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September 24, 2013

Via E-Mail to rule-comments@sec.gov

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

Re: File Number SR–FINRA–2013–035; Release No. 34-70272
SIFMA comment on FINRA proposed rule change to adopt FINRA Rules 4314, 4330 and 4340 (the "Proposal")

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Proposal. The Proposal seeks to adopt three new rules: (i) Proposed FINRA Rule 4314 (Securities Loans and Borrowings), setting forth requirements applicable to a member firm that is party to an agreement for the loan or borrowing of securities; (ii) Proposed FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities), setting forth requirements applicable to a member firm's borrowing or lending of a customer's margin securities that are eligible to be pledged or loaned; and (iii) Proposed FINRA Rule 4340 (Callable Securities), setting forth obligations applicable to any callable securities a member firm has in its possession or control (collectively, the "Proposed Rules").

I. Introduction

SIFMA understands that the Proposed Rules are designed to enhance and formalize the current safeguards in the securities lending market. The Proposed Rules seek to build upon and consolidate the current regulatory framework applicable to securities lending by adding certain disclosure obligations and incorporating requirements and guidance from various resources, including, among others, current NASD and Incorporated NYSE rules and the Agency Lending Disclosure Initiative ("ALD Initiative"). SIFMA represents members who engage in many different functions related to the securities lending market, and thus would be directly impacted by the Proposal. As such, SIFMA has a keen interest in the Proposed Rules and, in particular, mitigating any potential confusion or unintended consequences associated with the possible adoption of the Proposed Rules.

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

Towards that end, in response to a request for comment concerning an earlier version of the Proposed Rules published by FINRA in 2010,[2] SIFMA submitted a comment letter (the "2010 SIFMA Letter") outlining its concerns and recommendations regarding the Proposed Rules.[3] SIFMA recognizes and appreciates that, in the Proposal, FINRA acknowledged and incorporated many of the suggestions from the 2010 SIFMA Letter. For example, with respect to the notice requirement in proposed FINRA Rule 4330(b)(1)(C), in the Proposal, FINRA adopts the approach suggested in the 2010 SIFMA Letter, *i.e.*, that the 30-day notification period apply only 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 that notice would *not* be required for each new customer that enters into an established program. Further, with respect to the suitability determination required by FINRA Rule 4330(b)(2)(A), in the Proposal, FINRA adopts the approach suggested in the 2010 SIFMA Letter that member firms must make the suitability determination only prior to the member *first* entering into securities borrows with a customer, and not on a transaction-by-transaction basis. These clarifications will help minimize unnecessary costs and potential uncertainty in the anticipated implementation of these proposed rules by member firms.

While appreciative of the modifications and clarifications FINRA made in the Proposal, particularly those in response to the 2010 SIFMA Letter, SIFMA has identified additional areas of concern and possible confusion in the Proposal. In light of this, we have provided herein comments primarily designed to address these areas and request from FINRA additional clarification as needed in advance of finalizing the Proposed Rules.

II. Background

Securities borrowing and lending plays an essential role in the efficient operation of the financial markets, providing a critical element of market liquidity[4] and mitigating counterparty settlement and market risk. As the SEC Staff is aware, securities may be borrowed for certain purposes, including to facilitate delivery for timely trade settlement, to meet segregation requirements, or to allow the borrowing broker-dealer to on-lend securities to others. Furthermore, the need to borrow securities expeditiously has been emphasized due to the implementation of Rule 204, which imposes requirements on clearing firm participants to take prompt action to resolve settlement failures in all equity securities. In short, without the ability to efficiently borrow and lend securities, the trading markets would experience less liquidity and

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[2] *See* FINRA Regulatory Notice 10-03 (January 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120691.pdf.

[3] *See* Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Ms. Marcia E. Asquith, Office of the Corporate Secretary, FINRA, Re: Regulatory Notice 10-03 (Mar. 8, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p121087.pdf.

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

the settlement infrastructure would experience increased capital expenditures, extended fails and greater systemic risk.

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

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

In addition to the foregoing codified requirements, agent lender and broker-dealer participants in the securities lending market generally adhere to the ALD Initiative. Specifically, in 2007, SIFMA submitted a draft no-action request to the SEC proposing procedures for disclosures with respect to agency lending ("ALD No-Action Request").[5] The ALD No-Action Request sets forth procedures that enhance transparency of securities lending transaction information to broker-dealers. Specifically, the ALD No-Action Request requires agent lenders to provide borrowing broker-dealers with sufficient information to identify the principal, and relevant financial information about the principal. The ALD No-Action Request also calls for agent lenders to provide borrowing broker-dealers relevant information on the outstanding loans with each principal on a daily basis. Although the ALD No-Action Request remains in draft form, we understand that broker-dealers engaging in securities lending activities are currently examined by the SEC and FINRA for compliance with the terms of the ALD No-Action Request.

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

Among other things, Proposed FINRA Rule 4314(a) would require a member firm that enters into a transaction to lend or borrow securities to (i) if the member firm is acting as agent,

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[5] Letter from SIFMA to Michael A. Macchiaroli, Associate Director of the SEC Division of Market Regulation, Agency Lending Disclosure Initiative (Mar. 20, 2007), *available at* http://www.sifma.org/uploadedfiles/societies/sifma_securities_lending_section/ald%20initiative%20-%20sifma%20letter%20to%20the%20sec.pdf.

disclose its capacity to other party(s) to the transaction, and (ii) if a counterparty is acting as agent, maintain books and records concerning each principal on whose behalf the agent is acting. In the Proposal, FINRA notes its belief that the disclosure and recordkeeping requirements in proposed FINRA Rule 4314 are consistent with the ALD Initiative. SIFMA appreciates this acknowledgement of consistency between the proposed rule and the ALD Initiative, and interprets this statement as agreement with the position expressed in the 2010 SIFMA Letter that conduct consistent with the ALD Initiative, such as the transfer of data between the agent lender and broker-dealer under the ALD Initiative, should be sufficient to meet the books and records requirements in proposed FINRA Rule 4314.

However, SIFMA notes that there continues to be no explicit reference to the ALD Initiative in the text of the proposed rule. Although the ALD No-Action Request remains in draft form, as noted above, SIFMA understands that both SEC and FINRA examiners, as part of their inspection of broker-dealer firms, examine for compliance with the ALD No-Action Request. In light of this, SIFMA reiterates its recommendation that FINRA work with the SEC Staff to finalize the relief to be provided under the ALD No-Action Request prior to or simultaneous with the adoption of Proposed FINRA Rule 4314, and then cross-reference the ALD Initiative in the proposed rule. As noted in the 2010 SIFMA Letter, this could be accomplished, for example, by a statement in the proposed Supplementary Material that firms should structure their operations in a manner consistent with the cited ALD Initiative.

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

a. Customer's Written Authorization

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 the customer and are eligible to be pledged or loaned, thereby adopting the requirement in Incorporated NYSE Rule 402(b). Proposed Supplementary Material .02 would permit a member to satisfy this written authorization requirement by using a single customer signed margin agreement/loan consent, provided 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.

In the Proposal, FINRA notes that the safe harbor in Supplementary Material .02 is not new, but is identical to that in Incorporated NYSE Rule Interpretation 402(b)/01. Indeed, some SIFMA members have indicated that their customer margin account agreements contain a disclosure similar to the language proposed in Supplementary Material .02, although the exact language or placement may differ. Further, some members have developed independently a variety of approaches as to the manner in which they document their customers' written authorization to loan such customers' securities. These members believe that these documentary approaches comply with the letter and spirit of Incorporated NYSE Rule 402(b), even though they differ from the express safe harbor approach outlined in Incorporated NYSE Rule

Interpretation 402(b)/01. These members further believe their chosen approaches are equally as effective at ensuring that their customers are aware and acknowledge that their securities may be loaned out to the member or others. Given the prevalence of these alternative documentary approaches within the industry, and to avoid the costs and administrative burden of having to "re-paper" a firm's entire margin customer base, SIFMA respectfully requests that FINRA apply Supplementary Material .02 solely to customer margin agreements entered into after the effective date of the Proposed Rules.

Furthermore, SIFMA seeks clarity on the requirement in Supplementary Material .02 that the legend be placed "directly above the signature line." Specifically, we are concerned that the interpretation of this placement requirement may conflict with the required placement of other disclosures. For example, FINRA Rule 2268 (Requirements When Using Predispute Arbitration Agreements for Customer Accounts) provides that "[i]n any agreement containing a predispute arbitration agreement, there shall be a highlighted statement *immediately preceding any signature line or other place for indicating agreement* that states that the agreement contains a predispute arbitration clause." (emphasis added.) In light of this, to avoid potential conflicting requirements, SIFMA respectfully requests that FINRA clarify that placing the legend near and preceding the signature line, but not necessarily immediately above the signature line, would be deemed compliant with the placement requirement in Supplementary Material .02.

b. Suitability

Proposed FINRA Rule 4330(b)(2)(A) would impose a suitability obligation on member firms engaging in securities loan transactions, by requiring that a member have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer. Again, SIFMA appreciates that, in the Proposal, FINRA confirms that the foregoing suitability analysis would be required to be performed prior to the member first entering into securities borrows with a customer, and would apply with respect to a customer's overall participation in a fully paid securities lending program; *i.e.*, the suitability determination would *not* be required to be made on a transaction-by-transaction basis. SIFMA believes that this is the correct approach with respect to the securities lending market.

Further, SIFMA notes that the suitability requirement in FINRA Rule 2111 contains an exception for institutional customers that is not provided for in proposed FINRA Rule 4330. Specifically, FINRA Rule 2111(b) provides that a member firm fulfills its customer-specific suitability obligation for an institutional account if, generally, (a) the member firm has a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently, and (b) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the firm's recommendations. FINRA Rule 2111(b) also extends these factors to any agent to which an institutional customer has delegated decision making authority. SIFMA respectfully advocates for an institutional safe harbor under proposed FINRA Rule 4330(b) that provides that a member firm that has satisfied the requirements of FINRA Rule 2111(b) with respect to an institutional account shall be automatically deemed to have satisfied the suitability obligation in proposed FINRA Rule 4330 with respect to the institutional account. SIFMA believes that, if a member firm reasonably determines that an institutional customer is capable of evaluating the risks of engaging in a securities loan

transaction, and the institutional customer has indicated that it exercises independent judgment, such customer should require no greater protection with respect to a securities lending transaction than a recommended transaction or investment strategy involving a security. Additionally, establishing a safe harbor provides flexibility in a member firm's compliance with its suitability obligation for an institutional account, allowing firms to also develop reasonable grounds for a suitability determination outside the safe harbor. Further, similar to FINRA Rule 2111(b), SIFMA believes that the safe harbor should be equally applicable to an agent of a customer, as this would be generally consistent with the approach currently taken in Supplementary Material .04 to Proposed FINRA Rule 4330, which provides that, 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 firm that has a customer relationship with the lender.[6]

c. Standardized Risk Disclosure Form

Proposed FINRA Rule 4330(b)(2)(B) requires member firms to provide customers with certain disclosures related to the customer's securities loan transaction. SIFMA appreciates FINRA's acknowledgement in the Proposal that it would not object to the development of an industry standard risk disclosure form for purposes of complying with proposed FINRA Rule 4330(b)(2)(B). As discussed in the 2010 SIFMA Letter, SIFMA believes that such an approach has worked well in other contexts (*e.g.*, the options disclosure document, portfolio margining, prime brokerage 150 and 151 agreements), and would greatly help to alleviate confusion and establish uniformity across the industry.

Towards that end, SIFMA has established a working group to create such a template industry standard risk disclosure form. SIFMA intends to provide a draft of the template to FINRA for review, discussion and comment, with the aim of establishing mutually-agreeable standards between regulators and the industry. In order to accommodate the development of a comprehensive and acceptable industry standard risk disclosure form, SIFMA respectfully requests that FINRA extend beyond 90 days the proposed deadline by which member firms would be required to provide customers with the disclosures required by proposed FINRA Rule 4330(b)(2)(B). In particular, in light of FINRA's comment in the Proposal that members should carefully evaluate their activities and disclosure obligations when considering adopting a standardized disclosure document, drafting and agreeing with FINRA on an appropriate standardized form that adequately addresses the required disclosures for multiple member firms may be a time-consuming process. SIFMA respectfully recommends that FINRA extend this

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[6] Towards that end, SIFMA interprets Supplementary Material .04 to Proposed FINRA Rule 4330 to apply to a fully-paid lending arrangement between a carrying or clearing firm and an introducing firm, whether the introducing firm is a registered member of FINRA or registered and subject to regulation in its local jurisdiction. This approach is consistent with SEC Rule 15c3-3(a) and SEC Staff interpretive guidance in SEC Rule 15c3-3(a) Interpretations /01 and /033, which indicate that, in situations where an introducing firm maintains an account for customers with a clearing/carrying broker-dealer, whether on a fully-disclosed or omnibus basis, and including where the introducing firm is a foreign broker-dealer, then the introducing firm is the "customer" of the clearing/carrying firm.

deadline to 180 days, in order to provide sufficient time to draft, review, discuss, revise and ultimately approve an appropriate and comprehensive industry standard risk disclosure form.

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We appreciate this opportunity to respond to the Proposal, and welcome the chance to work with the SEC and FINRA on subsequent developments concerning the Proposed Rules and the ALD Initiative. If you have any questions or require additional information, or would like to further discuss any of the issues presented herein, please do not hesitate to contact the undersigned at 212.313.1280 or kbrandon@sifma.org.

Sincerely,

Kyle Brandon
Managing Director

cc: Mary Jo White, Chairman
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
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