, a member with any existing fully paid or excess margin securities borrows with customers as of the effective date of this rule, would be required to provide (1) written notification to FINRA within 30 days of the effective date of the new rule, in such manner and form as FINRA may require; and (2) such customers with the disclosures required by FINRA Rule 4330(b)(2)(B) within 90 days of the effective date of the new rule. FINRA recognizes that it may have knowledge of firms' existing fully-paid securities borrow programs or fully paid borrows done outside of a program, through the examination process; however, FINRA believes the proposed notification requirement for such existing activities is not overly burdensome and would provide FINRA with a comprehensive view of a firm's activities after the effectiveness of the proposed rule.

iii. Comments on Proposed FINRA Rule 4330(b)(2)(A) - Suitability

FINRA Rule 4330(b)(2)(A) as proposed in the Notice would require a member that borrows a customer's fully paid or excess margin securities, prior to entering into a securities borrow transaction with a customer, to determine that such transaction is suitable for the customer.

One commenter asks FINRA to clarify that suitability for purposes of this proposed new rule should apply with respect to a customer's overall participation in a fully paid securities lending program, and not on a transaction-by-transaction basis because this would be unduly burdensome and negatively impact the efficiency of security loans.[19] Another commenter requests further clarification on what would make a customer unsuitable to participate after a customer has been fully informed of the risks associated with the transaction, executes a master securities lending agreement with the firm which sets forth the terms and conditions of the loan, the loan is fully collateralized in accordance with SEA Rule 15c3-3(b)(3), and there are no limitations placed upon the customer's ability to sell the loaned security or draw upon the collateral.[20] The commenter further notes that it does not believe that a customer's investment objectives or net worth are applicable in determining whether customers should be able to generate additional income from their securities positions. The commenter agrees with FINRA's concern about customers buying hard-to-borrow securities for the sole intention of loaning them, but the commenter believes that NASD Rule 2310 (Recommendations to Customers—Suitability) would already cover this activity.[21]

In response to the commenters' concerns, FINRA is proposing to substantially revise the suitability provision in proposed paragraph (b)(2)(A) of Rule 4330. As revised, proposed paragraph (b)(2)(A) requires a member to have reasonable grounds for

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19 See SIFMA letter.

20 See Fidelity letter.

21 NASD Rule 2310 (Recommendations to Customers – Suitability) has been superseded by FINRA Rule 2111 (Suitability). See SR-FINRA-2010-039, which was amended by SR-FINRA-2011-016 and SR-FINRA-2012-027 eff. July 9, 2012.

believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the member 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 member or associated person in connection with entering such securities loans. To further address commenters' concerns about when this obligation arises in the customer relationship, FINRA is clarifying that a member must undertake this determination prior to first entering into securities borrows with a customer and not on a transaction by transaction basis. Accordingly, where a member has a securities borrow program, it would be required to determine the appropriateness of such activity for the customer prior to the customer entering into the first securities borrow. FINRA believes these proposed changes respond to commenters' concerns regarding the scope and application of the review.

iv. Comments on Proposed FINRA Rule 4330(b)(2)(B) – Risk Disclosures

Proposed FINRA Rule 4330(b)(2)(B), as proposed in the Notice, would require members to provide a customer with certain specific information regarding the risks associated with the customer's securities loan transaction, prior to entering into a securities borrow transaction with a customer. Several commenters raise general concerns regarding the proposed disclosure requirement, as well as concerns about specific required disclosures.[22]

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[22] See Plexus letter, SIFMA letter and Fidelity letter.

a. Standardized Risk Disclosure Form

Two commenters support the idea that customers should be fully informed of the risks associated with lending their fully-paid and excess margin securities but believe that an industry standard risk disclosure form should be developed to help ensure consistent standards across the industry. [23] In response, FINRA does not object to the development by the industry of a standardized risk disclosure form but cautions that such form may not be able to capture all of the risk disclosures specific to every member's individual fully-paid or excess margin securities lending activities, and members should carefully evaluate their activities and disclosure obligations when considering adopting a standardized disclosure document to address their compliance with the proposed rule.

b. Disclosure of Limitation on the Customer's Ability to Sell the Loaned Securities

Several commenters raise issues regarding the proposed requirement to disclose to the customer any limitations on the customer's ability to sell the loaned securities. Specifically, two commenters appear to raise issues relating to Regulation SHO and the SEC's guidance that if a person that has loaned a security to another person sells the security and a bona fide recall is initiated within two business days after trade date, the person that has loaned the security is "deemed to own" the security for purposes of Rule 200(g)(1) Regulation SHO, and such sale will not be treated as a short sale for purposes of the close-out requirements under Rule 204 of Regulation SHO. In addition, a broker-dealer may mark such orders as long sales provided such marking is in compliance with

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[23] See SIFMA letter and Fidelity letter.

Rule 200(c) of Regulation SHO.[24] In particular, one of the commenters contends that, since the proposed disclosure is not intended to provide guidance on the marking of customers' sales as "long" or "short," or otherwise provide guidance concerning Regulation SHO, FINRA should either eliminate this proposed disclosure to avoid potential confusion or clarify that such orders to sell may be marked "long," provided there is compliance with applicable guidance regarding Regulation SHO.[25] The other commenter notes the SEC's guidance and states that there should not be any distinction between hypothecated margin securities (securities bought by the customer with funds borrowed from the firm) and fully-paid or excess margin securities on loan, as long as it is reasonable to believe they can be recalled by settlement date for the sale.[26]

FINRA included the requirement to disclose "limitations on customer's ability to sell the loaned securities," in the original proposal as a result of concerns noted with regard to the adequacy of certain disclosures of material information to customers participating in the member's fully paid lending program including, specifically, failing to adequately disclose to customers that shares on loan could be sold at any time prior to recalling the shares or waiting for the delivery of shares back to their account. The proposed disclosure is not intended to address members' obligations under Regulation SHO or otherwise require members to provide guidance regarding Regulation SHO.

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[24] See Fidelity letter and SIFMA letter. See also Securities Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266, 38270, n.55 (July 31, 2009); and "SEC Division of Trading and Market Guidance Regarding Sale of Loaned But Recalled Securities" (Published on the SEC's website on October 20, 2008).

[25] See SIFMA letter.

[26] See Fidelity letter.

FINRA believes the proposed disclosure will alert customers regarding their right to sell the securities and any limitations on the customer's ability to do so. However, to further clarify its intent, FINRA has modified the rule text to require members to disclose "the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable."

c. Economics of the Transaction

With respect to the proposed disclosure of the economics of the securities loan transaction, one commenter does not agree that this disclosure should include the rate that the firm would earn on the loaned securities because it would be irrelevant to the customer's decision.[27] In addition, the commenter argues that any such disclosed rate would not provide the customer with meaningful information to assist the customer in making any decision, since this rate would be only a rough estimate as there would be no way of knowing exactly what rate the security would be lent out at initially or over the life of the loan.[28] Another commenter, noting that there may be different prices for securities borrow transactions involving the same security, requests that FINRA clarify in its rule filing that firms will be expected to provide adequate disclosure to customers that the price for a securities lending transaction can be affected by a variety of different factors (e.g., size of the transaction, expected stability of the borrow, collateral posted).[29]

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27 See Fidelity letter.

28 See Fidelity letter. The commenter does believe that a disclosure regarding the economics of the transaction should include the rate the customer will be paid for the securities borrow loan transaction.

29 See SIFMA letter.

Although not specifically addressed to the proposed "economics of the transaction" disclosure, one commenter states that the required disclosures should include the most opaque parts of short selling and stock lending practices.[30] In the same vein, the commenter suggests that the broker-dealer be required to explain the rebate it receives and the fact that the resulting short sale may be against the customer's own interest and perhaps that other more powerful customers may indeed participate in these stock loan profits.

After reviewing the comments received, FINRA has amended proposed FINRA Rule 4330(b)(2)(B) to remove the term "economics of the transaction," and is proposing to add more specific guidance on the types of disclosures that should be provided to customers. Specifically, pursuant to the amended rule text, a member must disclose, among other things, 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. Such disclosures would include, but not be limited to, (i) the loss of voting rights; (ii) the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable; (iii) the factors that determine the amount of compensation received by the member and its associated persons in connection with the use of the securities borrowed from the customer; (iv) 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 member under the terms of the borrow agreement; (v) the risks associated with each type of collateral provided to the customer; (vi) that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy

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30 See Plexus letter.

delivery requirements resulting from short sales; (vii) potential tax implications, including payments deemed cash-in-lieu of dividends paid on securities while on loan; and (viii) the member's right to liquidate the transaction because of a condition of the kind specified in proposed Rule 4314(b). FINRA believes this list provides greater clarity to members regarding the disclosures on rights and risks that must be given to customers prior to engaging in such securities borrows. This list is not intended to be exhaustive, and firms need to carefully consider the disclosures that are applicable to their specific activity/program.

One commenter seeks clarification that "for those principal lenders utilizing lending agents the recipient of the required disclosures should be lending agents in their capacity as such, and not the underlying principals."[31] FINRA believes that where the customer lender has legally authorized an agent to act on such customer's behalf in making a determination about whether to lend fully paid or excess margin securities to the member, the disclosures required pursuant to the proposed rule may be made to the lending agent in the lending agent's capacity as such, in lieu of being made to the underlying principal. FINRA also is proposing certain technical changes to the rule text as proposed in the Notice by adding headings to improve readability.

C. Proposed FINRA Rule 4340 (Callable Securities)

As detailed further above, proposed FINRA Rule 4340(a) would, among other things, require each member that has in its possession or under its control any security which, by its terms, may be called or redeemed prior to maturity, to establish and make available on the member's website procedures by which it will allocate among its

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31 See SIFMA letter.

customers the securities to be redeemed or selected as called in the event of a partial redemption or call.

One commenter requests that FINRA clarify whether the requirement that a member post its allocation procedures on its website would require a firm "to provide detailed, granular procedures" or whether it would be sufficient to provide a general statement describing its allocation procedures. [32] The commenter is concerned that, if detailed procedures are required, firms that clear through third parties and self-clearing firms using service bureaus systems would be unable to comply with the requirement as such procedures would constitute the third parties' proprietary information that firms would not be able to disclose without permission from the third parties. In response, FINRA notes that the proposed rule requirement is intended to require a member to describe its allocation procedures in sufficient detail to allow customers to understand the process for partial redemptions and the outcome of such processes. FINRA does not believe that such description generally would require a member to disclose a third-party's proprietary information.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[33]

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

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32 See SIFMA letter.

33 15 U.S.C. 78s(b)(2).a

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 10-03 (January 2010).

Exhibit 2b. A list of the comment letters received in response to Regulatory Notice 10-03 (January 2010).

Exhibit 2c. Copies of the comment letters received in response to Regulatory Notice 10-03 (January 2010).

Exhibit 5. Text of the proposed rule change.

Exhibit 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2013-035)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt FINRA Rules 4314 (Securities Loans and Borrowings), 4330 (Customer Protection – Permissible Use of Customers' Securities) and 4340 (Callable Securities) in the Consolidated FINRA Rulebook

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities, and callable securities as FINRA Rules in the consolidated FINRA rulebook. Specifically, the proposed rule change would adopt with amendments the following as FINRA Rules: (1) Incorporated NYSE Rule 296 (Liquidation of Securities Loans and Borrowings) and Supplementary Material paragraphs .10 and .20 regarding requirements applicable to a member that is a party to an agreement for the loan or borrowing of securities as FINRA Rule 4314

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

(Securities Loans and Borrowings); (2) Incorporated NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities) regarding requirements applicable to a member borrowing or lending a customer's securities that are eligible to be pledged or loaned as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities); and (3) Incorporated NYSE Rule 402.30 (Securities Callable in Part) regarding requirements applicable to a member that has in its possession or under its control any callable securities as FINRA Rule 4340 (Callable Securities).

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[3] FINRA is proposing to amend and adopt the following as FINRA

[3] 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

Rules in the Consolidated FINRA Rulebook: (1) NYSE Rule 296 (Liquidation of Securities Loans and Borrowings)[4] and Supplementary Material paragraphs .10 and .20 as FINRA Rule 4314 (Securities Loans and Borrowings); (2) NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities) as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities); and (3) NYSE Rule 402.30 (Securities Callable in Part) as FINRA Rule 4340 (Callable Securities).

a. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

i. Background

NYSE Rule 296 (Liquidation of Securities Loans and Borrowings) sets forth the obligations of a member that is party to an agreement with another member for the loan and borrowing of securities. Specifically, the rule provides that a member that is party to an agreement with another member for the loan and borrowing of securities has the right to liquidate such transaction whenever the other party to the transaction: (1) applies for or consents to a receiver, custodian, trustee or liquidator of itself or its property; (2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due; (3) makes a general assignment for the benefit of its creditors; or (4) files, or has filed against it, a petition for a Chapter 11 bankruptcy filing or a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA") ("liquidation conditions").

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).

4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

The rule further provides that no member may lend or borrow any security to or from any non-member of the NYSE, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon the member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified above.

NYSE Rule 296.10 defines the term "agreement for the loan and borrowing of securities," for purposes of NYSE Rule 296. NYSE Rule 296.20 provides that each member that is subject to SEA Rule 15c3-3 (Customer Protection – Reserves and Custody of Securities) and that borrows securities from a customer (as the term is defined in SEA Rule 15c3-3) must comply with SEA Rule 15c3-3's provisions requiring a written agreement between the borrowing member and the lending customer.

NYSE Rule 296 has been the basis for provisions incorporated in the industry standard Master Securities Lending Agreement ("MSLA"). The rule provides protection to members that may enter into a securities lending transaction without a duly signed MSLA with a counterparty. Should one of the counterparties become insolvent, the rule allows the other counterparty to liquidate immediately against collateral received. For these reasons, FINRA is proposing to adopt NYSE Rule 296 as FINRA Rule 4314 (Securities Loans and Borrowings) into the Consolidated FINRA Rulebook with the changes described below.

ii. Proposed FINRA Rule 4314

In 2006, the industry began to adopt voluntary books and records and disclosure practices relating to securities lending, as a result of an industry-wide initiative to address the risks associated with agency lending (the Agency Lending Disclosure Initiative

("ALD Initiative")). Consistent with the industry-wide initiative, FINRA is proposing a new requirement to make clear whether parties are acting as principals or agents when entering into an agreement to loan or borrow securities. The proposed rule would require a member that acts as agent in a loan or borrow transaction to disclose its capacity and, in cases where the member lends securities to or borrows securities from a counterparty that is acting in an agency capacity, require that the member 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 and the details of each transaction therewith.

Specifically, proposed new FINRA Rule 4314(a) would require a member that lends or borrows securities in the capacity of agent to disclose such capacity to the other party (or parties) to the transaction. The provision would further require a member, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction. When the other party (who may or may not be a member) is acting as agent in the transaction, the member would be 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. FINRA believes this requirement will help address concerns regarding the level of transparency and information disclosure in agency lending transactions. The new requirement would improve transparency by disclosing the name of the underlying principal(s) to the member and thereby give the member the ability to assess its creditworthiness, which is needed given the member's ongoing exposure in the lending transaction. In addition, the proposal establishes uniform books and records requirements.

Proposed FINRA Rule 4314(b), based on NYSE Rule 296(a), would continue to provide each member that is a party to an agreement with another member for the loan and borrowing of securities with the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions specified in the rule. FINRA is proposing to add the words "to liquidate such transaction" to the last sentence of proposed paragraph (b)(1) to clarify the meaning of the provision. FINRA believes a member's right to liquidate the transaction under the specified circumstances would assist the member in managing the risk associated with such transactions and maintaining compliance with its net capital requirements. In addition, the liquidation conditions have largely been incorporated into the industry standard MSLA developed as part of the ALD Initiative.

In addition, NYSE Rule 296(b) requires a member to have a written agreement with any non-member of the NYSE to whom it lends, or from whom it borrows, securities. FINRA is proposing to adopt this requirement so that all FINRA members that engage in such transactions with non-members of FINRA must have the written agreement as required in NYSE Rule 296(b). Specifically, proposed FINRA Rule 4314(c) would require that no member shall lend or borrow any security to or from any person that is not a member of FINRA, including any customer, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon such member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in proposed FINRA Rule 4314(b). FINRA believes that applying this requirement to all FINRA members is appropriate for the adoption of the rule into the Consolidated FINRA Rulebook, protects the member's

interests in the event of a liquidation condition specified in proposed FINRA Rule 4314(b) and supports the member's compliance with net capital requirements.

FINRA is proposing to transfer NYSE Rule 296.10, which defines the term "agreement for the loan and borrowing of securities," as Supplementary Material .01 to proposed FINRA Rule 4314, without substantive change. In addition, FINRA is proposing to add new Supplementary Material .02 through .05 to the proposed FINRA rule. FINRA believes the new Supplementary Material provides clarity and guidance by describing how a member firm can meet its disclosure obligations under the proposed rule, and clarifying the proposed rule's books and records requirements. Specifically, proposed Supplementary Material .02 clarifies the methods by which a member may satisfy its disclosure obligation in new paragraph (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 security exchanged between the parties for each loan and borrow transaction. Proposed Supplementary Material .03 clarifies the books and records requirements imposed by new paragraph (a) and requires members to create and maintain records for each security loan or borrow transaction in accordance with SEA Rules 17a-3 and 17a-4. It also provides that when a member enters into a security loan or borrow transaction with a party that is acting as agent on behalf of another principal(s), the member must maintain a record of details 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. FINRA believes proposed Supplementary

Material .03 will establish consistent industry standards regarding the types of information firms must maintain for each security loan or borrow transaction with an agent and the underlying principal(s) on whose behalf the agent is acting. Such detailed records will evidence that firms, when entering into security loan or borrow transactions, have knowledge of the parties involved to enable them to assess, among other things, the creditworthiness of the underlying principal(s).

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

iii. Eliminated Rules and Requirements

FINRA is proposing to eliminate NYSE Rule Interpretation 296(b)/01, which addresses transactions with non-member organizations and the written agreements required in regard to repurchase and reverse repurchase transactions not subject to SEA Rule 15c3-3, as the interpretation is beyond the scope of proposed FINRA Rule 4314.

b. Proposed FINRA Rule 4330 (Customer Protection - Permissible Use of Customers' Securities)

i. Background

NYSE Rule 402 (Customer Protection – Reserves and Custody of Securities), NASD Rule 2330(b)-(d) (Customers' Securities or Funds) and NASD IM-2330 (Segregation of Customers' Securities) set forth the requirements applicable to a member's use of customers' securities. Specifically, NYSE Rule 402 and NASD Rule 2330 prohibit a member from lending, either to itself or others, securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless the firm first obtains a written authorization from the customer permitting the lending of the customer's securities. NYSE Rule Interpretation 402(b)/01 (Agreements for Use of Customers' Securities/Application) permits a member to use a single customer signed margin agreement/loan consent in lieu of obtaining separate written documents. Both the NYSE and NASD rules contain similar provisions requiring members to comply with SEA Rule 15c3-3 in obtaining custody and control of securities and maintaining appropriate cash reserves.

FINRA is proposing to adopt NYSE Rule 402 as FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities), subject to certain significant changes, and eliminate NASD Rule 2330 and NASD IM-2330 as duplicative or otherwise unnecessary.[5] The proposed rule adds new disclosure requirements and establishes the need for members to conduct appropriateness determinations before engaging in the borrowing and lending of customers' fully paid and excess margin securities.

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[5] NASD Rule 2330(a), (e) and (f) are now marked "Reserved." The substantive provisions of these paragraphs were deleted in prior rule filings.

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

Proposed FINRA Rule 4330(a) would require a member 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. FINRA believes continuing the requirement to have written customer consent protects customers. FINRA is also proposing to delete the phrase "either to itself as a broker-dealer or to others" currently contained in NYSE Rule 402(b) that in relevant part provides that "[n]o member organization shall lend, either to itself as a broker-dealer or to others, securities which are held on margin for a customer and which are eligible to be pledged or loaned, unless …," because FINRA does not believe the language adds to the meaning of the sentence and may be confusing. Proposed FINRA Rule 4330(a) instead would clearly provide that "[n]o member shall lend securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless such member shall first have obtained a written authorization from such customer permitting the lending of such securities."

Proposed Supplementary Material .02 (Authorization to Lend Customers' Margin Securities) retains and codifies NYSE Rule Interpretation 402(b)/01, thereby continuing to permit a member to satisfy the written authorization requirement by using a single customer-signed margin agreement/loan consent, in lieu of obtaining a separate written authorization, provided that it contains a legend in bold type face placed directly above the signature line that states substantially the following:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

Consistent with NYSE Rule 402(a) and NASD Rule 2330(b), proposed Supplementary Material .01 (Definitions) would provide that the definitions contained in SEA Rule 15c3-3 would apply to proposed FINRA Rule 4330. However, the proposed rule does not include the requirement contained in both the NYSE and NASD rules for members to maintain cash reserves as prescribed by SEA Rule 15c3-3 because members continue to be subject to SEA Rule 15c3-3.

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

In addition, FINRA is proposing new requirements to address the borrowing and lending of customers' fully paid or excess margin securities. Specifically, proposed FINRA Rule 4330(b)(1) would require a member that borrows fully paid or excess margin securities carried for the account of any customer to: (A) comply with the requirements of SEA Rule 15c3-3; (B) comply with the requirements of Section 15(e) (Notices to Customers Regarding Securities Lending) of the Exchange Act to provide notices to customers regarding securities lending; and (C) notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to first engaging in such securities borrows.

Proposed Supplementary Material .03 (Notification to FINRA) would provide that upon FINRA's receipt of such written notification, FINRA may request such additional information as it may deem necessary to evaluate compliance with SEA Rule 15c3-3, Section 15(e) of the Exchange Act and other applicable FINRA rules or federal securities laws or rules. Examples of additional information would include, but would not be limited to:

(a) the written agreement authorizing such borrowing of securities, which shall reflect the material terms of the arrangement;

(b) the types of customers that are parties to such securities borrows;

(c) the types of accounts used to effect the securities borrows (i.e., whether the subject securities are maintained in customers' cash or margin or other accounts);

(d) the types of collateral provided to customers in connection with such securities borrows, the frequency of marking to market of the collateral and the custody arrangements for such collateral;

(e) the operational and recordkeeping processes related to such securities borrows;

(f) the rebates paid/received in connection with such securities borrows and any other compensation arrangements related thereto;

(g) the procedures for handling customers' requests to sell the securities subject to such borrows; and

(h) disclosures made to customers.

Proposed FINRA Rule 4330(b)(2) also imposes two new requirements that a member must satisfy prior to first entering into securities borrows with a customer. FINRA believes that these proposed new requirements will strengthen customer protection and increase investor confidence. First, proposed FINRA Rule 4330(b)(2)(A) would require that a member have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the member shall 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 member or associated person in connection with entering such securities loans. Accordingly, where a member has a securities borrow program, the member would be required to determine the appropriateness of such activity for the customer prior to the customer entering into the first securities borrow. In addition, proposed Supplementary Material .04 (Appropriateness of Customer's Loan(s) of Securities), clarifies that the member borrowing a customer's fully paid or excess margin securities is responsible for making the determination regarding the appropriateness of such borrow from a customer. The proposal would provide, however, that in making the determination, when the member has entered into a carrying agreement with an introducing member pursuant to FINRA Rule 4311, the member may rely on the representations of the introducing member that has a customer relationship with the lender.

Second, proposed FINRA Rule 4330(b)(2)(B) would require a member, prior to first entering into securities borrows with a customer, to provide the customer, in writing (which may be electronic), with a clear and prominent notice stating that the provisions of 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's obligation in the event the member fails to return the securities.

FINRA believes that providing customers with clear and prominent disclosure of potential risks associated with customers' loans of securities will allow customers to make more informed investment decisions. In addition, proposed FINRA Rule 4330(b)(2)(B) would require a member 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: (i) loss of voting rights; (ii) the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable; (iii) the factors that determine the amount of compensation received by the member and its associated persons in connection with the use of the securities borrowed from the customer; (iv) 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 member under the terms of the borrow agreement; (v) the risks associated with each type of collateral provided to the customer; (vi) that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales; (vii) potential tax implications, including payments deemed cash-in-lieu of dividend paid on securities while on loan; and (viii) the member's right to liquidate the transaction because of a condition of the kind specified in FINRA Rule 4314(b) (Securities Loans and Borrowings-Right to Liquidate Transaction) (discussed above).

Proposed FINRA Rule 4330(b)(3) would require that a member create and maintain books and records evidencing compliance with proposed FINRA Rule 4330(b)(2). Such records must be maintained in accordance with the requirements of SEA Rule 17a-4(a).

Proposed Supplementary Material .05 (Notification to FINRA of Pre-existing Fully Paid or Excess Margin Securities Borrows and Disclosures to Customers) would require members that have any existing fully paid or excess margin securities borrows with customers as of the effective date of proposed Rule 4330 to notify FINRA in

writing, in such manner and format as FINRA may require, of such borrows within 30 days from the effective date of the rule. Notifications may be provided to a member's FINRA Regulatory Coordinator in writing, either in hard copy or electronically. FINRA will specify the manner and format of such notification in a Regulatory Notice announcing the effectiveness of the rule. In addition, such members would be required to provide such customers with the disclosures required by proposed FINRA Rule 4330(b)(2)(B) within 90 days from the effective date of the rule. FINRA believes that the requirement to provide notice to FINRA of existing programs is necessary for it to have a more complete picture of members' activities in this area when the rule becomes effective, and that the proposed timeframes for notice to FINRA and providing disclosures to existing customers are reasonable.

iv. Eliminated Rules and Requirements

Proposed FINRA Rule 4330 would not retain the provisions in NYSE Rule 402 that are duplicative of the requirements in SEA Rule 15c3-3 or the outdated provisions regarding the physical segregation of securities. In addition, the proposed rule change would eliminate NASD Rule 2330 and NASD IM-2330, which also contain duplicative provisions relating to SEA Rule 15c3-3 and outdated provisions relating to the physical segregation of securities.

c. Proposed FINRA Rule 4340 (Callable Securities)

i. Background

NYSE Rule 402.30 (Securities Callable in Part) requires a member that has in its possession or control securities that are callable in part to identify each such security so

that its records clearly show for whose account it is held. The following securities are exempt from this requirement:

(1) certain bonds that have not paid interest for at least two interest periods;

(2) Euro-dollar bonds deposited in a central clearing facility for such bonds, provided that customers are notified of the deposit into the central clearing facility and also that the member has the right to withdraw uncalled bonds from the facility at any time; and

(3) bonds or preferred stocks, provided that the member has satisfied certain requirements, including adopting an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member.

NYSE Rule 402.30 also requires that a member provide written disclosure to all customers of the systems and the manner in which securities are held and their rights to withdraw uncalled securities, as described above, prior to: (1) the member depositing the securities in bulk; or (2) the customer purchasing such securities, except in the case of a new account, provided that such notice was sent to the customer prior to the settlement date. The rule further requires that in the event of a favorable call of the securities, the member shall not allocate any securities to any account in which it or its general, limited, or special partners, officers, directors, approved persons or employees have an interest until all other customers' positions in the securities have been satisfied. There is no comparable NASD rule.

FINRA is proposing to adopt FINRA Rule 4340 (Callable Securities), based in part on NYSE Rule 402.30. The proposed rule changes are detailed further below.

ii. Proposed FINRA Rule 4340(a): Allocation Procedures and Customer Notice

Proposed FINRA Rule 4340(a) would retain in substance the provision in NYSE Rule 402.30 requiring each member that has in its possession or under its 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. However, proposed FINRA Rule 4340(a) would apply this provision to any security that by its terms may be called or redeemed prior to maturity. FINRA believes firms should establish allocation procedures for all securities that may be partially redeemed, not just securities designated as callable securities. The proposed rule change also would eliminate the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member. Instead, proposed FINRA Rule 4340(a)(1) would adopt a more flexible approach that would allow a member to establish and make available on the member's 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. Proposed Supplementary Material .02 (Allocations of Partial Redemptions or Calls) would clarify that such 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.

Proposed FINRA Rule 4340(a)(2) would require the member 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 member's website and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer. FINRA believes the proposed periodic notice to customers of the firm's allocation procedures will allow customers to be better informed regarding their rights in the event of a partial redemption or call of securities in their accounts.

iii. Proposed FINRA Rule 4340(b) and (c): Favorable and Unfavorable Redemptions

Proposed FINRA Rule 4340(b) would retain in substance the restriction in NYSE Rule 402.30 prohibiting a member from allocating securities to any of its accounts or those of its "employees, partners, officers, directors, and approved persons" in a redemption offered on terms favorable to the called parties until all other customers' positions have been satisfied. However, proposed FINRA Rule 4340(b) would apply the restriction to a member and its "associated persons," rather than to a member's "employees, partners, officers, directors, and approved persons." Accordingly, the proposed rule would provide that, where redemption of callable securities is made on terms favorable to the called parties, a member shall 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.

Proposed Supplementary Material .01 (Definition of Associated Person; Clerical and Ministerial Functions) would clarify that the term "associated person" as used in the proposed rule would have the meaning provided in Section 3(a)(18) of the Exchange Act, 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").[6] The proposed supplementary material also would make clear that, in the event of a redemption made on terms favorable to the called parties, a member may include the accounts of clerical and ministerial associated persons in the pool of securities eligible to be called. FINRA believes the proposed change strikes the proper balance by prohibiting firms from favoring the member and its associated persons in any allocation. However, FINRA believes permitting firms to include clerical and ministerial associated persons of the firm in the pool of securities eligible to be called for a redemption favorable to the called parties is reasonable because such allocation does not present the same potential for conflicts of interest as positions held by the firm and its non-clerical and non-ministerial associated persons, and does not unduly burden associated persons engaged in clerical and ministerial functions.

Similarly, where the redemption of callable securities is made on terms unfavorable to the called parties, proposed FINRA Rule 4340(c) and proposed Supplementary Material .03 would make clear that a member 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. FINRA believes that requiring a firm to include the positions of the firm and all its associated persons

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6 15 U.S.C. 78c-3(a)(18).

(including those engaged in clerical and ministerial functions) when a redemption is on terms unfavorable to the called parties is reasonable because the provision ensures that all parties are on parity. In addition, proposed Supplementary Material .03 (Accounts of an Introducing Member and its Associated Persons) would codify that where an introducing member is a party to a carrying agreement with another member that is conducting an allocation pursuant to proposed FINRA Rule 4340(a), any accounts in which the introducing member 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 member must identify such accounts to the member conducting the allocation.

iv. Eliminated Rules and Requirements

Finally, the proposed rule change would eliminate as unnecessary NYSE Rule 402.30 in its entirety, including eliminating the rule's provision permitting customers to withdraw uncalled fully paid securities at any time prior to a partial call, and also to withdraw excess margin securities, provided that the customers' accounts are not subject to restrictions under Regulation T, or such withdrawals will not cause an under-margined condition.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[7] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will clarify and streamline the financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities and callable securities for adoption as FINRA Rules in the new Consolidated FINRA Rulebook. FINRA notes that the proposed rule change transfers provisions from NASD Rule 2330 and NYSE Rules 296, 402 and 402.30 unchanged into the Consolidated Rulebook and, as such, those transferred provisions do not impose any new requirements for the industry and member firms engaging in securities loans and borrows that are already subject to the requirements of the current rules. FINRA believes the proposed changes to the current rules address concerns regarding transparency and disclosure under various borrowing and lending arrangements, both among members and with customers. Specifically, FINRA believes the new disclosure and recordkeeping requirements in proposed FINRA Rule 4314 adopt industry practices consistent with industry-wide initiatives that were developed in 2006, through the ALD Initiative. FINRA further believes that the new requirements in proposed FINRA Rule 4330 that a member, prior to first entering into a securities borrow with a customer, have reasonable grounds to believe the customer's loans of securities are appropriate, and send certain specified disclosures to the customer regarding the possible

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7 15 U.S.C. 78o–3(b)(6).

risks associated with securities loan transactions, are reasonable investor protections given the increasing number of retail customers involved in these types of transactions. In general, FINRA believes that the proposed rule change will provide consistency with respect to disclosures and recordkeeping in the marketplace to members, customers and other parties under various borrowing and lending arrangements. Similarly, FINRA believes that proposed FINRA Rule 4340, which adds new disclosure requirements to make the process of partial redemption of callable securities more transparent to customers, provides enhanced investor protection to the market.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA believes that the proposed rule change is necessary because clarifying and streamlining the financial and operational rules relating to securities loans and borrowings, permissible use of customers' securities and callable securities for adoption as FINRA Rules in the new Consolidated FINRA Rulebook will provide consistency with respect to disclosures to customers and other parties and to the recordkeeping requirements of members, under various borrowing and lending arrangements. Specifically, FINRA believes the new disclosure and recordkeeping requirements proposed in FINRA Rule 4314 adopt industry practices consistent with industry-wide initiatives that were developed in 2006, through the ALD Initiative. FINRA further believes that the new requirements in proposed FINRA Rule 4330 that a member, prior to first entering into a securities borrow with a customer, have reasonable grounds to believe the customer's loans of securities are appropriate, and send certain specified disclosures

to the customer regarding the possible risks associated with securities loan transactions, are reasonable investor protections given the increasing number of retail customers involved in these types of transactions. Similarly, FINRA believes proposed FINRA Rule 4340, which adds new disclosure requirements to make the process of partial redemption of callable securities more transparent to customers, provides enhanced investor protection to the market. FINRA notes that the proposed rule change transfers certain provisions from NASD Rule 2330 and NYSE Rules 296, 402 and 402.30 unchanged into the Consolidated Rulebook and, as such, those transferred provisions do not impose any new requirements for the industry and member firms engaging in securities loans and borrows that are already subject to the requirements of the current rules.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In January 2010, FINRA published Regulatory Notice 10-03 soliciting comment on proposed FINRA Rules 4314, 4330 and 4340. FINRA received four comment letters in response to the Notice,[8] which are discussed below. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached

[8] See Letter from Peter J. Chepucavage, Executive Director, CFAW General Counsel Plexus Consulting LLC, received January 20, 2010 ("Plexus"); letter from Erica M. Vaters, Vice President - Fidelity Institutional Compliance, Fidelity Brokerage Services LLC, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 5, 2010 ("Fidelity"); letter from Daniel C. Rome, Executive Consultant, Accounting and Compliance International, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 8, 2010 ("ACI"); and letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 8, 2010 ("SIFMA").

as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

One commenter had a general comment on the proposed rules.[9] The commenter strongly supported FINRA's efforts to streamline and add clarity to the new consolidated rulebook. Specifically, the commenter noted that "[t]he proposed consolidation of the rules governing securities loans and borrowing seems to be an example of a simplified rule that eliminates duplicative and/or outdated provisions. Furthermore, the elimination of specific allocation requirements will allow members to establish procedures more tailored to their unique operation."[10]

1. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

As discussed above, proposed FINRA Rule 4314(a) requires a member that enters into a transaction to lend or borrow securities as agent to disclose its capacity to the other party (or parties) to the transaction. In addition, the paragraph would require a member, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction.

Only one of the four commenters commented on this proposed rule.[11] The commenter "supports FINRA's goals of enhancing the current safeguards within the securities lending market to further address investor protection concerns, and promote the fundamental goal of lenders – incremental income with limited risk." However, the

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9 See ACI letter.

10 See ACI letter.

11 See SIFMA letter.

commenter would like FINRA to explicitly recognize in the proposed rule the ALD Initiative and that transfer of data between the agent lender and broker-dealer under the ALD regime is sufficient to meet the books and records requirements. In addition, the commenter strongly recommends that FINRA work with the SEC to adopt the final version of the SEC's ALD no-action letter prior to or simultaneous with the adoption of proposed Rule 4314. The commenter further notes that "[d]ue to the procedural nature of the no-action letter, firms believe it could prove unwieldy to incorporate all of the detailed requirements of the no-action relief into the proposed rule." The commenter suggests that firms would rather FINRA adopt an "interpretation to the rule (set forth in the Supplementary Material) that references the fact that firms should structure their operations in a manner consistent with the cited SEC no-action letter."[12]

FINRA recognizes the work of the ALD Initiative and has been actively involved for several years with SIFMA, industry participants, the SEC and other regulators regarding the procedures that broker-dealers borrowing securities through intermediaries should follow in order to have adequate information regarding the principals on whose behalf the securities are being loaned. Based on FINRA's involvement with the ALD no-action letter initiative to date, FINRA believes proposed Rule 4314 is consistent with the ALD Initiative. In addition, FINRA believes that it is appropriate to move forward with the proposed rule to address concerns regarding transparency and disclosure under these lending arrangements. If the Commission approves proposed FINRA Rule 4314 and thereafter an ALD no-action letter were to be issued by the SEC staff, and there were

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12 See SIFMA letter.

inconsistencies between the two, FINRA would carefully review the rule at that time and consider amendments as necessary to eliminate such inconsistencies.

The commenter also urges FINRA to clarify that, with respect to certain "anonymous loan markets," where the actual counterparty to securities loans and borrows is a central counterparty, that the required disclosures of Rule 4314 would be made to the central counterparty, and not any underlying counterparty.[13] FINRA understands that with respect to such "anonymous loan markets" the borrower's and lender's transactions are matched by an electronic borrow/loan system in a manner that does not disclose the borrowing and lending parties' identity to each other and the only known counterparty to both the borrower and the lender is the central counterparty, which acts as principal in the transactions with both the borrower and lender. In such cases, the disclosures required by Rule 4314 would be required to be made to the central counterparty

2. Proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities)

a. Comments on Proposed FINRA Rule 4330(a)

As described above, proposed FINRA Rule 4330(a) would retain the requirement in NYSE Rule 402(b) that a member obtain a customer's written authorization prior to lending the customer's margin securities. In addition, proposed Supplementary Material .02 would retain and codify NYSE Rule Interpretation 402(b)/01, which permits a member to satisfy the written authorization requirement by using a single customer signed margin agreement/loan consent, provided that it contains a legend in bold type face directly above the signature line substantially stating the following: "BY SIGNING

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13 See SIFMA letter.

THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

One commenter generally supports the retention of NYSE Rule 402(b) and NYSE Rule Interpretation 402(b)/01.[14] However, that commenter and another commenter believe that firms currently have similar, but not identical language in the legends of their customer margin agreements, and they request that, to avoid substantial repapering costs for firms, existing customer margin agreements be grandfathered and the new language in the legend of proposed Supplementary Material .02 be required only for new margin customer agreements.[15] In response, FINRA notes that, since the legend in proposed Supplementary Material .02 is identical to the legend required by NYSE Rule Interpretation 402(b)/01, and since that legend, as explained in the interpretation, applies to "margin eligible securities," any existing customer margin account agreements containing such legend that includes the words "margin securities" would be deemed in compliance with the NYSE Rule Interpretation 402(b)/01 legend requirement and would continue to comply with proposed Supplementary Material .02. However, FINRA would expect firms to review existing customer margin account agreements for compliance and if, upon finding any non-compliant customer margin account agreements, have customers sign new customer margin account agreements.

In addition, one of the commenters requests that the proposed legend refer to "margin securities" to clarify that "the language is only meant to apply to margin securities (i.e., not excess margin securities or fully-paid securities) in customer margin

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14 See Fidelity letter.

15 See Fidelity letter and SIFMA letter.

account agreements."[16] FINRA notes that proposed FINRA Rule 4330(a) and Supplementary Material .02 specifically address a member's obligation to obtain a customer's written authorization prior to lending the customer's *margin* securities. As such, while the legend does not specify "margin securities," FINRA believes that its inclusion in the section of the rule that is specific to the requirements for borrowing customer's margin securities, clarifies its applicability to margin securities. Accordingly, FINRA does not believe the change recommended by the commenter is necessary.

b. Comments on Proposed FINRA Rule 4330(b)(1)(C) –Notification to FINRA

As discussed further above, FINRA Rule 4330(b)(1)(C), as required in the Notice, would require a member borrowing a customer's fully paid or excess margin securities carried for the account of any customer, to notify FINRA in writing at least 30 days prior to engaging in such borrow activities.

One commenter recommends that FINRA clarify that the 30-day notification period applies only to a firm's initiation of a fully-paid customer securities lending program and does not impose a separate requirement prior to entering into securities borrows with specific customers.[17] In addition, the commenter recommends that with respect to existing securities lending programs, notification could be provided to FINRA within a certain period of time after the new rules become effective.[18] Another commenter generally agrees with FINRA Rule 4330(b)(1)(C) as applied going forward to members that currently do not have programs in place to borrow customer fully-paid or

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16 See SIFMA letter.

17 See SIFMA letter.

18 See SIFMA letter.

excess margin securities, but does not believe that there is any benefit to imposing this requirement on firms with existing programs that FINRA already reviews during both routine and "sweep" FINRA examinations.[19]

In response to comments, FINRA seeks to clarify that the notification requirement in proposed FINRA Rule 4330(b)(1)(C) applies prior to the time a firm first enters into either a fully paid or excess margin securities borrow program or if it has no program, prior to first entering into such fully paid securities borrows with one or more customers, and is proposing to amend the rule text accordingly. A notice is not required for each new customer that enters an established program. FINRA also is replacing the terms "borrow activities," "transaction" and "program" with the term "securities borrows" to make the terminology consistent throughout the provision. In addition, FINRA is adding proposed Supplementary Material .05 to address fully paid or excess margin securities borrows with customers that exist as of the effective date of this proposed rule, either as part of a program or outside of a program. In such cases, a member with any existing fully paid or excess margin securities borrows with customers as of the effective date of this rule, would be required to provide (1) written notification to FINRA within 30 days of the effective date of the new rule, in such manner and form as FINRA may require; and (2) such customers with the disclosures required by FINRA Rule 4330(b)(2)(B) within 90 days of the effective date of the new rule. FINRA recognizes that it may have knowledge of firms' existing fully-paid securities borrow programs or fully paid borrows done outside of a program, through the examination process; however, FINRA believes the proposed notification requirement for such existing activities is not overly

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19 See Fidelity letter.

burdensome and would provide FINRA with a comprehensive view of a firm's activities after the effectiveness of the proposed rule.

c. Comments on Proposed FINRA Rule 4330(b)(2)(A) - Suitability

FINRA Rule 4330(b)(2)(A) as proposed in the Notice would require a member that borrows a customer's fully paid or excess margin securities, prior to entering into a securities borrow transaction with a customer, to determine that such transaction is suitable for the customer.

One commenter asks FINRA to clarify that suitability for purposes of this proposed new rule should apply with respect to a customer's overall participation in a fully paid securities lending program, and not on a transaction-by-transaction basis because this would be unduly burdensome and negatively impact the efficiency of security loans.[20] Another commenter requests further clarification on what would make a customer unsuitable to participate after a customer has been fully informed of the risks associated with the transaction, executes a master securities lending agreement with the firm which sets forth the terms and conditions of the loan, the loan is fully collateralized in accordance with SEA Rule 15c3-3(b)(3), and there are no limitations placed upon the customer's ability to sell the loaned security or draw upon the collateral.[21] The commenter further notes that it does not believe that a customer's investment objectives or net worth are applicable in determining whether customers should be able to generate additional income from their securities positions. The commenter agrees with FINRA's concern about customers buying hard-to-borrow securities for the sole intention of

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20 See SIFMA letter.

21 See Fidelity letter.

loaning them, but the commenter believes that NASD Rule 2310 (Recommendations to Customers—Suitability) would already cover this activity.[22]

In response to the commenters' concerns, FINRA is proposing to substantially revise the suitability provision in proposed paragraph (b)(2)(A) of Rule 4330. As revised, proposed paragraph (b)(2)(A) requires a member to have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the member 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 member or associated person in connection with entering such securities loans. To further address commenters' concerns about when this obligation arises in the customer relationship, FINRA is clarifying that a member must undertake this determination prior to first entering into securities borrows with a customer and not on a transaction by transaction basis. Accordingly, where a member has a securities borrow program, it would be required to determine the appropriateness of such activity for the customer prior to the customer entering into the first securities borrow. FINRA believes these proposed changes respond to commenters' concerns regarding the scope and application of the review.

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22 NASD Rule 2310 (Recommendations to Customers – Suitability) has been superseded by FINRA Rule 2111 (Suitability). See SR-FINRA-2010-039, which was amended by SR-FINRA-2011-016 and SR-FINRA-2012-027 eff. July 9, 2012.

d. Comments on Proposed FINRA Rule 4330(b)(2)(B) – Risk Disclosures

Proposed FINRA Rule 4330(b)(2)(B), as proposed in the Notice, would require members to provide a customer with certain specific information regarding the risks associated with the customer's securities loan transaction, prior to entering into a securities borrow transaction with a customer. Several commenters raise general concerns regarding the proposed disclosure requirement, as well as concerns about specific required disclosures.[23]

i. Standardized Risk Disclosure Form

Two commenters support the idea that customers should be fully informed of the risks associated with lending their fully-paid and excess margin securities but believe that an industry standard risk disclosure form should be developed to help ensure consistent standards across the industry. [24] In response, FINRA does not object to the development by the industry of a standardized risk disclosure form but cautions that such form may not be able to capture all of the risk disclosures specific to every member's individual fully-paid or excess margin securities lending activities, and members should carefully evaluate their activities and disclosure obligations when considering adopting a standardized disclosure document to address their compliance with the proposed rule.

ii. Disclosure of Limitation on the Customer's Ability to Sell the Loaned Securities

Several commenters raise issues regarding the proposed requirement to disclose to the customer any limitations on the customer's ability to sell the loaned securities. Specifically, two commenters appear to raise issues relating to Regulation SHO and the

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23 See Plexus letter, SIFMA letter and Fidelity letter.

24 See SIFMA letter and Fidelity letter.

SEC's guidance that if a person that has loaned a security to another person sells the security and a bona fide recall is initiated within two business days after trade date, the person that has loaned the security is "deemed to own" the security for purposes of Rule 200(g)(1) Regulation SHO, and such sale will not be treated as a short sale for purposes of the close-out requirements under Rule 204 of Regulation SHO. In addition, a broker-dealer may mark such orders as long sales provided such marking is in compliance with Rule 200(c) of Regulation SHO.[25] In particular, one of the commenters contends that, since the proposed disclosure is not intended to provide guidance on the marking of customers' sales as "long" or "short," or otherwise provide guidance concerning Regulation SHO, FINRA should either eliminate this proposed disclosure to avoid potential confusion or clarify that such orders to sell may be marked "long," provided there is compliance with applicable guidance regarding Regulation SHO.[26] The other commenter notes the SEC's guidance and states that there should not be any distinction between hypothecated margin securities (securities bought by the customer with funds borrowed from the firm) and fully-paid or excess margin securities on loan, as long as it is reasonable to believe they can be recalled by settlement date for the sale.[27]

FINRA included the requirement to disclose "limitations on customer's ability to sell the loaned securities," in the original proposal as a result of concerns noted with regard to the adequacy of certain disclosures of material information to customers

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25 See Fidelity letter and SIFMA letter. See also Securities Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266, 38270, n.55 (July 31, 2009); and "SEC Division of Trading and Market Guidance Regarding Sale of Loaned But Recalled Securities" (Published on the SEC's website on October 20, 2008).

26 See SIFMA letter.

27 See Fidelity letter.

participating in the member's fully paid lending program including, specifically, failing to adequately disclose to customers that shares on loan could be sold at any time prior to recalling the shares or waiting for the delivery of shares back to their account. The proposed disclosure is not intended to address members' obligations under Regulation SHO or otherwise require members to provide guidance regarding Regulation SHO. FINRA believes the proposed disclosure will alert customers regarding their right to sell the securities and any limitations on the customer's ability to do so. However, to further clarify its intent, FINRA has modified the rule text to require members to disclose "the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable."

iii. Economics of the Transaction

With respect to the proposed disclosure of the economics of the securities loan transaction, one commenter does not agree that this disclosure should include the rate that the firm would earn on the loaned securities because it would be irrelevant to the customer's decision.[28] In addition, the commenter argues that any such disclosed rate would not provide the customer with meaningful information to assist the customer in making any decision, since this rate would be only a rough estimate as there would be no way of knowing exactly what rate the security would be lent out at initially or over the life of the loan.[29] Another commenter, noting that there may be different prices for securities borrow transactions involving the same security, requests that FINRA clarify in

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28 See Fidelity letter.

29 See Fidelity letter. The commenter does believe that a disclosure regarding the economics of the transaction should include the rate the customer will be paid for the securities borrow loan transaction.

its rule filing that firms will be expected to provide adequate disclosure to customers that the price for a securities lending transaction can be affected by a variety of different factors (e.g., size of the transaction, expected stability of the borrow, collateral posted).[30]

Although not specifically addressed to the proposed "economics of the transaction" disclosure, one commenter states that the required disclosures should include the most opaque parts of short selling and stock lending practices.[31] In the same vein, the commenter suggests that the broker-dealer be required to explain the rebate it receives and the fact that the resulting short sale may be against the customer's own interest and perhaps that other more powerful customers may indeed participate in these stock loan profits.

After reviewing the comments received, FINRA has amended proposed FINRA Rule 4330(b)(2)(B) to remove the term "economics of the transaction," and is proposing to add more specific guidance on the types of disclosures that should be provided to customers. Specifically, pursuant to the amended rule text, a member must disclose, among other things, 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. Such disclosures would include, but not be limited to, (i) the loss of voting rights; (ii) the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable; (iii) the factors that determine the amount of compensation received by the member and its associated persons in connection with the use of the securities borrowed from the customer; (iv) the factors that determine the amount of

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30 See SIFMA letter.

31 See Plexus letter.

compensation (e.g., interest rate) to be paid to the customer and whether or not such compensation can be changed by the member under the terms of the borrow agreement; (v) the risks associated with each type of collateral provided to the customer; (vi) that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales; (vii) potential tax implications, including payments deemed cash-in-lieu of dividends paid on securities while on loan; and (viii) the member's right to liquidate the transaction because of a condition of the kind specified in proposed Rule 4314(b). FINRA believes this list provides greater clarity to members regarding the disclosures on rights and risks that must be given to customers prior to engaging in such securities borrows. This list is not intended to be exhaustive, and firms need to carefully consider the disclosures that are applicable to their specific activity/program.

One commenter seeks clarification that "for those principal lenders utilizing lending agents the recipient of the required disclosures should be lending agents in their capacity as such, and not the underlying principals."[32] FINRA believes that where the customer lender has legally authorized an agent to act on such customer's behalf in making a determination about whether to lend fully paid or excess margin securities to the member, the disclosures required pursuant to the proposed rule may be made to the lending agent in the lending agent's capacity as such, in lieu of being made to the underlying principal. FINRA also is proposing certain technical changes to the rule text as proposed in the Notice by adding headings to improve readability.

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32 See SIFMA letter.

3. Proposed FINRA Rule 4340 (Callable Securities)

As detailed further above, proposed FINRA Rule 4340(a) would, among other things, require each member that has in its possession or under its control any security which, by its terms, may be called or redeemed prior to maturity, to establish and make available on the member's website procedures 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.

One commenter requests that FINRA clarify whether the requirement that a member post its allocation procedures on its website would require a firm "to provide detailed, granular procedures" or whether it would be sufficient to provide a general statement describing its allocation procedures. [33] The commenter is concerned that, if detailed procedures are required, firms that clear through third parties and self-clearing firms using service bureaus systems would be unable to comply with the requirement as such procedures would constitute the third parties' proprietary information that firms would not be able to disclose without permission from the third parties. In response, FINRA notes that the proposed rule requirement is intended to require a member to describe its allocation procedures in sufficient detail to allow customers to understand the process for partial redemptions and the outcome of such processes. FINRA does not believe that such description generally would require a member to disclose a third-party's proprietary information.

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33 See SIFMA letter.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2013-035 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2013-035. This file number should be included on the subject line if e-mail is used. To help the Commission process

and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2013-035 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[34]

Elizabeth M. Murphy

Secretary

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[34] 17 CFR 200.30-3(a)(12).

Regulatory Notice 10-03

Financial Responsibility and Operational Rules

FINRA Requests Comments on Proposed Consolidated FINRA Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities

Comment Period Expires: March 8, 2010

Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook),[1] FINRA is requesting comment on three proposed FINRA rules. Proposed FINRA Rule 4314 (Securities Loans and Borrowings) sets forth the requirements applicable to a member firm that is a party to an agreement for the loan or borrowing of securities. Proposed FINRA Rule 4330 (Customer Protection— Permissible Use of Customers' Securities) sets forth the requirements applicable to a member firm's borrowing or lending of a customer's margin securities that are eligible to be pledged or loaned. Proposed FINRA Rule 4340 (Callable Securities) sets forth the obligations applicable to any callable securities a member firm has in its possession or control.

The text of the proposed rules is set forth in Attachment A.

Questions regarding this *Notice* should be directed to:

- Kris Dailey, Vice President, Risk Oversight & Operational Regulation, at (646) 315-8434; or
- Yui Chan, Managing Director, Risk Oversight & Operational Regulation, at (646) 315-8426.

January 2010

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Systems

Key Topic(s)

- Books and Records
- Callable Securities
- Customer Funds and Securities
- Disclosure of Agency Capacity
- Lending and Borrowing Arrangements
- Liquidation
- Loan Consent Agreements
- Margin Securities
- Redemptions
- SIPC Protection

Referenced Rules & Notices

- NASD IM-2330
- NASD Rule 2330
- NYSE Rule 296
- NYSE Rule 402
- NYSE Rule 402.30
- NYSE Rule Interpretation 402(b)/01
- SEA Rule 15c3-3

Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by March 8, 2010. Member firms 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

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]

Discussion

I. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

A. Background

NYSE Rule 296 (Liquidation of Securities Loans and Borrowings)[4] sets forth the obligations of a member that is party to an agreement with another member for the loan and borrowing of securities. Specifically, the rule provides that a member that is party to an agreement with another member for the loan and borrowing of securities has the right to liquidate such transaction whenever the other party to the transaction:

(1) applies for or consents to a receiver, custodian, trustee or liquidator of itself or its property;

(2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due;

(3) makes a general assignment for the benefit of its creditors; or

(4) files, or has filed against it, a petition for a Chapter 11 bankruptcy filing or a protective decree under Section 5 of the Securities Investor Protection Act of 1970 (SIPA) (liquidation conditions).

The rule further provides that no member may lend or borrow any security to or from any non-member of the NYSE, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, which confers upon the member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified above.

NYSE Rule 296.10 defines the term "agreement for the loan and borrowing of securities," for purposes of NYSE Rule 296. NYSE Rule 296.20 provides that each member that is subject to SEA Rule 15c3-3 and that borrows from a customer (as the term is defined in SEA Rule 15c3-3) must comply with Rule 15c3-3's provisions requiring a written agreement between the borrowing member and the lending customer.

FINRA believes that the rule has been the basis for similar provisions incorporated in the industry standard Master Securities Lending Agreement (MSLA). Furthermore, FINRA believes that the rule provides protection to members that may enter into a securities lending transaction without a duly signed MSLA with a counterparty, should one of the counterparties become insolvent, allowing for the ability to immediately liquidate against collateral received.

FINRA proposes to adopt NYSE Rule 296 as FINRA Rule 4314 (Securities Loans and Borrowings) into the Consolidated FINRA Rulebook with the changes described below.

B. Proposed FINRA Rule 4314

In 2006, the industry began to adopt voluntary practices initiated by the SEC, including books and records and disclosure practices, as a result of an industry-wide initiative to address the risks associated with agency lending (the Agency Lending Disclosure Initiative). Consistent with the industry-wide initiative, FINRA is proposing a new requirement to address concerns about whether parties are acting as principals or agents when entering into an agreement to loan or borrow securities. The proposed rule requires a member firm that acts as agent in a loan or borrow transaction to disclose its capacity, and, in cases where the member firm lends securities to or borrows securities from a counterparty that is acting in an agency capacity, requires that the member firm maintain books and records to reflect the identity of both the agent and the principal(s) on whose behalf the agent is acting and the contract terms between the parties.

Specifically, proposed new FINRA Rule 4314(a) requires a member firm that enters into a transaction to lend or borrow securities as agent to disclose its capacity to the other party (or parties) to the transaction. The provision further requires the member firm, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction. When the other party (who may or may not be a member) is acting as agent in the transaction, the member firm is required to maintain books and records that: (1) reflect the details of the transaction with each such agent; and (2) reflect each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

Proposed FINRA Rule 4314(b), based on NYSE Rule 296(a), continues to provide each member firm that is a party to an agreement with another member firm for the loan and borrowing of securities with the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions specified in the rule.

In addition, FINRA is proposing to expand upon the written agreement requirement in NYSE Rule 296(b). Specifically, proposed FINRA Rule 4314(c) requires that no member firm shall lend or borrow securities to or from any person that is not a member of FINRA, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, which confers upon such member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in proposed FINRA Rule 4314(b), as detailed above. In contrast, NYSE Rule 296(b) requires a member to have a written agreement only with any non-member of the NYSE. FINRA believes that expanding the requirement to have a written agreement with all non-members of FINRA, including any customer, protects the member firm's interests in the event of a liquidation condition specified in proposed FINRA Rule 4314(b) and supports the member's compliance with net capital requirements.

Further, FINRA is proposing to transfer NYSE Rule 296.10, which defines the term "agreement for the loan and borrowing of securities," as Supplementary Material .01 to proposed FINRA Rule 4314, without substantive change. In addition, FINRA is proposing to add new Supplementary Material .02 through .04 to the proposed FINRA rule. Proposed Supplementary Material .02 clarifies the methods by which a member firm may satisfy its disclosure obligation in new paragraph (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 transaction between the parties. Proposed Supplementary Material .03 clarifies the books and records requirements imposed by new paragraph (a). Proposed Supplementary Material .04 reminds member firms of their obligations under proposed FINRA Rule 4330(b) (discussed further below) to provide a written notice when borrowing securities from customers regarding the associated risks of such transactions, and requires that member firms disclose in such written notice their right to liquidate under the conditions specified in paragraph (c) of proposed FINRA Rule 4314.

C. Eliminated Rules and Requirements

FINRA is proposing to eliminate existing NYSE Rule 296.20, which, as discussed above, requires each member firm that is subject to the provisions of SEA Rule 15c3-3 and that borrows securities from a customer to comply with the provisions relating to the requirements for a written agreement between the borrowing member and the lending customer, as the substance of this provision has been included in proposed FINRA Rule 4330(b).

FINRA is also proposing to eliminate NYSE Rule Interpretation 296(b)/01, which addresses transactions with non-member organizations and the written agreements required in regard to repurchase and reverse repurchase transactions not subject to SEA Rule 15c3-3, as the interpretation is beyond the scope of the proposed rule.

II. Proposed FINRA Rule 4330 (Customer Protection—Permissible Use of Customers' Securities)

A. Background

NYSE Rule 402(a)-(b) (Customer Protection—Reserves and Custody of Securities), NASD Rule 2330(b)-(d) (Customers' Securities or Funds) and NASD IM-2330 (Segregation of Customers' Securities) set forth the requirements applicable to a member firm's use of customers' securities. Specifically, NYSE Rule 402 and NASD Rule 2330 prohibit a member firm from lending, either to itself or others, securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless the firm first obtains a written authorization from the customer permitting the lending of the customer's securities. NYSE Rule Interpretation 402(b)/01 (Agreements for Use of Customers' Securities/Application) permits a member firm to use a single customer-signed margin agreement/loan consent in lieu of obtaining separate written documents. Both the NYSE and NASD rules contain similar provisions requiring members to comply with SEA Rule 15c3-3 in obtaining custody and control of securities and maintaining appropriate cash reserves.

FINRA proposes to adopt NYSE Rule 402 as FINRA Rule 4330 (Customer Protection—Permissible Use of Customers' Securities), subject to certain significant changes, and eliminate NASD Rule 2330(b)-(d) and NASD IM-2330 as duplicative or otherwise unnecessary.

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

Proposed FINRA Rule 4330(a) continues to require a member firm to obtain a customer's written authorization prior to lending the customer's eligible margin securities. Also, proposed supplementary material retains and codifies NYSE Rule Interpretation 402(b)/01, thereby continuing to permit a member firm to satisfy the written authorization requirement by using a single customer-signed margin agreement/loan consent, provided that it contains a legend in bold type face placed directly above the signature line that states:

> "BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

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

Additionally, FINRA is proposing new requirements to address the increase in the borrowing and lending of customers' fully paid or excess margin securities. Specifically, proposed FINRA Rule 4330(b)(1) requires a member firm to notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to engaging in such activities. FINRA may request related information, including the written agreement authorizing such arrangements, the types of customers, the accounts used and the collateral involved in the transactions.

Proposed FINRA Rule 4330(b)(2) also imposes a new requirement that a member firm, prior to entering into a securities borrow transaction with a customer, provide the customer, in writing (which may be electronic), with a clear and prominent notice that the provisions of SIPA may not protect the customer with respect to such 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 securities. In addition, a member firm would be required to provide the customer with information regarding risks associated with the transaction (*e.g.*, the potential loss of SIPC protection as described above, a loss of voting rights, possible limitations on the ability to sell the borrowed securities); the economics of the transaction, including potential tax implications; and the member firm's right to liquidate the transaction because of a condition of the kind specified in proposed FINRA Rule 4314(b) (Securities Loans and Borrowings—Right to Liquidate Transaction) (discussed above).

Additionally, proposed FINRA Rule 4330(b)(2) requires for the first time that a member firm determine whether the transaction is suitable for the customer. However, proposed supplementary material, while clarifying that the member firm borrowing a customer's securities is responsible for making the suitability determination regarding the customer, permits the member firm to rely on any representations made by another member firm that has a customer relationship with the lender. Proposed FINRA Rule 4330(b)(3) also requires that a member maintain books and records evidencing compliance with proposed FINRA Rule 4330(b)(2).

D. Eliminated Rules and Requirements

Proposed FINRA Rule 4330 does not retain the provisions in NYSE Rule 402 that are duplicative of the requirements in SEA Rule 15c3-3 or the outdated provisions regarding the physical segregation of securities. Additionally, the proposed rule change eliminates NASD Rule 2330(b)-(d) and NASD IM-2330, which contain similar duplicative and outdated provisions.

III. Proposed FINRA Rule 4340 (Callable Securities)

A. Background

NYSE Rule 402.30 (Securities Callable in Part) requires a member firm that has in its possession or control securities that are callable in part to identify each such security so that its records clearly show for whose account it is held. The following securities are exempt from this requirement:

(1) certain bonds that have not paid interest for at least two interest periods;

(2) Euro-dollar bonds deposited in a central clearing facility for such bonds, provided that customers are notified of the deposit into the central clearing facility and also that the member has the right to withdraw uncalled bonds from the facility at any time; and

(3) bonds or preferred stocks, provided that the member has satisfied certain requirements, including adopting an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member firm.

NYSE Rule 402.30 also requires that a member firm provide written disclosure to all customers of the systems and the manner in which securities are held and their rights to withdraw uncalled securities, as described above, prior to: (1) the member depositing the securities in bulk; or (2) the customer purchasing such securities, except in the case of a new account, provided that such notice was sent to the customer prior to the settlement date. The rule further requires that in the event of a favorable call of the securities, the member shall not allocate any securities to any account in which it or its general, limited, or special partners, officers, directors, approved persons or employees have an interest until all other customers' positions in the securities have been satisfied. There is no comparable NASD rule.

FINRA proposes to adopt FINRA Rule 4340 (Callable Securities), based in part on NYSE Rule 402.30. The proposed rule changes are detailed further below.

B. Proposed FINRA Rule 4340(a): Allocation Procedures and Customer Notice

Proposed FINRA Rule 4340(a) retains in concept the provision in NYSE Rule 402.30 requiring each member firm that has in its possession or control certain callable securities to establish procedures by which it will allocate among its customers the shares to be redeemed or selected as called in the event of a partial redemption or call. However, proposed FINRA Rule 4340(a) applies this provision to any security, which by its terms, may be called or redeemed prior to maturity.

The proposal eliminates the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member firm. Instead, proposed FINRA Rule 4340(a) adopts a more flexible approach and allows member firms to establish procedures that require the allocation to be conducted on a fair and impartial basis. Proposed supplementary material clarifies that such 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.

Proposed FINRA Rule 4340(a) also requires the member firm to post its allocation procedures on its Web site and 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, explaining how customers may access the procedures on the member's Web site and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

C. Proposed FINRA Rule 4340(b) and (c): Favorable and Unfavorable Redemptions

Proposed FINRA Rule 4340(b) retains in concept the restriction in NYSE Rule 402.30 prohibiting a member firm from allocating securities to any of its accounts or those of its "employees, partners, officers, directors, and approved persons" in a redemption offered on terms favorable to a customer until all other customers' positions have been satisfied. However, proposed FINRA Rule 4340(b) applies the restriction to a member and its "associated persons," rather than to a member's "employees, partners, officers, directors, and approved persons."

Proposed supplementary material clarifies that the term "associated person" as used in the proposed rule would have the meaning provided in Exchange Act Section 3(a)(18), which expressly excludes for certain purposes any persons associated with the member firm whose functions are solely clerical or ministerial (referred to as "clerical and ministerial associated persons").[5] Proposed supplementary material also makes clear that, in the event of a redemption offered on terms favorable to a customer, a member firm may include the accounts of clerical and ministerial associated persons in the pool of securities eligible to be called. However, where the redemption of callable securities is offered on terms unfavorable to a customer, proposed FINRA Rule 4340(c) expressly prohibits a member firm from excluding its accounts and those of its associated persons, including the accounts of clerical and ministerial associated persons, from the pool of securities eligible to be called.

Additionally, proposed supplementary material codifies that where an introducing member firm is a party to a carrying agreement with another member firm that is conducting an allocation pursuant to proposed FINRA Rule 4340(a), any account in which the introducing member 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 member firm must identify such accounts to the member firm conducting the allocation.

D. Eliminated Rules and Requirements

Finally, the proposed rule change eliminates NYSE Rule 402.30 in its entirety, including eliminating as unnecessary the rule's provision permitting customers to withdraw uncalled fully paid securities at any time prior to a partial call, and also to withdraw excess margin securities, provided that the customers' accounts are not subject to restrictions under Regulation T, or such withdrawals will not cause an under-margined condition.

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 Although the FINRA By-Laws define associated persons, FINRA is proposing the Exchange Act definition of "associated person" to permit members to include accounts held by clerical and ministerial persons in favorable calls or redemptions.

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 Rules

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4000. FINANCIAL AND OPERATIONAL RULES

* * * * *

4300. OPERATIONS

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[Rule 296]4314. [Liquidation of] Securities Loans and Borrowings

(a) Disclosure of Parties' Capacity in Loan or Borrow Transactions

(1) A member that lends or borrows securities in the capacity of agent shall disclose such capacity to the other party (or parties) to the transaction.

(2) Prior to lending securities to or borrowing securities from a person that is not a member of FINRA, a member shall determine whether the other party is acting as principal or agent in such transaction.

(3) With respect to paragraphs (a)(1) and (2) above, when the other party to a security loan or borrow transaction is acting as agent in such transaction, the member shall:

(A) maintain books and records that reflect the details of the transaction with each such agent; and

(B) maintain books and records that reflect each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

([a]b) Right to Liquidate Transaction

Each member [or member organization] that is a party to an agreement with another member [or member organization] providing for the loan and borrowing of securities shall have the right to liquidate such transaction whenever the other party to such transaction:

(1) applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property[,];

(2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due[,];

(3) makes a general assignment for the benefit of its creditors[,]; or

(4) files, or has filed against it, a petition under Title 11 of the United States Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA")[,];

unless that right is stayed, avoided, or otherwise limited by an order authorized under the provisions of [the Securities Investor Protection Act of 1970] SIPA or any statute administered by the [Securities and Exchange Commission] SEC.

([b]c) Written Agreement with Non-Members

No member [or member organization] shall lend or borrow any security to or from any person that is not a member of FINRA [non-member of the Exchange], except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon such member [or member organization] the contractual right to liquidate such transaction because of a condition of the kind specified in paragraph ([a]b) above.

• • • Supplementary Material: ————————

[.10].01 Definition of Agreement. [As used herein]For purposes of this Rule, an agreement for the loan and borrowing of securities shall mean a securities contract or other agreement, including related terms, for the transfer of securities against the transfer of funds, securities, or other collateral, with a simultaneous agreement by the transferee to transfer to the transferor against the transfer of funds, securities, or other collateral, upon notice, at a date certain, or upon demand, the same or substituted securities.

.02 Disclosure of Capacity. A member may satisfy its disclosure obligation in paragraph (a)(1) of this Rule 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 security exchanged between the parties for each loan and borrow transaction.

.03 Details of Transactions with Parties Acting as Agents. For purposes of paragraph (a)(3) of this Rule, when entering into a security loan or borrow transaction with a party that is acting as agent on behalf of another principal(s), the member shall maintain a record of the details of each security loan or borrow with each agent, identifying the specific security and quantity loaned or borrowed, the contract value and the type and description of the collateral provided to such agent. In addition, the member's records shall reflect the quantity of securities loaned or borrowed from each principal on whose behalf the agent is acting and the amount and description of the collateral allocated to each such principal. Such records shall be maintained in accordance with the requirements of SEA Rule 17a-4(a).

.04 Compliance with Rule 4330 When Borrowing Securities from a Customer. When a member borrows securities from a customer, the member is also subject to Rule 4330(b)(2)(A)(ii), which requires members to provide information to customers regarding the risks associated with the customer's securities loan transaction. Such written notice shall include a disclosure of the right of the member to liquidate the borrow transactions with the customer, as provided by paragraph (c) of this Rule.

[**.20** Each member or member organization subject to the provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 that borrows securities from a customer (as defined in said rule) shall comply with the provisions thereof relating to the requirements for a written agreement between the borrowing member or member organization and the lending customer.]

* * * * *

[Rule 402]4330. Customer Protection—[Reserves and Custody of Securities] Permissible Use of Customers' Securities

[(a) General Provisions]

[Each member organization shall obtain custody and control of securities and maintain reserves as prescribed by Rule 15c3-3 promulgated under the Securities Exchange Act of 1934. For the purpose of this Rule the definitions contained in such Rule 15c3-3 shall apply.]

([b]a) [Agreements for Use of] Authorization to Lend Customers' Margin Securities

No member [organization] shall lend, either to itself [as a broker-dealer] or to others, securities [which] that are held on margin for a customer and [which] that are eligible to be pledged or loaned, unless such member [organization] shall first have obtained a written authorization from such customer permitting the [loan] lending of such securities [by the member organization].

(b) Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities

(1) A member that borrows fully paid or excess margin securities carried for the account of any customer shall comply with the requirements of SEA Rule 15c3-3 and shall notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to engaging in such borrow activities.

(2) A member that engages in borrow activities pursuant to paragraph (b)(1) of this Rule shall, prior to entering into a securities borrow transaction with a customer:

(A) provide the customer, in writing (which may be electronic), with:

(i) clear and prominent notice stating that the provisions of the Securities Investor Protection Act of 1970 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's obligation in the event the member fails to return the securities; and

(ii) information regarding the risks associated with the customer's securities loan transaction, including but not limited to:

a. potential loss of SIPC protection as described in paragraph (b)(2)(A)(i) of this Rule;

b. loss of voting rights;

c. the type and sufficiency of collateral provided to the customer;

d. any limitations on the customer's ability to sell the loaned securities, if applicable;

e. the economics of the transaction, including potential tax implications, as applicable; and

f. the member's right to liquidate the transaction because of a condition of the kind specified Rule 4314(b); and

(B) determine that such transaction is suitable for the customer.

(3) A member that engages in borrow activities pursuant to paragraph (b)(1) of this Rule shall create and maintain records evidencing the member's compliance with the requirements of paragraph (b)(2) of this Rule.

• • • **Supplementary Material:**

.01 Definitions. For purposes of this Rule, the definitions contained in SEA Rule 15c3-3 shall apply.

.02 Authorization to Lend Customers' Margin Securities. For purposes of paragraph (a) of this Rule, members may use a single margin agreement/loan consent signed by a customer as written authorization to permit the lending of a customer's margin eligible securities in lieu of obtaining a separate written authorization. Such margin agreement/loan consent must contain a legend in bold type face placed directly above the signature line that states substantially the following:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

.03 Notification to FINRA. FINRA, upon receipt of a member's written notification pursuant to paragraph (b)(1) of this Rule of the member's intent to engage in such borrow activities, may request such additional information as it may deem necessary to evaluate compliance with SEA Rule 15c3-3 and other applicable FINRA rules or federal securities laws or rules. Examples of additional information include, but are not limited to:

(a) the written agreement authorizing such borrowing of securities, which shall reflect the material terms of the arrangement;

(b) the types of customers that are parties to such arrangements;

(c) the types of accounts used to effect such transactions (i.e., whether the subject securities are contained in customers' cash or margin accounts or separate accounts);

(d) the types of collateral provided to customers in connection with such transactions, the frequency of marking to market and the custody of such types of collateral;

(e) net capital compliance of such transactions;

(f) the operational and recordkeeping processes related to such transactions;

(g) the rebates paid/received in connection with such transactions and any other compensation arrangements related thereto; or

(h) the procedures for handling customers' requests to sell the fully paid or excess margin securities subject to such transactions; and

(i) any applicable disclosure requirements.

.04 Suitability Determination. The member borrowing a customer's fully paid or excess margin securities is responsible for making the suitability determination regarding the customer required by paragraph (b)(2)(B) of this Rule. However, in making that determination, the member may rely on the representations of another member that has a customer relationship with the lender.

[.30 Securities Callable in Part]

* * * * *

4340. Callable Securities

(a) Each member that has in its possession or control any security which, by its terms, may be called or redeemed prior to maturity, shall:

(1) establish and make available on the member's Web site procedures by which it will allocate among its customers, on a fair and impartial basis, the shares to be redeemed or selected as called in the event of a partial redemption or call; and

(2) provide written notice (which may be electronic) to new customers at the opening of an account, and all customers at least once every calendar year, of the manner in which they may access the allocation procedures on the member's Web site and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

(b) Where redemption of callable securities is offered on terms favorable to a customer, a member shall 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.

(c) Where the redemption of callable securities is made on unfavorable terms to a customer, a member shall not exclude its positions or those of its associated persons (including those persons performing solely clerical and ministerial functions) from the pool of the securities eligible to be called.

• • • Supplementary Material:————————-

.01 Definition of Associated Person; Clerical and Ministerial Functions. The term "associated person" as used in this Rule shall have the meaning provided in Section 3(a)(18) of the Exchange Act, which expressly excludes, for certain purposes, any person associated with the member whose functions are solely clerical or ministerial (referred to as "clerical and ministerial associated persons"). With respect to a redemption offered on terms favorable to a customer, for purposes of paragraph (b) of this Rule, a member may include the accounts of clerical and ministerial associated persons in the pool of the securities eligible to be called. With respect to a redemption offered on unfavorable terms to a customer, for purposes of paragraph (c) of this Rule, a member shall not exclude the accounts of clerical and ministerial associated persons from the pool of the securities eligible to be called.

.02 Allocations of Partial Redemptions or Calls. For purposes of paragraph (a)(1) of this Rule, a member's 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.

.03 Accounts of an Introducing Member and its Associated Persons. Where an introducing member is a party to a carrying agreement with another member that is conducting an allocation pursuant to paragraph (a) of this Rule, any accounts in which the introducing member or its associated persons have an interest shall be subject to paragraphs (b) and (c) of this Rule. The introducing member also shall identify such accounts to the member conducting the allocation.

Exhibit 2b

List of the comment letters received in response to Regulatory Notice 10-03 (January 2010).

1. Letter from Peter J. Chepucavage, Executive Director, CFAW General Counsel Plexus Consulting LLC, received January 20, 2010 ("Plexus")

2. Letter from Erica M. Vaters, Vice President - Fidelity Institutional Compliance, Fidelity Brokerage Services LLC, dated March 5, 2010 ("Fidelity").

3. Letter from Daniel C. Rome, Executive Consultant, Accounting and Compliance International, dated March 8, 2010 ("ACI").

4. Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, The Securities Industry and Financial Markets Association, dated March 8, 2010 ("SIFMA").

PLEXUS
CONSULTING GROUP

This proposed rule 4330(a),http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120691.pdf requires firms to obtain a written authorization from customers before their margin securities may be loaned out. However after years of debate about short selling and stock loan practices surely the disclosure could and should cover the most opaque parts of this transaction. These include the fact that only the broker -dealer will make money on this transaction and that the securities most likely will be used for short selling. Thus the customer who pays margin interest receives no compensation and his own securities are used to short his own stock. While this has been common practice for many years it can easily be included in the required disclosure. While legitimate debate about short selling continues there is no debate that retail customers receive little benefit when their securities are used and are not likely to understand they are conspiring against their own position.We suggest therefore that the broker explain the rebate he receives and the fact that the resulting short sale may be against their own interest and perhaps that other more powerful customers may indeed participate in these stock loan profits.

The following more colorfully describes the arguably inherent unfairness of this limited disclosure and suggests an appropriate disclosure at the end. We can substitute Dendreon as the real world example of the hypothetical Acme Pharmaceutical.While the language here may be exaggerated its message is not.;

WALL STREET VERSUS MAIN STREET AND THE USE OF MARGIN ACCOUNTS by Dr. Jim Decosta

Let's assume "Buyer Bob B." has $10,000 to invest and he wants to buy shares of Acme Pharmaceutical which has a new cancer cure. Bob is an immunologist and very familiar with the efficacy of Acme's new breakthrough drug. Bob places an order for $10,000 worth of Acme and his broker informs him that he could actually buy $20,000 worth of Acme if he would just open up a margin account. Bob may not be able to afford to lose $20,000 half of which is borrowed but knowing of the potential for the new drug he takes the bait and opens up a margin a/c and buys $20,000 worth of Acme. Bob can **afford** to buy "X" amount of Acme but he ends up buying "2X" worth but it was his choice. After all, to an immunologist like Bob Acme's chances for an FDA approval is a no-brainer.

Bob's brokerage firm's clearing firm earns a fee for the "banking" business it provided to Bob and the full "2X" amount of shares serves as the collateral for that $10,000 loan. Bob's brokerage firm incurs veritably no risk for default on this loan with 200% collateral because they can easily sell these shares out from underneath Bob should the price drop. Let's assume that the shares that Bob bought were short sold from a short seller. This "2X" amount of shares were originally bought by an investor across town named "Buyer Bob A." They too were bought in a margin a/c; that's why they were available for lending to the short seller.

After processing Bob B.'s $20,000 purchase order his broker now becomes the "legal owner" of that particular parcel of 2X amount of shares unknowingly "co-beneficially owned" by Bob A. and Bob B. Being the new "legal owner" of that 2X parcel of Acme shares Bob B.'s broker has all of the right in the world to rent them to yet another short seller who then sells them to yet another Bob, "Buyer Bob C." There are now 3 "co-beneficial owners" of that **one** parcel of **impossible to identify** shares. The most recent purchaser is referred to as the "legal owner" and all previous purchasers of that same parcel of shares are referred to as "security entitlement holders". This parcel of shares is impossible to identify because of the NSCC's insistence on holding "street name" shares in an "anonymously pooled" format and because of the circa 1970 "dematerialization" of tough to counterfeit paper-certificated shares into easy to counterfeit electronic book entry shares.

All "security entitlement holders" are allowed by UCC Article 8 to sell that which they purchased at any time they so choose. After a year or so let's assume that through the magic of theoretically "legal" short selling there are now 11 "co-beneficial owners" and one "legal owner" of that **one** impossible to identify parcel of Acme shares. Keep in mind that this is just one of many, many "daisy chains" of bogus Acme "shares" possible.

Picture Acme Pharmaceutical as a small tree attempting to grow into a big Pharmaceutical company via the introduction of their new breakthrough cancer cure. Every single time a short sale of Acme shares occurred a readily sellable **unregistered** share price depressing "security entitlement" was essentially "issued". Due to their being treated as being readily sellable they add to the "supply" or "float" of Acme shares which must be treated as being readily sellable. Each "borrow" associated with each short sale damaged Acme's share price similar to an ax chopping away at the young "Acme tree's" trunk.

As Acme's share price dropped from all of this wonderful "liquidity" being injected by these 12 different short sellers the 12 purchasers of the very same parcel of Acme shares through their margin accounts started to get margin calls. Since they already bought 2 times as much Acme as they could afford they were not able to meet these margin calls with cash. Therefore their brokers had to sell some of their Acme shares to meet these margin calls. This put yet further pressure on Acme's share price which resulted in yet more margin calls which in turn put yet further pressure on Acme's share price ad infinitum. Acme's share price is now into what is referred to as a self-sustaining "death spiral".

A self-propelling negative feedback loop has been established and Acme's share price went to zero as they lost any ability to raise money to advance any further through the lengthy and expensive FDA approval process. Acme had become an "easy prey" due to the nature of the business they were in, the nature of margin accounts and the DTCC's refusal to bring transparency to shares being held in "street name". Perhaps none of those 12 investors would have invested in Acme shares if they had visibility of the immense number of share price depressing "security entitlements" poisoning the share structure of Acme.

During all of this "liquidity injecting" short selling the Wall Street "securities intermediaries" made an absolute fortune. The margin a/c hosts were making banking fees right and left, the lending agents were making lending fees, the prime brokers were going to town, the executing brokers were going to town and the short selling hedge fund manager and his investors absolutely cleaned up while raking in all of the money the 12 investors lost. In fact, 12 different brokerage firms were earning rental fees while renting out the very same parcel of impossible to identify shares in 12 different directions **simultaneously**.

In slow motion what just happened here. An investor unaware of how margin accounts and short selling "DTCC style" operates got talked into buying twice the amount of Acme shares that he could afford; shame on him. His margin a/c "host" took the shares purchased, both the "X" amount of shares that the investor could afford and the "X" amount of shares that he couldn't afford and rented both parcels to a short seller whose goal it was to bankrupt Acme. In order to effect that goal the short seller needs shares to borrow and the brokerage firms earning commissions from the sale and banking income from the loan were more than happy to earn rental income from those trying to bankrupt the invested in company. One might ask what happened to the '34 Exchange Act's forbidding of **conflicts of interest** between brokerage firms and their commission paying clients.

This loan to short sellers started a "daisy chain" involving an inherent "counterfeiting/replicating" phenomenon associated with how our DTCC-administered clearance and settlement system is "rigged" in favor of the Wall Street "securities intermediaries" that own it over the Main Street investors in the Acme's of the world. It wouldn't't take two seconds to put an identifier onto parcels of shares to block this "counterfeiting/replicating" process but those Wall Street insiders in favor of the corrupt status quo claim that it would be too expensive, it would decrease "market efficiency", the technology is not there yet, pricing efficiency would be lost, etc.

At the end of the day we have witnessed a very predictable "transfer of wealth" from Main Street to Wall Street because the NSCC insists on holding "street name" securities in an "anonymously pooled" format enabling this "counterfeiting/replicating" phenomenon to occur and be abused. Even though these are theoretically "borrows" occurring in short sales the key to this fraud is to craftily transfer "legal ownership" to the new purchasers of these "borrowed" shares. Why? Because nobody can stop the new "legal owner" of shares to rent them out to anybody he so chooses. But shouldn't't the

previous purchaser of the borrowed shares be identified and told that he lost his "legal ownership" and therefore can no longer sell that which he purchased? That's the trick; you can't identify the original purchaser of those shares when shares are held in an "anonymously pooled" format and if you can't identify him you can't inform him that he lost his ability to sell that which he purchased. Besides, not being able to sell that which one purchased wouldn't go over too well with him anyways and nobody would opt to use margin accounts. All of that **extra** banking and rental income would be lost. Thus you can see the need to characterize what is clearly a "sale" as a "borrow".

The key to this totally corrupt concept of holding shares in an "anonymously pooled" format is firstly the inability to keep the original purchaser of a specific parcel of shares from reselling that which he purchased after his shares were loaned out from underneath him and secondly you can't **prove** that 12 investors bought and now "co-beneficially own" the very **same** parcel of shares and thirdly you can't **prove** that 12 brokerage firms are earning rental proceeds from the simultaneous renting out of the very **same** parcel of shares in 12 different directions. Pretty slick, huh?

The victims of these thefts on Main Street refer to this phenomenon as the "counterfeiting of securities" that needs to be done away with. Technically what is being "counterfeited" is not a "share" of a corporation as there are a fixed amount of those "outstanding" at any given time and this number doesn't get altered during abusive short selling. What are being "counterfeited" are the "units" on Wall Street that contribute to the "supply" of that which must be treated as being readily sellable. These "units" include legitimate registered shares and the unregistered "security entitlements" issued during each otherwise legal "pre-borrow", each and every NSCC SBP "borrow" and each failure to deliver that is yet to be bought-in.

Abusive Wall Street insiders will argue that there is no such thing as "phantom shares" being created during short selling as the number of "shares outstanding" does not increase. What they (not so mysteriously) forget to mention is that the number of "shares outstanding" is not the only component of the "supply" variable that interacts with the "demand" variable to determine share prices. The other component is the number of "security entitlements" that are issued. I think that you in Congress can appreciate the reason why the DTCC management needs to make these intentional misrepresentations i.e. the aforementioned "iceberg" that nobody except for U.S. "long" investors and U.S. corporations are in a hurry to address.

The beneficiaries of these thefts inhabiting Wall Street refer to this blatant "counterfeiting" process as the "injection of liquidity" and the enhancement of "market and pricing efficiencies" which they lobby aggressively to maintain as the status quo. Although mere "security entitlements" are not technically "shares" of a corporation they are indeed "securities" as any "evidence of indebtedness" qualifies as a "security". Thus the "counterfeiting" of securities phraseology is quite accurate but technically perhaps ***"the abusive inducing of the issuance of readily sellable share price depressing "security entitlements" with the intent to defraud the purchasers of nonexistent shares for one's own financial gain"*** would be more accurate.

Theoretically "anonymous pooling" is used to enhance "market efficiency" and "streamline" the clearance and settlement process. In the case of abusive short selling, however, what is really being "streamlined" is the flow of investor funds into the wallets of abusive short sellers and those that act as "securities intermediaries" in the short selling process. At the recent SEC "roundtable" we saw the Wall Street insiders aggressively lobby to maintain the corrupt "status quo" and all of the standard malarkey about the theoretical benefits of short selling were cited.

In the example cited above the Main Streeters using margin accounts lost not only that which they could afford to lose but twice that amount and those extra shares they purchased "on credit" actually provided the **leverage** to augment, via the triggering of unable to meet margin calls, the already inherent "counterfeiting/replicating" phenomenon associated with otherwise legal short selling. Margin accounts clearly need a "black box warning" that unsophisticated investors can read and understand. Encouraging U.S. "long" investors to "double down" on their investments only to use the shares bought on credit as leverage against the **entire amount** of the "double down" is a very dirty trick especially when all of the "securities intermediaries" on Wall Street are heavily financially incentivized to assist in the defrauding process.

Didn't we just witness the exact same modus operandi in the housing industry wherein Main Streeters were encouraged by Wall Street "banksters" to "leverage up" and get in over their heads so that the "banksters" could make tons of money in loan processing fees, commissions, banking income, rental income, etc. Doesn't that seem like a bit of a dirty trick to facilitate the "doubling down" by client's owed a fiduciary duty of care only to take that double amount of shares that were purchased to facilitate the destruction of the investment made all while raking in income that was otherwise unattainable if the client did not double down?

Can you see in the above example how the more an investor knew about the company he was investing in the more he would be tempted to buy on margin which paradoxically made it more probable that those that knew absolutely nothing about this new medical breakthrough would end up predictably siphoning his investment funds into their wallet? Abusive short sellers refer to this as the enhanced "market efficiency" they wouldn't want any new regulations to do away with.

Should margin accounts have a "black box warning" similar to this? **Warning:** *There is a significant chance that the shares you are purchasing partially on credit will act as a "seed" to propagate the formation of an unlimited amount of readily sellable share price depressing "security entitlements" that can be used to loan to short sellers to aid them in their attempts to bring down the corporation you chose not only to invest in but to actually double down on your investment bet.*

The shares you purchased plus all of their "offspring" will be used to predictably manipulate the share price of the "invested in company" downwards. This may likely result in you receiving "margin calls" which if you cannot answer with cash will result in a portion of your shares and those of other margin a/c holders to be forcefully sold which

will exacerbate this downward movement in share prices which may lead to yet more margin calls.

This is due to how shares held in "street name" are currently held in an impossible to identify "anonymously pooled" format that provides enough opacity to allow abusive DTCC "participants" and their hedge fund "guests" to systematically use the shares you purchased in your margin a/c to augment your own brokerage firm's well-compensated efforts to route your investment funds into their wallets aided by an inherent "counterfeiting/replicating" phenomenon naturally present in any system using "anonymous pooling". The brokerage firm you paid a commission to and are paying banking fees and interest to will be handsomely rewarded via banking fees, commissions, rental income, enhanced order flow from the hedge funds they are aiding and abetting, etc. for their efforts rendered on behalf of the financial interests of those trying to bankrupt your invested in corporation.

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March 5, 2010

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

Dear Ms. Asquith:

National Financial Services LLC and Fidelity Brokerage Services LLC ("Fidelity") appreciate the opportunity to comment on FINRA's Regulatory Notice 10-03, which sets forth three proposed rules: FINRA Rule 4314 (Securities Loans and Borrowings); FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities); and FINRA Rule 4340 (Callable Securities).

After carefully reviewing the Regulatory Notice, we submit the following comments specific to proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities).

We generally support proposed FINRA Rule 4330(a), which continues to require a member firm to obtain a customer's written authorization prior to lending the customer's eligible margin securities, and would permit a member firm to satisfy the written authorization requirement by using a single customer-signed margin agreement/loan consent, provided that it contains a legend in bold type face placed directly above the signature line that states:

> **BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS.**

Considering the existing requirement under NYSE 402(b) and Interpretation 01, most member firms currently have similar language already contained within their margin agreement. We believe this new language and placement is relatively easy to accomplish, but hereby request that this requirement apply only to new margin agreements established, as opposed to requiring firms to repaper all existing margin customers with the new language. Given that existing margin agreements generally contain similar language already, we believe repapering existing agreements provides only minor additional benefit at best and that the benefit would pale in comparison to the tremendous cost involved in such an undertaking.

We have several comments related to proposed FINRA Rule 4330(b) (Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities).

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Proposed FINRA Rule 4330(b)(1) requires members to notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to engaging in such activities. FINRA may request related information, including the written agreement authorizing such arrangements, the types of customers, the accounts used and the collateral involved in the transactions.

We generally agree with this requirement as applied going forward to member firms that do not currently have programs in place to borrow customer fully-paid or excess-margin securities. However, given that fully-paid programs have been a focus area during both routine and "sweep" FINRA examinations over the last couple of years, we do not believe there is any benefit to imposing this requirement on firms with existing programs that FINRA has already taken the opportunity to review.

Proposed FINRA Rule 4330(b)(2) imposes a new requirements that a member firm, prior to entering into a securities borrow transaction with a customer, provide the customer , in writing (which may be electronic), with a clear and prominent notice that the provisions of SIPA may not protect the customer with respect to such 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 securities. In addition, a member firm would be required to provide the customer with information regarding risks associated with the transaction (e.g., the potential loss of SIPC protection as described above, a loss of voting rights, possible limitations on the ability to sell the borrowed securities); the economics of the transaction, including potential tax implications; and the member firm's right to liquidate the transaction because of a condition of the kind specified in proposed FINRA Rule 4314(b).

We agree that customers should be fully informed of the risks associated with lending their fully-paid and excess-margin securities and believe that an industry-standard risk disclosure form should be developed to help ensure consistent standards for disclosure across the industry.

FINRA has expressed concerns about limitations on the ability of the customer to sell the borrowed security. The SEC has issued guidance on ability to sell securities on loan "long," provided certain conditions are met (*e.g.*, recall within 2 days etc.). We do not believe any distinction should be drawn between hypothecated margin securities and fully-paid or excess margin securities on loan, as long as it is reasonable to believe they can be recalled by settlement date of the sale.

Although loaned securities are no longer covered by SIPC protection, it is important to recognize that each loan of fully-paid or excess-margin securities must comply with Rule 15c3-3 of the Securities Exchange Act of 1934. Rule 15c3-3(b)(3) specifies, among

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other things, that the broker or dealer must provide to the lender collateral consisting exclusively of cash or United States Treasury bills and Treasury notes, or an irrevocable letter of credit issued by a bank as defined in Section 3(a)(6)(A)-(C) of the Act which fully secures the loan of securities.[1] Rule 15c3-3 also sets forth the requirement to mark the loan to the market not less than daily.

Proposed FINRA Rule 4330(b)(2) includes disclosure of the "economics of the transaction." We believe this should include the rate the customer will be paid by the broker or dealer to borrow the securities, which already must be disclosed to the customer as required under the standard master securities lending agreement executed between the customer and the broker or dealer. We also believe customers should be made aware of the potential for different tax treatment on the payment of dividends, while the security is on loan.

However, we are aware that FINRA has discussed applying a mark-up type analysis to this activity, which would not be analogous and we believe would be inappropriate.[2] First, we note unlike typical securities transactions, the customer is receiving income from the broker-dealer in these loan transactions as opposed to incurring an expense or transaction cost on a trade. This transaction is more analogous to a customer's cash balance resulting in the firm paying interest to the customer out of the interest income the firm earns off of the resulting free credit balance. In order for a customer to make an informed decision as to what firm to place a cash balance with a firm or whether to invest the cash balance, a customer only needs to know what rate they will receive. The rate earned by the firm is irrelevant to the customer's decision.

Second, there is not a one-to-one relationship between a customer's loan of securities to the firm and the firm's loans to other customers or the street. The borrowed securities are fungible with other like securities available for loan by the firm and may be effectively lent to several different counterparties at different market rates and combined with other available securities over the life of the loan. It would be impossible to definitively identify for any fully-paid stock loan customer how much spread the firm made on their particular securities just as a bank could not say how much it made on any particular deposit through its loan portfolio. Any rate provided to the customer at the time of the loan would be an average blended rate for that security. In addition, it would only be an

[1] Interpretations to Rule 15c3-3 have also set forth other types of acceptable collateral, including, securities issued by the United States Treasury, Participation Certificates and Mortgage-Backed securities guaranteed by GNMA, and negotiable bank certificates of deposit and bankers acceptances issued by banking institutions in the United States and payable to the United States.

[2] For example, one senior FINRA executive has indicated that that FINRA is concerned that, when borrowing fully paid for/excess margin securities from retail customers, firms are not adequately disclosing among other things the amount of revenue that firms are deriving from the on-lend of such securities.

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Ms. Marcia E. Asquith
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FINRA
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estimate at that moment in time as there would be no way of knowing exactly what rate that security would be lent out at initially or over the life of the loan. Because this disclosure would not provide meaningful information to assist the customer in making any loan or investment-related decision and would only be a rough estimate in any event, we do not believe it is appropriate to require firms to generate and disclose this type of information to customers that are prospective loan counterparties.

Proposed FINRA Rule 4330(b)(2) also requires a member firm to determine whether the transaction is suitable for the customer. As it relates to this requirement, we request further clarity about FINRA's views on a suitability determination with respect to stock loan transactions. If a customer is fully informed of the risks associated with the transaction, executes a master securities lending agreement with the firm which sets forth the terms and conditions of the loan, the loan is fully collateralized in accordance with Rule 15c3-3(b)(3), and there are no limitations placed upon the customer's ability to sell the loaned security or draw upon the collateral, we would like further clarification on what would make a customer unsuitable to participate.

Fundamentally, we question FINRA's implicit assumption that the loan increases rather than decreases the customer's risk position. Although the customer is foregoing SIPC protection, the customer is doing so only upon receipt of Rule 15c3-3(b)(3) qualifying collateral. Furthermore, if the collateral is placed with a separate custodian, the customer may have two counterparties standing behind the obligation to return the securities or release the collateral rather than just a single counterparty (i.e. their broker-dealer backstopped by SIPC). Although we firmly agree that each customer should be informed that they are losing SIPC coverage in making these loans, we question whether the customer is actually taking on additional risk rather than mitigating risk by doing so.

In this regard, we do not believe a customer's investment objective is applicable, as these are loans and not investments or securities purchase or sale transactions. We also do not believe a customer's net worth or net equity should be used to determine whether a customer is suitable to participate in a fully-paid or excess margin securities lending program, particularly if a customer already owns individual securities and bears the risk of those investments. Ultimately, we do not believe that customers should be excluded from the opportunity to generate additional income on their securities positions, solely based upon not meeting certain net income or equity standards, as long as the terms of these programs are fully disclosed.

We do agree with FINRA's concerns about member firms recommending that customers purchase certain hard to borrow securities for the sole purpose of lending such securities as fully-paid securities. However, such activity is already covered under NASD Conduct Rule 2310 (Recommendations to Customers – Suitability), as it relates to the purchase of

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the securities. Finally, if a FINRA believes it is necessary to establish a separate suitability determination as it relates to the lending of fully-paid or excess margin securities, we believe it should be applied at the program level and not on a transaction by transaction basis.

Although not without some risk, we believe that if structured appropriately, and member firms adhere to their Physical Possession or Control obligations set forth under Rule 15c3-3, a fully-paid or excess-margin securities lending program provides customers with a beneficial opportunity to earn income by lending brokers or dealers certain hard to borrow securities positions held long in their account. This opportunity has not typically been available to retail customers in the past. Although we agree that firms have an obligation to make customers fully aware of the risks associated with this type of activity, such risks alone should not prevent less affluent retail customers from being allowed to participate in these loan programs, nor should they impose additional suitability obligations on a member firm, unless the member firm's program has limitations on the customer's ability to sell the securities on loan.

We would like to thank FINRA for considering our comments. Please contact me at (617) 563-0312 should you have any questions concerning this letter.

Sincerely yours,

Erica M Vaters

Erica M. Vaters
Vice President – Fidelity Institutional Compliance
Fidelity Capital Markets, a division of National Financial Services LLC.

ACI

March 8, 2010

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington DC 20006-1506

Re: Proposed Consolidated FINRA Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities – Regulatory Notice 10-03.

Dear Ms. Asquith:

Accounting and Compliance International (ACI) strongly supports the efforts to streamline and add clarity to the new consolidated rulebook. The proposed consolidation of the rules governing securities loans and borrowing seems to be an example of a simplified rule that eliminates duplicative and/or outdated provisions. Furthermore, the elimination of specific allocation requirements will allow member firms to establish procedures more tailored to their unique operation.

ACI would like to encourage FINRA staff to take the same approach towards simplification as the rulebook consolidation continues.

ACI is a premier provider of cost-effective financial industry consulting services. Based in the heart of Wall Street, ACI constantly strives to strike a balance between customer protection and market efficiency and is a proponent of rule proposals that streamline, simplify and clarify the compliance obligations of member firms and applicants.

Please feel free to contact me at (212) 668-8700 or at drome@acisecure.com if you have any questions or would like to further discuss these comments. Thank you again for the opportunity to comment.

Sincerely,

Daniel C. Rome
Executive Consultant

40 Wall Street, 34th Floor
New York, NY 10005
212.668.8700
www.ACIsecure.com

March 8, 2010

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

Re: Regulatory Notice 10-03: FINRA Request for Comment on Proposed Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities.

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on three proposed consolidated rules discussed in FINRA Regulatory Notice 10-03: (i) Proposed FINRA Rule 4330 – setting forth requirements applicable to a member firm's borrowing or lending of a customer's margin securities that are eligible to be pledged or loaned; (ii) Proposed FINRA Rule 4314 – setting forth requirements applicable to a member firm that is party to an agreement for the loan or borrowing of securities; and (iii) Proposed FINRA Rule 4340 – setting forth obligations applicable to any callable securities a member firm has in its possession or control.

I. Introduction

The proposed FINRA rules are designed to address certain aspects of the securities lending market, an increasingly integral component of the U.S. securities markets overall. The proposed FINRA rules build upon the current extensive regulatory framework applicable to securities lending by adding certain additional disclosure obligations and other requirements in securities lending transactions, with a particular focus on increased disclosure with respect to borrowing from fully-paid customers. The proposed rules are also designed to incorporate recent developments in securities lending, including the Agency Lending Disclosure Initiative ("ALD"). SIFMA supports FINRA's goals of enhancing the current safeguards within the securities lending market to further address investor protection concerns, and promote the fundamental goal of lenders – incremental income with limited risk. At the same time, SIFMA also is cognizant of the need to mitigate any confusion or unintended consequences associated with FINRA's proposed requirements. The comments provided herein are primarily designed to address these aspects, and raise certain

[1] The Securities Industry and Financial Markets Association (SIFMA) bring together the shared interests of hundreds of securities firms, bank and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global financial Markets Association (GFMA). For more information visit www.sifma.org.

interpretive issues that SIFMA believes should be clarified by FINRA in its rule filing to the Commission.

II. Background

As the Staff is aware, securities may be borrowed for a number of different purposes, including to facilitate delivery for timely trade settlement, to meet segregation requirements, or to allow the borrowing broker-dealer to on-lend securities to others. The ability of broker-dealers to borrow securities plays a critical role in supporting market liquidity[2] and mitigating counterparty settlement and market risk. Furthermore, the need to borrow securities expeditiously has been emphasized due to the implementation of Rule 204 (and its predecessor Rule 204T), which imposes requirements on clearing firm participants to take prompt action to resolve settlement failures in all equity securities. In short, without the ability to efficiently borrow and loan securities the trading markets would experience less liquidity and the settlement infrastructure would experience increased capital expenditures, elongated fails, and greater systemic risk.

The securities lending market in the U.S. operates on a well-established base of legal principles and business practices, supported by an infrastructure that has evolved significantly over time through a combination of industry efforts and commercial technology developments. Such advances have also allowed broker-dealers and lending agents to automate securities lending transactions, which has been critical in allowing borrowers and lenders of securities to keep pace with the growth and expansion that has taken place in the capital markets over the past 40 years.

The securities lending market today is subject to extensive regulatory requirements and oversight, including but not limited to: (i) Federal Reserve Board Regulation T, which generally specifies the conditions under which a U.S. broker-dealer may engage in securities lending transactions (including the "permitted purpose requirement"); (ii) Exchange Act Rule 15c3-3, which contains the requirements for how a U.S. broker-dealer documents and collateralizes securities borrows from customers, including extensive requirements applicable to borrows from "fully-paid" customers; (iii) Exchange Act Rule 15c3-1, containing provisions that relate to how a U.S. broker-dealer must adjust the minimum net capital it is required to maintain based on its securities borrowing and lending activities; and (iv) various FINRA rules imposing other specific requirements with respect to securities borrowing and lending transactions. Other regulations, such as the Investment Company Act of 1940 and ERISA, directly impact the supply side by setting conditions on securities lending for investment fiduciaries. In addition, with the advent of ALD, SIFMA believes that the last remaining credit and capitalization gaps have been closed.

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[2] Liquidity is facilitated not only in the equities markets but also in the options and futures markets where short selling may be used as a hedge to options and futures trading strategies.

III. Proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities)

A. Fully-Paid Securities

The proposed rule requires member firms, prior to entering into securities borrow transactions with customers, to provide certain information on risks. FINRA has enumerated certain disclosures in Rule 4330(b)(2)(A)(ii), but has also indicated that this is not intended to be an exclusive list.

SIFMA firms support further disclosure of potential risks to investors, however believe that the best means to accomplish this goal is through the development of an industry-standard form of risk disclosure. This form could be provided to FINRA for comments, with the aim of establishing mutually-agreeable standards between the regulators and the industry. SIFMA believes that such an approach has worked well in other contexts (*e.g.*, the options disclosure document, portfolio margining, prime brokerage 150 and 151 agreements), and would greatly help to alleviate confusion and establish uniformity across the industry.

With respect to the frequency of disclosure, SIFMA believes that it should be sufficient to provide the required information to customers at the outset of the securities lending relationship. If FINRA believes that more frequent disclosures would be beneficial, firms could provide an annual disclosure notice to customers. SIFMA further urges FINRA to clarify in its rule filing to the Commission that for those principal lenders utilizing lending agents the recipient of the required disclosures should be lending agents in their capacity as such, and not the underlying principals.

SIFMA believes that FINRA should provide further clarification in its rule filing regarding certain of the proposed disclosures. For example, 4330(b)(2)(A)(ii)(d) discusses disclosure regarding "limitations on customer's ability to sell the loaned securities." Firms understand that intent of this disclosure is to notify customers of any situations where securities may be subject to an actual restriction on sale due to the loan[3], and is not intended to provide guidance on the marking of customers' sales as "long" or "short," or otherwise provide guidance concerning Regulation SHO. To avoid any doubt, and ensure consistency with current regulatory requirements, SIFMA recommends that FINRA eliminate the proposed disclosure concerning the limitation on the ability to sell the loaned securities or clarify that such orders to sell may be marked "long," provided there is compliance with any applicable guidance from the SEC on this issue.[4]

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[3] Please note that SIFMA is not aware of any such applicable restrictions.

[4] In the Adopting Release on Rule 204, the Commission repeated its position taken in a prior FAQ and the Release on Interim Final Temporary Rule 204T, specifically stating that the sale of a security on loan may be treated as a long sale for purposes of Regulation SHO, as follows: "We note that if a person that has loaned a security to another person sells the security and a bona fide recall of the security is initiated within two business days after trade date, the person that has loaned the security will be 'deemed to own' the security for purposes of Rule 200(g)(1) of Regulation SHO, and such sale will not be treated as a short sale for purposes of temporary Rule 204T. In addition, a broker-dealer may mark such orders as 'long' sales provided such marking is also in compliance with Rule 200(c) of Regulation SHO. Thus, the close-out requirement of Rule 204(a)(1) applies to sales of such securities." Securities Exchange Act Release No. 60388, 74 FR 38266, 38270 (July 31, 2009). While not specifically addressed in the Releases or prior FAQ, SIFMA notes that

In addition, SIFMA notes that the proposed disclosures would require information concerning the "economics of the transaction." There are a variety of different factors that may go toward determining the price for a securities lending transaction. These may include, among others, the size of the transaction, the expected stability of the borrow, and the collateral posted. As a result, different than the market for securities transactions, there may be different prices for securities loans/borrows involving the same security (*i.e.*, there is no NBBO with respect to the securities lending market). SIFMA believes that FINRA should clarify in its rule filing that firms will be expected to provide adequate disclosure to customers that price can be impacted by the existence of these different factors.

FINRA has proposed certain suitability requirements in 4330(b)(2)(B). While the Regulatory Notice did not identify criteria for suitability, we understand FINRA considers that the following may be factors in determining whether a customer's participation in a securities lending program is suitable for the particular customer: the type of collateral posted for the loan, potential impacts on customers associated with the loss of voting rights on securities loaned, and tax consequences associated with the receipt of manufactured versus actual dividends. SIFMA believes that FINRA should clarify that firms' suitability obligations should apply with respect to customers' overall participation in a securities lending program, and not on a transaction-by-transaction basis, which would otherwise be unduly burdensome and negatively impact the efficiency of securities loans and borrows. Furthermore, the proposed Supplementary Material to Rule 4330(b)(2) permits the member firm to rely on any representations made by another member firm that has a customer relationship with the lender. This is consistent with the general understanding that suitability determinations are the responsibility of the introducing broker, with such allocation of responsibility generally set forth in the Clearing Agreement between clearing and introducing brokers. SIFMA requests that FINRA clarify that a clearing firm can meet its requirements through reliance on a representation by the introducing broker that, with respect to any customer it introduces into a securities lending program, the introducing broker has determined the program to be suitable for that customer.

Finally, with respect to FINRA's proposed 30-day notification provision in 4330(b)(1), SIFMA recommends that FINRA confirm that the 30-day notification provision applies prior to a broker-dealer's initiation of a fully-paid customer securities lending program, and does not impose a separate requirement prior to entering into agreements with specific customers. With respect to existing securities lending programs, notification could be provided to FINRA within a certain period of time after the new rules become effective.

B. Margin Securities

In the Supplementary Material relating to proposed Rule 4330(a), FINRA has set forth the language for a "legend" to be incorporated in customer agreements. SIFMA recommends revising

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when a customer who has lent securities out of its broker-dealer custody securities account sells those securities, it does not issue a recall to its broker. Instead, the customer generally notifies the broker of its need for the securities through the long sale itself. As this achieves the same objective as a recall, SIFMA submits that it therefore should be treated as a recall for the purpose of the Release and FAQ.

the legend to make clear that this language is only meant to apply to margin securities (*i.e.*, not excess margin securities or fully-paid securities) in customer margin account agreements. Therefore, the recommended revised legend would read as follows:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY MARGIN SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

Furthermore, to the extent that language in firms' existing customer margin account agreements is sufficiently comparable to the proposed language, SIFMA requests existing customer margin account agreement be grand-fathered from the requirement for broker-dealers to re-paper existing agreements to incorporate the exact wording of the stated "legend" or to adjust its placement in the agreement.

IV. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

Regulatory Notice 10-03 indicates that certain of the proposed requirements in new Rule 4314 are designed to address and maintain consistency with ALD. While it is true that disclosure of capacity and determination of whether the other party is acting as principal or agent are not new concepts, firms believe that FINRA needs to explicitly recognize in the rule the ALD initiative and that transfer of data between the agent lender and broker-dealer under the ALD regime is sufficient to meet the books and records requirements. In this regard, firms strongly recommend that FINRA work with the SEC to adopt the final version of the SEC's ALD no-action letter prior to or simultaneous with the adoption of Rule 4314. Due to the procedural nature of the no-action letter, firms believe it could prove unwieldy to incorporate all of the detailed requirements of the no-action relief into the proposed rule, but rather believe that an interpretation to the rule (set forth in the Supplementary Material) could reference the fact that firms should structure their operations in a manner consistent with the cited SEC no-action letter.

Finally, SIFMA urges FINRA to clarify that, with respect to certain "anonymous loan markets," where the actual counterparty to securities loans and borrows is a central counterparty, it is expected that the required disclosures of Rule 4314 be made to the central counterparty, and not any underlying counterparty.

V. Proposed FINRA Rule 4340 (Callable Securities)

Proposed Rule 4340(a) eliminates the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system, in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member firm. Instead, the proposed rule would allow member firms to establish procedures that require the allocation to be conducted on a fair and impartial basis, but also require a member firm to post the allocation procedures on its web site, as well as provide notice to new and existing customers explaining how the procedures may be accessed.

SIFMA firms would like clarification on the requirement that a member post its allocation procedures on its website. If FINRA's intent is that firms provide detailed, granular procedures,

firms clearing through third parties and self-clearing firms using Service Bureau systems likely will not be able to comply with this requirement, in that such procedures would constitute proprietary information belonging to the third-party, and the third-party would likely be disinclined to make such proprietary information publicly available via the member's website. If FINRA believes that disclosure of allocation procedures would provide benefits to customers, it should be sufficient for firms to provide a general statement describing the allocation procedures and to post such on the member firms' internet site, but FINRA should not require the actual procedures to be disclosed.

If you have any questions or require additional information, please do not hesitate to contact the undersigned, Rob Toomey at 212-313-1124 or Tom Tierney at 212-313-1237. Thank you for your attention to this matter.

Sincerely,

Ira D. Hammerman
SIFMA Senior Managing Director and
General Counsel

cc: Grace Vogel, Executive Vice President, Member Regulation
Kris Dailey, Vice President, Risk Oversight and Operational Regulation
Yui Chan, Managing Director, Risk Oversight and Operational Regulation
Kevin J. Campion, Sidley Austin LLP

EXHIBIT 5

Exhibit 5 shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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Text of Proposed New FINRA Rule
(Marked to Show Changes from Incorporated NYSE Rules 296 and 402; Incorporated NYSE Rules 296 and 402 to be Deleted in their Entirety from the Transitional Rulebook)

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4000. FINANCIAL AND OPERATIONAL RULES

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4300. OPERATIONS

4310. Member Agreements and Contracts

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[Rule 296]<u>4314</u>. [Liquidation of] Securities Loans and Borrowings

<u>(a) Disclosure of Parties' Capacity in Loan or Borrow Transactions</u>

<u>(1) A member that lends or borrows securities in the capacity of agent shall disclose such capacity to the other party (or parties) to the transaction.</u>

<u>(2) Prior to lending securities to or borrowing securities from a person that is not a member of FINRA, a member shall determine whether the other party is acting as principal or agent in such transaction.</u>

<u>(3) A member that is a party to a security loan or borrow transaction, where the other party to such transaction is acting as agent, shall maintain books and records that reflect:</u>

(A) the details of the transaction with the agent; and

(B) each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

([a]b) Right to Liquidate Transaction

Each member [or member organization] that is a party to an agreement with another member [or member organization] providing for the loan and borrowing of securities shall have the right to liquidate such transaction whenever the other party to such transaction:

(1) applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property[,];

(2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due[,];

(3) makes a general assignment for the benefit of its creditors[,]; or

(4) files, or has filed against it, a petition under Title 11 of the United States Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA"),

unless the[at] right to liquidate such transaction is stayed, avoided, or otherwise limited by an order authorized under the provisions of [the Securities Investor Protection Act of 1970] SIPA or any statute administered by the [Securities and Exchange Commission] SEC.

([b]c) Written Agreement with Non-Members

No member [or member organization] shall lend or borrow any security to or from any person that is not a member of FINRA [non-member of the Exchange], except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon such member [or member organization] the contractual right to liquidate such transaction because of a condition of the kind specified in paragraph ([a]b) [above] of this Rule.

• • • Supplementary Material: ----------

[.10].01 Definition of Agreement. [As used herein]For purposes of this Rule, an agreement for the loan and borrowing of securities shall mean a securities contract or other agreement, including related terms, for the transfer of securities against the transfer of funds, securities, or other collateral, with a simultaneous agreement by the transferee to transfer to the transferor against the transfer of funds, securities, or other collateral, upon notice, at a date certain, or upon demand, the same or substituted securities.

.02 Disclosure of Capacity. A member may satisfy its disclosure obligation in paragraph (a)(1) of this Rule 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 security exchanged between the parties for each loan and borrow transaction.

.03 Details of Transactions with Parties. For purposes of this Rule, a member shall create and maintain records for each security loan or borrow transaction in accordance with the requirements of SEA Rules 17a-3 and 17a-4. For purposes of paragraph (a)(3) of this Rule, when entering into a security loan or borrow transaction with a party that is

acting as agent on behalf of another principal(s), the member shall maintain a record of the details of each security loan or borrow with the agent, identifying the specific security and quantity loaned or borrowed, the contract value and the type and description of the collateral provided to the agent. In addition, the member's records shall reflect the quantity of securities loaned or borrowed from each principal on whose behalf the agent is acting and the amount and description of the collateral allocated to each such principal.

.04 Compliance with Rule 4330 When Borrowing Securities from a Customer. When a member borrows securities from a customer, the member also is subject to Rule 4330(b)(2)(B)(ii), which requires members to provide disclosures to customers regarding the risks and financial impact associated with the customer's loan(s) of securities. Such written notice shall include a disclosure of the right of the member to liquidate the borrow transactions with the customer, as provided by paragraph (b) of this Rule.

[**.20]** **.05 Compliance with SEA Rule 15c3-3.** For purposes of paragraph (c) of this Rule, **[**E]each member [or member organization]subject to the provisions of SEA Rule 15c3-3 [under the Securities Exchange Act of 1934]that borrows securities from a customer (as defined in said rule) shall comply with the provisions thereof relating to the requirements for a written agreement between the borrowing member [or member organization]and the lending customer.

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[Rule 402]4330. Customer Protection—[Reserves and Custody of Securities] Permissible Use of Customers' Securities

[(a) General Provisions]

[Each member organization shall obtain custody and control of securities and maintain reserves as prescribed by Rule 15c3-3 promulgated under the Securities Exchange Act of 1934. For the purpose of this Rule the definitions contained in such Rule 15c3-3 shall apply.]

([b]a) [Agreements for Use of] Authorization to Lend Customers' Margin Securities

No member [organization] shall lend[, either to itself as a broker-dealer or to others,] securities [which] that are held on margin for a customer and [which] that are eligible to be pledged or loaned, unless such member [organization] shall first have obtained a written authorization from such customer permitting the [loan] lending of such securities [by the member organization].

(b) Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities

(1) A member that borrows fully paid or excess margin securities carried for the account of any customer shall:

(A) comply with the requirements of SEA Rule 15c3-3;

(B) comply with the requirements of Section 15(e) of the Exchange Act; and

(C) notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to first engaging in such securities borrows.

(2) Prior to first entering into securities borrows with a customer pursuant to paragraph (b)(1) of this Rule, a member shall:

(A) have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. In making this determination, the member shall 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 member or associated person in connection with entering such securities loans.

(B) provide the customer, in writing (which may be electronic), with the following:

(i) clear and prominent notice stating that the provisions of the Securities Investor Protection Act of 1970 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's obligation in the event the member fails to return the securities; and

(ii) 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, including, but not limited to:

a. loss of voting rights;

b. the customer's right to sell the loaned securities and any limitations on the customer's ability to do so, if applicable;

c. the factors that determine the amount of compensation received by the member and its associated persons in connection with the use of the securities borrowed from the customer;

d. 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 member under the terms of the borrow agreement;

e. the risks associated with each type of collateral provided to the customer;

f. that the securities may be "hard-to-borrow" because of short-selling or may be used to satisfy delivery requirements resulting from short sales;

g. potential tax implications, including payments deemed cash-in-lieu of dividend paid on securities while on loan; and

h. the member's right to liquidate the transaction because of a condition of the kind specified in Rule 4314(b).

(3) A member that is subject to paragraph (b)(1) of this Rule shall create and maintain records evidencing the member's compliance with the requirements of paragraph (b)(2) of this Rule. Such records shall be maintained in accordance with the requirements of SEA Rule 17a-4(a).

• • • Supplementary Material:----------

.01 Definitions. For purposes of this Rule, the definitions contained in SEA Rule 15c3-3 shall apply.

.02 Authorization to Lend Customers' Margin Securities. For purposes of paragraph (a) of this Rule, members may use a single margin agreement/loan consent signed by a customer as written authorization to permit the lending of a customer's margin eligible securities in lieu of obtaining a separate written authorization. Such margin agreement/loan consent shall contain a legend in bold type face placed directly above the signature line that states substantially the following:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

.03 Notification to FINRA. FINRA, upon receipt of a member's written notification pursuant to paragraph (b)(1)(C) of this Rule, may request such additional information as it may deem necessary to evaluate compliance with SEA Rule 15c3-3, Section 15(e) of the Exchange Act and other applicable FINRA rules or federal securities laws or rules. Examples of additional information include, but are not limited to:

(a) the written agreement authorizing such borrowing of securities, which shall reflect the material terms of the arrangement;

(b) the types of customers that are parties to such securities borrows;

(c) the types of accounts used to effect the securities borrows (i.e., whether the subject securities are maintained in customers' cash or margin or other accounts);

(d) the types of collateral provided to customers in connection with such securities borrows, the frequency of marking to market of the collateral and the custody arrangements for such collateral;

(e) the operational and recordkeeping processes related to such securities borrows;

(f) the rebates paid/received in connection with such securities borrows and any other compensation arrangements related thereto;

(g) the procedures for handling customers' requests to sell the securities subject to such borrows; and

(h) disclosures made to customers.

.04 Appropriateness of Customer's Loan(s) of Securities. The member borrowing a customer's fully paid or excess margin securities is responsible for making the determination regarding the appropriateness of such borrow from a customer required by paragraph (b)(2)(A) of this Rule. However, in making that determination, when the member has entered into a carrying agreement with an introducing member, pursuant to Rule 4311, the member may rely on the representations of the introducing member that has a customer relationship with the lender.

.05 Notification to FINRA of Pre-existing Fully Paid or Excess Margin Securities Borrows and Disclosures to Customers. Members with any existing fully paid or excess margin securities borrows with customers as of [insert effective date of the

proposed rule change] shall notify FINRA in writing, in such manner and format as FINRA may require, of such borrows within 30 days from [insert effective date of the proposed rule change]. Further, such members shall provide such customers with the disclosures required by paragraph (b)(2)(B) of this Rule within 90 days of [insert effective date of the proposed rule change].

[.30 Securities Callable in Part][1]

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Text of Proposed New FINRA Rule

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4340. Callable Securities

(a) Allocation Procedures and Customer Notice

Each member that has in its possession or under its control any security which, by its terms, may be called or redeemed prior to maturity, shall:

(1) establish and make available on the member's 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; and

(2) provide written notice (which may be electronic) to new customers at the opening of an account, and all customers at least once every calendar year, of the manner in which they may access the allocation procedures on the member's website and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

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[1] NYSE Rule 402.30 is being addressed separately as proposed new FINRA Rule 4340.

(b) Favorable Redemptions

Where redemption of callable securities is made on terms that are favorable to the called parties, a member shall 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.

(c) Unfavorable Redemptions

Where the redemption of callable securities is made on terms that are unfavorable to the called parties, a member shall not exclude its positions or those of its associated persons (including those persons performing solely clerical and ministerial functions) from the pool of the securities eligible to be called.

• • • Supplementary Material:----------

.01 Definition of Associated Person; Clerical and Ministerial Functions. The term "associated person" as used in this Rule shall have the meaning provided in Section 3(a)(18) of the Exchange Act, which expressly excludes, for certain purposes, any person associated with the member whose functions are solely clerical or ministerial (referred to as "clerical and ministerial associated persons"). With respect to a redemption made on terms that are favorable to the called parties, for purposes of paragraph (b) of this Rule, a member may include the accounts of clerical and ministerial associated persons in the pool of the securities eligible to be called. With respect to a redemption made on terms that are unfavorable to the called parties, for purposes of paragraph (c) of this Rule, a member shall not exclude the accounts of clerical and ministerial associated persons from the pool of the securities eligible to be called.

.02 Allocations of Partial Redemptions or Calls. For purposes of paragraph (a)(1) of this Rule, a member's 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.

.03 Accounts of an Introducing Member and its Associated Persons. Where an introducing member is a party to a carrying agreement with another member that is conducting an allocation pursuant to paragraph (a) of this Rule, any accounts in which the introducing member or its associated persons have an interest shall be subject to paragraphs (b) and (c) of this Rule. The introducing member also shall identify such accounts to the member conducting the allocation.

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Text of NASD Rules, Incorporated NYSE Rule and Incorporated NYSE Rule Interpretations to be Deleted in their Entirety from the Transitional Rulebook

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NASD Rules

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[2330. Customers' Securities or Funds]

Entire text deleted.

[IM-2330. Segregation of Customers' Securities]

Entire text deleted.

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Incorporated NYSE Rule

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[402.30. Securities Callable in Part]

Entire text deleted.

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Incorporated NYSE Rule Interpretations

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[Rule 296. Liquidation of Securities Loans and Borrowings]

Entire text deleted.

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[Rule 402. Customer Protection — Reserves and Custody of Securities]

Entire text deleted.

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