FINRA issues proposed rules on securities lending, permissible use of customer securities and callable securities

As part of the process of developing a consolidated rulebook, FINRA has proposed FINRA Rules 4314 (Securities Loans and Borrowings), 4330 (Customer Protection – Permissible Use of Customer Securities) and 4340 (Callable Securities). Rule 4314 sets forth the requirements for a member firm that is a party to an agreement for the loan or borrowing of securities. Rule 4330 governs the borrowing or lending of a customer’s margin securities that are eligible to be pledged or loaned and Rule 4340 establishes the obligations of a member as to callable securities in its possession or control. The comment period for the proposed rules expires on March 8, 2010. The entire release can be viewed by clicking here.

Rules 4314 (Securities Loans and Borrowings)

Current NYSE Rule 296 provides a right of liquidation when a member enters into an agreement with another member for the borrowing or lending of securities and requires that a member engaging in borrowing or lending with a non-NYSE member do so pursuant to a written agreement providing the member with contractual rights to liquidate upon the occurrence of certain stated events. Further, the rule provides that a member that borrows from a “customer” (as defined in SEC Rule 15c3-3) must comply with the written agreement requirement of Rule 15c3-3. The liquidation conditions have been incorporated into the industry standard Master Securities Lending Agreement, which also satisfies the written agreement requirements of Rule 15c3-3. Under the proposal, NYSE Rule 296 would be adopted as Rule 4314, with the changes described below.

Because of risks associated with agency securities lending, the industry has adopted certain voluntary practices under the SEC’s Agency Lending Disclosure Initiative to address concerns about whether a party to a securities lending agreement is acting as principal or agent. Consistent with this Initiative,

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1 See FINRA Regulatory Notice 10-03.
2 These events include when a counterparty: (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).
FINRA Rule 4314(a) would require a broker-dealer acting as agent to disclose its capacity to the other party. When the other party is not a member of FINRA, the member must determine whether it is acting as principal or agent and, when it is acting as agent, maintain books and records: (1) reflecting the details of the transaction with the agent and (2) reflecting the name of the principal on whose behalf the agent is acting and the details of the principal transaction. Rule 4314(b) would continue the right to liquidate upon the occurrence of any of the liquidation conditions described above, and Rule 4314(c) would expand the written agreement requirement to include all non-FINRA member counterparties, including customers, in order to support compliance with the broker-dealer’s net capital requirements.

Rule 4314 would incorporate NYSE Rule 296.10, defining the term “agreement for the loan and borrowing of securities,” as Supplemental Material. Such material also would include clarification of the methods to satisfy the rule’s disclosure and books and records obligations, describe the risk disclosure obligations of Rule 4330 (discussed below) and require inclusion in such disclosure notice the right to liquidate under the conditions provided in the rule. The current NYSE Rule 296.20, requiring a written agreement between a lending customer and a member subject to SEC Rule 15c3-3, would be removed and included in proposed Rule 4330(b), and NYSE Rule Interpretation 296(b)/01, pertaining to written agreements for repurchase and reverse repurchase agreements, would be removed as outside the scope of the new rule.

**Rule 4330 (Customer Protection – Permissible Use of Customer Securities)**

Current NYSE Rule 402 and NASD Rule 2330 prohibit a broker-dealer from lending to itself or to others securities held on margin for a customer that are eligible to be loaned or pledged unless the firm obtains a written consent of the customer permitting the lending of such securities. FINRA proposes to adopt NYSE Rule 402 as FINRA Rule 4330, with certain changes. Rule 4330(a) would incorporate NYSE Rule Interpretation 402(b)/01, which permits such customer consent through the use of a single customer margin agreement/loan consent, but would add a requirement that the agreement contain a legend in bold type face directly above the signature line as follows:

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

In the most significant change from current rules, Rule 4330(b) would contain new requirements addressing the recent increase in borrowing and lending customers fully paid and excess margin securities. Proposed Rule 4330(b)(1) would require 30 days notice to FINRA prior to engaging in such activities after which FINRA may request related information on such business.

In another new requirement, under proposed Rule 4330(b)(2), a broker-dealer would be required to provide a customer, prior to entering into a securities borrow transaction, a clear and prominent written notice (which may be electronic) that the provisions of SIPA may not protect the customer on the transaction, and that the collateral delivered to the customer may constitute the only source of satisfaction.
of the member’s obligation in the event of default. Also, the member must advise the customer of the risks of the transaction (loss of voting rights, possible limitations on ability to sell the borrowed securities), details on the economics of the transaction, tax implications and the right to liquidate because of an event specified in Rule 4314(b).

In an additional new requirement for such transactions, proposed Rule 4330(b)(2) would require the broker-dealer to make a suitability determination for the customer and maintain records pertaining to its compliance with this obligation, provided that a broker-dealer borrowing a customer’s securities may rely on a representation made by another broker-dealer that has a customer relationship with the lender.

**Rule 4340 (Callable Securities)**

Proposed FINRA Rule 4340 would incorporate current NYSE Rule 402.30 with certain changes. That rule currently requires that a member which has securities in its possession and control that are callable in part identify clearly in its records the accounts for which the securities are held, provide certain disclosure of the systems and the manner in which such securities are held and their rights to withdraw uncalled securities and to establish an impartial lottery system as to partially redeemed or called securities corresponding to the proportional holdings of such securities held in bulk by the member. Certain securities are exempt under NYSE 402.30.

Proposed Rule 4340 would apply to any callable security and would eliminate the specific impartial lottery requirement as long as the broker-dealer establishes procedures that require allocation on a fair and impartial basis, which may include: the use of such an impartial lottery system, acting on a pro rata basis or any other means which will result in a fair and impartial allocation of partially redeemed or called securities. These procedures must be posted on the firm’s website, and a notice must be provided to new customers at the opening of their accounts and at least annually as to how to access the procedures on the website, and the fact that hard copies will be provided upon a customer’s request. Rule 4340(c) would prohibit the firm from favoring the member and its “associated persons” in any allocation.

**Summary**

Proposed FINRA Rule 4314 is intended to clarify liquidation rights under securities lending arrangements and to extend the written agreement requirement to all non-FINRA counterparties. It also would mandate certain practices which have been developed under the SEC’s Agency Lending Disclosure Initiative to address the risks of agency securities lending. Proposed FINRA Rule 4330 would expand the disclosure and consent requirements and establish a suitability obligation for broker-dealers engaging in borrowing and lending of customers fully paid and excess margin securities. These requirements are intended to

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3 For this purpose, “associated person” is as defined in Securities Exchange Act Section 3(a)(18), which excludes clerical and ministerial employees. Under the proposed rule, such employees may be included in the pool of securities eligible to be called for a redemption favorable to customers, but the accounts of the firm, its associated persons and clerical and ministerial personnel must be included when a redemption is on terms unfavorable to a customer.
address concerns arising out of the expansion of securities lending activities to the retail market due to the decrease of institutional investor lending and the more stringent delivery requirements for short sales under Regulation SHO. Finally, proposed FINRA Rule 4340 would expand current rules on callable securities in the broker-dealer’s possession and control to include all callable securities, clarify recordkeeping requirements and to allow any allocation process for such securities as long as it will result in a fair and impartial allocation.

Broker-dealers engaging in securities lending activities will need to review their agreements, disclosures and recordkeeping procedures in order to comply with the proposed rules upon their adoption, particularly those who may engage in such activities involving fully paid and excess margin securities. As to the proposed new rule on callable securities in their possession and control, broker-dealers will need to review their recordkeeping procedures and consider whether they want to adopt more flexible procedures on allocations involving partially redeemed or called securities.

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If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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