

issued securities.<sup>11</sup> In the event that NSCC proposes to implement this, NSCC states that it will submit a rule filing to the Commission.<sup>12</sup>

According to NSCC, the effective date of the proposed rule changes will be announced via an NSCC Important Notice at least 30 days in advance of its implementation.<sup>13</sup>

## II. Discussion

Section 19(b)(2)(C) of the Act<sup>14</sup> directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act<sup>15</sup> requires the rules of a clearing agency to be designed to, among other things, promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, and protect investors and the public interest. The Commission finds that NSCC's proposed rule changes are consistent with these requirements, primarily because, this change promotes transaction comparison at the point of trade, which increases operational efficiencies. Further, by deleting two obsolete provisions in Procedure II, NSCC is ensuring its rules are accurate and reflect its operations.

## III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act<sup>16</sup> and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NSCC-2013-09) be, and hereby is, approved.<sup>17</sup>

<sup>11</sup> See *id.*

<sup>12</sup> See *id.*

<sup>13</sup> See *id.*

<sup>14</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>15</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>16</sup> 15 U.S.C. 78q-1.

<sup>17</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>18</sup>

**Kevin M. O'Neill,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-70272; 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

August 27, 2013.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("SEA" or "Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 14, 2013, 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 substantially 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 (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 Web site 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"),<sup>3</sup> 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)<sup>4</sup> 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

<sup>3</sup> 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).

<sup>4</sup> For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

<sup>18</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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”).

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”).<sup>5</sup> 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 because it 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

<sup>5</sup> The Commission notes that it recently adopted an amendment to Rule 15c3-1(c)(2)(iv)(B) that would deem broker-dealers providing securities borrowing and lending settlement services as principals subject to certain capital deductions, unless certain steps are taken to disclaim principal liability. See Securities Exchange Act Release No. 70072 (July 30, 2013), 78 FR 51824, 51846 (August 21, 2013).

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.<sup>6</sup> 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.

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)*

<sup>6</sup> NASD Rule 2330(a), (e) and (f) are now marked "Reserved." The substantive provisions of these paragraphs were deleted in prior rule filings.

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 Web site 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 Web site 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 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").<sup>7</sup> 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

<sup>7</sup> 15 U.S.C. 78c(a)(18).

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.

*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,<sup>8</sup> 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 FINRA 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.

*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 FINRA 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*,<sup>9</sup> which are discussed below. A copy of the *Notice* is attached as Exhibit 2a. A list of the comment letters

<sup>9</sup> 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").

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

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.<sup>10</sup> 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."<sup>11</sup>

#### 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.<sup>12</sup> 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 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."<sup>13</sup>

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.<sup>14</sup> 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 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.<sup>15</sup> 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.<sup>16</sup> 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."<sup>17</sup> 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,"

<sup>10</sup> See ACI letter.

<sup>11</sup> See ACI letter.

<sup>12</sup> See SIFMA letter.

<sup>13</sup> See SIFMA letter.

<sup>14</sup> See SIFMA letter.

<sup>15</sup> See Fidelity letter.

<sup>16</sup> See Fidelity letter and SIFMA letter.

<sup>17</sup> See SIFMA letter.

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.<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup>

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 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.<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup>

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.

*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.<sup>24</sup>

*i. Standardized Risk Disclosure Form*

<sup>23</sup> 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.

<sup>24</sup> See Plexus letter, SIFMA letter and Fidelity letter.

<sup>18</sup> See SIFMA letter.

<sup>19</sup> See SIFMA letter.

<sup>20</sup> See Fidelity letter.

<sup>21</sup> See SIFMA letter.

<sup>22</sup> See Fidelity letter.

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.<sup>25</sup> 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 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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup>

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. 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.<sup>29</sup> 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.<sup>30</sup> 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).<sup>31</sup>

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.<sup>32</sup> 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 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

<sup>25</sup> See SIFMA letter and Fidelity letter.

<sup>26</sup> 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 Web site on October 20, 2008).

<sup>27</sup> See SIFMA letter.

<sup>28</sup> See Fidelity letter.

<sup>29</sup> See Fidelity letter.

<sup>30</sup> 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.

<sup>31</sup> See SIFMA letter.

<sup>32</sup> See Plexus letter.

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.”<sup>33</sup> 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.

### 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 Web site 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 Web site would require a firm “to provide detailed, granular procedures” or whether it would be sufficient to provide a general statement describing its allocation procedures.<sup>34</sup> 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.

### 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 email to [rule-comments@sec.gov](mailto: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 email 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 Web site (<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 Web site 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 September 24, 2013.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>35</sup>

**Kevin M. O’Neill**,  
*Deputy Secretary.*

[FR Doc. 2013-21300 Filed 8-30-13; 8:45 am]

**BILLING CODE 8011-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-70268; File No. SR-FINRA-2013-032]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Revise the Series 16 Examination Program

August 27, 2013.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “SEA”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 20, 2013, 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. FINRA has designated the proposed rule change as “constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule” under Section 19(b)(3)(A)(i) of the Act<sup>3</sup> and Rule 19b-4(f)(1) thereunder,<sup>4</sup> which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

<sup>35</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>4</sup> 17 CFR 240.19b-4(f)(1).

<sup>33</sup> See SIFMA letter.

<sup>34</sup> See SIFMA letter.