SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–63961; File No. SR–FINRA–2010–059]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change To Adopt FINRA Rule 4360 (Fidelity Bonds) in the Consolidated FINRA Rulebook

February 24, 2011.

I. Introduction

On November 10, 2010, the Financial Industry Regulatory Authority, Inc., ("FINRA") filed with the Securities and Exchange Commission ("SEC") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act") [1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt NASD Rule 3020 (Fidelity Bonds) with certain changes into the consolidated FINRA rulebook as FINRA Rule 4360 (Fidelity Bonds). The proposed rule change was published for comment in the **Federal Register** on November 26, 2010.[3] The Commission received three comment letters on the proposed rule change.[4]

II. Description of Proposed Rule Change

A. Summary

FINRA is proposing to adopt NASD Rule 3020 (Fidelity Bonds) with certain changes into the consolidated FINRA rulebook as FINRA Rule 4360 (Fidelity Bonds), taking into account Incorporated NYSE Rule 319 (Fidelity Bonds) and its Interpretation. NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) generally require members to maintain minimum amounts of fidelity bond coverage for officers and employees, and that such coverage address losses incurred due to certain specified events. The purpose of a fidelity bond is to protect a member against certain types of losses, including, but not limited to, those caused by the malfeasance of its officers and employees, and the effect of such losses on the member's capital.

B. Description of Proposed Rule Change

1. General Provision

NASD Rule 3020(a) generally provides that each member required to join the Securities Investor Protection Corporation ("SIPC") that has employees and that is not a member in good standing of one of the enumerated national securities exchanges must maintain fidelity bond coverage; NYSE Rule 319(a) generally requires member organizations doing business with the public to carry fidelity bonds. Proposed FINRA Rule 4360 would require each member that is required to join SIPC to maintain blanket fidelity bond coverage with specified amounts of coverage based on the member's net capital requirement, with certain exceptions.[5]

NASD Rule 3020(a)(1) requires members to maintain a blanket fidelity bond in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the Surety Association of America. Under NYSE Rule 319(a), the Stockbrokers Partnership Bond and the Brokers Blanket Bond approved by the NYSE are the only bond forms that may be used by a member organization; NYSE approval is required for any variation from such forms. Proposed FINRA Rule 4360 would require members to maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability.

Under proposed FINRA Rule 4360, a member's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: Fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency. The proposed rule change modifies the descriptive headings for these Insuring Agreements, in part, from NASD Rule 3020(a)(1) and NYSE Rule 319(d) to align them with the headings in the current bond forms available to broker-dealers.

Proposed FINRA Rule 4360 would also eliminate the specific coverage provisions in NASD Rule 3020(a)(4) and (a)(5), and NYSE Rule 319(d)(ii)(B) and (C), and (e)(ii)(B) and (C), that permit less than 100 percent of coverage for certain Insuring Agreements (*i.e.,* fraudulent trading and securities forgery) to require that coverage for all Insuring Agreements be equal to 100 percent of the firm's minimum required bond coverage.[6]

As currently provided in NASD Rule 3020 and NYSE Rule 319, proposed FINRA Rule 4360 would require that a member's fidelity bond include a cancellation rider providing that the insurer will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or "substantially modified." Also, the proposed rule change would adopt the definition of "substantially modified" in NYSE Rule 319 and would incorporate NYSE Rule 319.12's standard that a firm must *immediately* advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.[7]

FINRA is proposing to add supplementary material to proposed FINRA Rule 4360 that would require members that do not qualify for a bond with per loss coverage without an aggregate limit of liability to secure alternative coverage. Specifically, a member that does not qualify for blanket fidelity bond coverage as required by proposed FINRA Rule 4360(a)(3) would be required to maintain substantially similar fidelity bond coverage in compliance with all other provisions of the proposed rule, provided that the member maintains written correspondence from two insurance providers stating that the member does not qualify for the coverage required by proposed FINRA Rule 4360(a)(3).

2. Minimum Required Coverage

Proposed FINRA Rule 4360 would require each member to maintain, at a minimum, fidelity bond coverage for any person associated with the member, except directors or trustees of a member who are not performing acts within the scope of the usual duties of an officer or employee. As further detailed below, the proposed rule change would eliminate the exemption in NASD Rule 3020 for sole stockholders and sole proprietors.

The proposed rule change would increase the minimum required fidelity bond coverage for members, while continuing to base the coverage on a member's net capital requirement. To that end, proposed FINRA Rule 4360 would require a member with a net capital requirement that is less than $250,000 to maintain minimum coverage of the greater of 120 percent of the firm's required net capital under Exchange Act Rule 15c3–1 or $100,000. The increase to $100,000 would modify the present minimum requirement of $25,000.

Under proposed FINRA Rule 4360, members with a net capital requirement of at least $250,000 would use a table in the rule to determine their minimum fidelity bond coverage requirement. The

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

[2] 17 CFR 240.19b–4.

[3] *See* Exchange Act Release No. 63331 (Nov. 17, 2010), 75 FR 72850 (Nov. 26, 2010) ("Notice").

[4] *See* Letters from Richard M. Garone, Travelers, dated Dec. 16, 2010 ("Travelers"); Letter from Robert J. Duke, The Surety & Fidelity Association of America, dated Dec. 17, 2010 ("SFAA"); and Letter from Albert Kramer, Kramer Securities Corporation, dated Dec. 31, 2010 ("Kramer").

[5] *See* Notice, *supra* note 3, for a more detailed discussion of the proposed rule change.

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

[7] NYSE Rule 319 defines the term "substantially modified" as any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of the rule.

table is a modified version of the tables in NASD Rule 3020(a)(3) and NYSE Rule 319(e)(i). The identical NASD and NYSE requirements for members that have a minimum net capital requirement that exceeds $1 million would be retained in proposed FINRA Rule 4360; however, the proposed rule would adopt the higher requirements in NYSE Rule 319(e)(i) for a member with a net capital requirement of at least $250,000, but less than $1 million.

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

3. Deductible Provision

Under current NASD Rule 3020(b), a deductible provision may be included in a member's bond of up to $5,000 or 10 percent of the member's minimum insurance requirement, whichever is greater. If a member desires to maintain coverage in excess of the minimum insurance requirement, then a deductible provision may be included in the bond of up to $5,000 or 10 percent of the amount of blanket coverage provided in the bond purchased, whichever is greater. The excess of any such deductible amount over the maximum permissible deductible amount based on the member's minimum required coverage must be deducted from the member's net worth in the calculation of the member's net capital for purposes of Exchange Act Rule 15c3–1. Where the member is a subsidiary of another member, the excess may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

Under NYSE Rule 319(b), each member organization may self-insure to the extent of $10,000 or 10 percent of its minimum insurance requirement as fixed by the NYSE, whichever is greater, for each type of coverage required by the rule. Self-insurance in amounts exceeding the above maximum may be permitted by the NYSE provided the member or member organization certifies to the satisfaction of the NYSE that it is unable to obtain greater bonding coverage, and agrees to reduce its self-insurance so as to comply with the above stated limits as soon as possible, and appropriate charges to capital are made pursuant to Exchange Act Rule 15c3–1. This provision also contains identical language to the NASD rule regarding net worth deductions for subsidiaries.

Proposed FINRA Rule 4360 would provide for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a member. Any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the member[8] would be deducted from the member's net worth in the calculation of its net capital for purposes of Exchange Act Rule 15c3–1.[9] Like the NASD and NYSE rules, if the member is a subsidiary of another FINRA member, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

4. Annual Review of Coverage

Consistent with NASD Rule 3020(c) and NYSE Rule 319.10, proposed FINRA Rule 4360 would require a member (including a firm that signs a multi-year insurance policy), annually as of the yearly anniversary date of the issuance of the fidelity bond, to review the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the proposed rule. Under proposed FINRA Rule 4360(d), a member's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), would be used as the basis for determining the member's minimum required fidelity bond coverage for the succeeding 12-month period. The "preceding 12-month period" includes the 12-month period that ends 60 days before the yearly anniversary date of a member's fidelity bond. This would give a firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

Proposed FINRA Rule 4360 would allow a member that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement to use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member would not be permitted to carry less minimum fidelity bond coverage in its second year than it carried in its first year.

5. Exemptions

Based in part on NASD Rule 3020(a), proposed FINRA Rule 4360 would exempt from the fidelity bond requirements members in good standing with a national securities exchange that maintain a fidelity bond subject to the requirements of such exchange that are equal to or greater than the requirements set forth in the proposed rule. Additionally, consistent with NYSE Rule Interpretation 319/01, proposed FINRA Rule 4360 would continue to exempt from the fidelity bond requirements any firm that acts solely as a Designated Market Maker ("DMM"),[10] floor broker or registered floor trader and does not conduct business with the public.

Proposed FINRA Rule 4360 would not maintain the exemption in NASD Rule 3020(e) for a one-person firm.[11] Historically, a sole proprietor or sole stockholder member was excluded from the fidelity bond requirements based upon the assumption that such firms were one-person shops and, therefore, could not obtain coverage for their own acts. FINRA has determined that sole proprietors and sole stockholder firms can and often do acquire fidelity bond coverage, even though it is currently not required, since all claims (irrespective of firm size) are likely to be paid or denied on a facts-and-circumstances basis. Also, certain coverage areas of the fidelity bond benefit a one-person shop (*e.g.,* those covering customer property lost in transit).

[8] FINRA notes that a member may elect, subject to availability, a deductible of less than 10 percent of the coverage purchased.

[9] NASD Rule 3020 bases the deduction from net worth for an excess deductible on a firm's minimum required coverage, while proposed FINRA Rule 4360 would base such deduction from net worth on coverage *purchased* by the member.

[10] *See* Exchange Act Release No. 58845 (Oct. 24, 2008), 73 FR 64379 (Oct. 29, 2008) (Order Approving File No. SR–NYSE–2008–46). In this rule filing, the role of the specialist was altered in certain respects and the term "specialist" was replaced with the term "Designated Market Maker."

[11] A one-person member (that is, a firm owned by a sole proprietor or stockholder that has no other associated persons, registered or unregistered) has no "employees" for purposes of NASD Rule 3020, and therefore such a firm currently is not subject to the fidelity bonding requirements. Conversely, a firm owned by a sole proprietor or stockholder that has other associated persons has "employees" for purposes of NASD Rule 3020, and currently is, and will continue to be, subject to the fidelity bonding requirements.

III. Summary of Comments

The Commission received three comment letters in response to the proposed rule change addressing different aspects of the proposal.[12] FINRA submitted a response to these comment letters.[13]

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

All three commenters oppose the proposed elimination of the exemption from the fidelity bond requirements in NASD Rule 3020 for sole proprietors and sole stockholders.[14] One commenter believes that it is irresponsible to require one-person shops to maintain a fidelity bond that would provide little, if any, true coverage and that a one-person shop should be allowed to decide if they want to self-insure in other areas that would not invoke the alter-ego concept.[15] Another commenter requests that the proposed rule change not be approved without an exemption for sole proprietors and sole stockholders and notes that maintaining a fidelity bond will be a great financial burden for small firms.[16] The third commenter agrees with the premise that sole proprietors and sole stockholders may rely on certain Insuring Agreements in a fidelity bond.[17] However, two commenters, including the third commenter referenced above, are concerned that Insuring Agreement A—Fidelity as required by the proposed rule, is not available in the market for a sole proprietor or sole stockholder because the sole owner is considered an alter-ego of the company and dishonesty of a sole owner cannot be underwritten prudently.[18] One commenter suggests language that would exclude sole proprietors and sole stockholders from Insuring Agreement A—Fidelity coverage and believes that the rule filing does not accurately describe Insuring Agreement A—Fidelity because it uses the term "malfeasance."[19]

In its response to comments, FINRA notes that a one-person member has no "employees" for purposes of the rule, and therefore such a firm currently is not subject to the fidelity bonding requirements.[20] However, a firm owned by a sole proprietor or stockholder that has other associated persons has "employees" for purposes of current NASD Rule 3020, and currently is, and will continue to be, subject to fidelity bonding requirements.[21] FINRA further disputes the claim that sole proprietors and sole stockholder firms cannot obtain fidelity bond coverage. Specifically, FINRA has determined that sole proprietors and sole stockholder firms can and do acquire fidelity bond coverage, even though it is not currently required under the NASD rule.[22]

FINRA further provides that Insuring Agreements B through F in the proposed rule are all premised on losses suffered by the insured based on the acts of another person; such persons do not have to be an "employee" of the firm and therefore sole proprietor and sole stockholder firms can obtain fidelity coverage through these agreements.[23] FINRA notes that the term "employee" currently is defined in the Securities Dealer Blanket Bond to include, among others, an officer or other employee of the insured, while employed in, at or by any of the insured's offices or premises, an attorney retained by the insured while performing legal services for the insured and any natural person performing acts coming with the scope of the usual duties of an officer or employee of the insured, including any persons provided by an employment contractor. FINRA believes that while a sole proprietor or sole stockholder may not have other associated persons or registered persons, it may have "employees" for purposes of a fidelity bond and therefore may benefit from Fidelity coverage.[24] FINRA believes that requiring all SIPC member firms, regardless of size, to maintain fidelity bond coverage promotes investor protection objectives and protects firms from unforeseen losses.

With respect to the comment that the rule filing inaccurately describes Insuring Agreement A—Fidelity by using the term "malfeasance," FINRA responds that the term "malfeasance" was used as part of a description of the purpose of the fidelity bond in general and does not aim to impose additional requirements beyond what is covered by the proposed rule.[25]

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

One commenter notes that the proposed rule change, which would require members to maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability, will significantly modify the Financial Institutional Form 14 Bond ("Form 14") by creating a competitive disadvantage to underwriters that do not offer this type of coverage.[26] The commenter further stated that only two underwriting firms offer this type of coverage and therefore the proposed rule change would increase costs to members.[27]

FINRA argues that a member's fidelity bond coverage should not include an aggregate limit of liability to prevent a member's coverage from being eroded by covered losses within the bond period.[28] FINRA further states that it was advised by industry representatives that Form 14 could be revised to provide this type of coverage and that it could be offered by a firm that offers the current Form 14.[29]

C. Proposed Changes to the Deductible Provision

One commenter opposes provision (c) in proposed FINRA Rule 4360 that would require a deduction from net capital in the case of certain deductible levels.[30] This commenter supported the increased maximum permissible deductible of 25% of the coverage purchased by a member, but believes that the net capital deduction that the broker-dealer would be required to take for any deductible greater than 10% of their fidelity bond limit could provide a strong disincentive for any firm to consider a higher deductible. The commenter believes that this could lead to higher premium costs for members.[31]

In response, FINRA notes the difference between the deduction linked to the current NASD rule and what is proposed. Specifically, the proposed rule eliminates the current concept of an "excess deductible" linked to a member's required *minimum* bond requirement and instead proposed Rule 4360 would only be subject to a deduction from net capital in the amount of any deductible over 10% of the coverage *purchased* by the member. Therefore, FINRA does not believe that the proposed deductible provision will result in a higher premium costs than the current rule. Rather, FINRA argues that the option for a deductible of up to 25% of the coverage purchased and any

[12] *See supra* note 4.

[13] *See* Letter from Erika L. Lazar, Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated February 23, 2010 ("FINRA Letter").

[14] *See* Kramer, SFAA and Travelers.

[15] *See* Travelers.

[16] *See* Kramer.

[17] *See* SFAA.

[18] *See* SFAA and Travelers.

[19] *See* SFAA.

[20] *See* FINRA Letter.

[21] *Id.*

[22] *See* Notice, *supra* note 3; *see also* FINRA Letter.

[23] *See* FINRA Letter.

[24] *Id.*

[25] *Id.*

[26] *See* Travelers. Furthermore, Travelers argues that this proposed change would remove the industry standard aggregate limit of liability.

[27] *Id.*

[28] *See* FINRA Letter.

[29] *Id.*

[30] *See* Travelers.

[31] *Id.*

deductible amount elected by the member that is greater than 10% of the coverage purchased must be deduced from the member's net worth in the calculation of its net capital for purposes of Exchange Act Rule 15c3–1.

IV. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[32] In particular, the Commission believes the proposal is consistent with the requirements of Section 15A(b)(6) of the Act,[33] which requires, among other things, that the Association's rules 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. The Commission believes that FINRA adequately addressed the comments raised in response to the notice of this proposed rule change.

The Commission believes that FINRA's proposed Rule 4360 (Fidelity Bond) will update and clarify the requirements governing fidelity bonds for adoption in the Consolidated FINRA Rulebook. The Commission believes that the proposed requirements of FINRA Rule 4360, including, but not limited to, requiring each member that is required to join SIPC to maintain blanket fidelity bond coverage, increasing the minimum requirement fidelity bond coverage and maintaining a fidelity bond that provides for per loss coverage without an aggregate limit of liability promotes investor protection by protecting firms from unforeseen losses.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[34] that the proposed rule change (SR–FINRA–2010–059) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[35]

Cathy H. Ahn,

Deputy Secretary.

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[32] In approving this rule proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[33] 15 U.S.C. 78o–3(b)(6).

[34] 15 U.S.C. 78s(b)(2).

[35] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–63962; File No. SR–MSRB–2011–05]

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing and Immediate Effectiveness of Amendments to Rule A–15, on Notification To Board of Termination of Municipal Securities Activities and Change of Name or Address

February 24, 2011.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act") [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on February 14, 2011, the Municipal Securities Rulemaking Board ("Board" or "MSRB") 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 the MSRB. The MSRB has filed the proposal as a "non-controversial" rule change pursuant to Section 19(b)(3)(A)(iii) of the Act,[3] and Rule 19b–4(f)(6) thereunder,[4] which renders the proposal effective upon filing with the Commission. 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

The MSRB is filing a proposed rule change relating to the notification requirements in the event of a change in status of a broker, dealer, municipal securities dealer, or municipal advisor, consisting of amendments to Rule A–15, on Notification to Board of Termination of Municipal Securities Activities and Change of Name or Address.

The text of the proposed rule change is available on the MSRB's website at *http://www.msrb.org/Rules-and-Interpretations/SEC–Filings/2011–Filings.aspx*, at the MSRB's principal office, 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, the MSRB 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. The Board 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

The purposes of the proposed rule change are: (i) To extend the provisions of Rule A–15 to municipal advisors; and (ii) to expand the circumstances under which the MSRB must be notified to include: (A) a bar or suspension from engaging in municipal securities activities or municipal advisory activities by the appropriate regulatory agency, judicial authority, or otherwise; and (B) in the case of a broker, dealer, or municipal securities dealer, expulsion or suspension from membership or participation in a national securities exchange or registered securities association. Although existing Rule A–15 establishes a procedure for notification of a change in status with respect to brokers, dealers and municipal securities dealers, it does not apply to municipal advisors. Further, existing Rule A–15 does not provide for notification to the Board in the event of disbarment or suspension by regulatory agencies or judicial authorities or otherwise, or, with respect to brokers, dealers and municipal securities dealers, expulsion or suspension from membership or participation in a national securities exchange or registered securities association. The proposed rule change (i) adds municipal advisors to the entities subject to the rule; (ii) requires notification if (A) a broker, dealer, municipal securities dealer, or municipal advisor has been barred or suspended from engaging in municipal securities activities or municipal advisory activities by the appropriate regulatory agency, judicial authority or otherwise; and (B) if a broker, dealer or municipal securities dealer has been expelled or suspended from membership or participation in a national securities exchange or registered securities association.

2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2) of the Act, which provides that:

The Board shall propose and adopt rules to effect the purposes of this title with respect

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

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A)(iii).

[4] 17 CFR 240.19b4–(f)(6).