NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street, NE, Suite 1140
Washington, DC 20002
202/737-0900
www.nasaa.org

February 14, 2022

By email to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006

RE: Regulatory Notice 21-43: Prohibition on Borrowing from or Lending to Customers

Dear Ms. Mitchell:

I am writing on behalf of the North American Securities Administrators Association, Inc. ("NASAA")[1] in response to Financial Industry Regulatory Authority ("FINRA") *Regulatory Notice 21-43: Prohibition on Borrowing from or Lending to Customers – Proposed Amendments to FINRA Rule 3240 and Retrospective Rule Review Report* (the "Proposal"),[2] which would amend the current prohibition on borrowing from or lending to customers and would expand on exceptions to the prohibition. NASAA previously commented on proposed changes to Rule 3420 through Regulatory Notice 19-27.[3] While we applaud FINRA for taking steps toward protecting investors from borrowing and lending arrangements that may not be in their best interests, NASAA's positions have not changed since the October 2019 letter.

In brief, NASAA maintains that there should be an outright prohibition on borrowing from or lending to customers, including family members. The conflicts of interest for a registered person inherent in a lender-debtor relationship and the potential harm to investors outweigh any benefit to be gained under this rule. Should FINRA, however, decide to move forward with allowing borrowing and lending arrangements to exist between registered persons and their customers, the related accounts should be subject to, at a minimum, heightened supervision to ensure that any conditions and limitations imposed by the firm are followed. Additionally, the cooling off period before entering into a lending or borrowing arrangement with a former customer should be extended to at least 12 months.

---

1 Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

2 The Proposal is available at https://www.finra.org/sites/default/files/2021-12/Regulatory-Notice-21-43.pdf.

3 *See* Letter from Chris Gerold, NASAA President, to Jennifer Piorko Mitchell, FINRA Office of the Corporate Secretary, *Re: Regulatory Notice 19-27: Retrospective Rule Review* (Oct. 8, 2019) at 5-7, *available at* https://www.nasaa.org/wp-content/uploads/2019/10/NASAA-Comment-Letter-Re-Reg-Notice-19-27-10-8-19.pdf.

President: Melanie Senter Lubin (Maryland)
President-Elect: Andrew Hartnett (Iowa)
Past-President: Lisa Hopkins (West Virginia)
Executive Director: Joseph Brady
Secretary: Kevin Hoyt (New Brunswick)
Treasurer: Claire McHenry (Nebraska)
Directors: William Beatty (Washington)
Marni Gibson (Kentucky)
Leslie Van Buskirk (Wisconsin)
Diane Young-Spitzer (Massachusetts)

I. The Proposed Rule Would Continue to Subject Registered Persons to Disparate Regulatory Requirements.

The proposed amendments to Rule 3240 would allow registered persons to maintain pre-existing loan agreements or enter into new agreements with customers as long as certain criteria are met.[4] NASAA asserts that a registered person should simply be prohibited from these loan agreements with customers. In 1983, NASAA members adopted the Dishonest or Unethical Business Practices of Broker-Dealers and Agents model rule, which prohibits such conduct.[5] Since that time, 44 jurisdictions have enacted the model rule in part or in whole. The rule prohibits agents from "[e]ngaging in the practice of lending or borrowing money or securities from a customer, or acting as a custodian for money, securities or an executed stock power of a customer."[6] NASAA included similar provisions in a model rule applicable to investment advisers.[7] NASAA maintains that the conflicts of interest that exist when a registered person enters into a lending or borrowing arrangement cannot simply be mitigated by additional policies and procedures imposed by the registered person's firm.

NASAA's position is consistent with the approach of the Securities and Exchange Commission (the "Commission") with regard to certain other broker-dealer conflicts of interest.

---

[4] Proposal at 3. Those criteria include:

- the customer is a member of the registered person's immediate family;
- the customer (i) is a financial institution regularly engaged in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in the ordinary course of business and (ii) is acting in the course of such business;
- the customer and registered person are both registered persons of the same member firm;
- the lending arrangement is based on a personal relationship with the customer, such that the loan would not have been solicited, offered, or given had the customer and the registered person not maintained a relationship outside of the broker-customer relationship; or
- the lending arrangement is based on a business relationship outside of the broker-customer relationship.

[5] NASAA Model Rule, *Dishonest or Unethical Business Practices of Broker-Dealer Agents*, May 23, 1983, *available at* https://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf.

[6] *Id.* at 3. *See also*, *e.g.,* 10 Pa. Code § 305.019 (1990, amended 2018); Tenn. Comp. R. & Regs. 0780-04-03-.02 (1983; amended 2016); Wis. Admin. Code DFI-Sec § 4.06 (1983; amended 2009); Wash. Admin. Code §460-22B-090(1).

[7] NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers Model Rule 102(a)(4)-1 (2019), *available at* NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf. Prohibiting investment advisers from:

- Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser or a financial institution engaged in the business of loaning funds.
- Loaning money or securities to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

As the Commission recognizes in the context of Regulation Best Interest – where it has required the elimination of sales contests, sales quotas and certain compensation arrangements – some conflicts of interest are "so pervasive such that they cannot be reasonably mitigated and must be eliminated in their entirety, as we believe they create too strong of an incentive for the associated person to make a recommendation that places their financial and other interest ahead of the interest of retail customers' interests …."[8] The direct personal incentives inherent in lending and borrowing arrangements, and the desire to collect or the duty to pay a customer, are of equal if not greater concern. Though the Proposal addresses the fiduciary duties of federally registered investment advisers, similar requirements and responsibilities under Regulation Best interest must be considered in context of the proposed amendments. Ultimately, we believe that these arrangements should be prohibited entirely.

We also note that the Proposal updates the definition of immediate family to align with the definition in Rule 3421. NASAA supports this modernization and appreciates the decision to narrow the inclusion of financially-supported persons as "immediate family" to those who live in the same household as the registered person. However, family members are not immune from, and may in fact be susceptible to, fraudulent activities and bad actors. While statistics on familial fraud are limited,[9] by focusing on the elderly and those at a higher risk of abuse we see that in almost 60% of elder abuse and neglect incidents the perpetrator is a family member.[10] Given the stakes at issue – namely investor protection from predatory lending or undue influence in a broker-customer relationship – it is not prudent to allow an exception to regulatory scrutiny based on assumptions about familial fidelity. For that reason, if FINRA retains the current framework for Rule 3240, NASAA recommends that even borrowing from or loaning to customers that are immediate family members should be subject to firm scrutiny and approval. This is particularly important where the customer is a senior or may otherwise be a vulnerable adult under applicable state law.

---

[8] SEC Rel. No. 34-86031, *Regulation Best Interest: The Broker-Dealer Standard of Conduct* (June 5, 2019) at 352-53.

[9] *See* Strategic Finance, *Shattered Trust: Fraud in the Family*, Stephen Pedneault and Bonita Peterson Kramer (May 1, 2015), *available at* https://sfmagazine.com/post-entry/may-2015-shattered-trust-fraud-in-the-family/; *see also* AARP, *Older Americans Hit Hard by Financial Fraud*, Katherine Skiba (Feb. 28, 2019), *available at* https://www.aarp.org/money/scams-fraud/info-2019/cfpb-report-financial-elder-abuse.html (noting that nearly 40% of reported elder financial abuse came from a family member or fiduciary).

[10] National Council on Aging, *Elder Abuse Facts* (accessed Feb. 2, 2022), *available at* https://www.ncoa.org/public-policy-action/elder-justice/elder-abuse-facts/; *see also* Stephen Deane, SEC Office of the Investor Advocate, *Elder Financial Exploitation – Why it is a concern, what regulators are doing about it, and Looking Ahead* (June 2018) at 23, *available at* https://www.sec.gov/files/elder-financialexploitation.pdf (citing MetLife Mature Market Inst. et al, *The MetLife Study of Elder Financial Abuse: Crimes of Occasion, Desperation, and Predations Against America's Elders 5* (2011) (stating that data at that time showed that 55% of financial abuse in the United States is committed by family members, caregivers, and close friends).

II. FINRA Must Implement Stronger Guidelines, Disclosure Requirements, and Lockout Periods for the Proposed Rule to Protect Investors.

The Proposal provides a non-exclusive, non-exhaustive list of potential factors for a firm to consider as part of its written policy on loans between registered persons and customers. Yet, firms are not required to take any particular consideration into account. That is too lax. The rule should require a minimum amount of disclosure and required evaluation, from which the firms can elevate to a higher standard, to ensure adequate consideration among similar situations across similarly situated firms. Registered persons entering into these agreements should be required, at a minimum, to disclose the Proposal's recommended disclosures.[11] Likewise, NASAA believes that a robust documentation program should include, at a minimum, the firm's consideration of:

- the steps that the member firm undertook to assess the risk prior to the registered person being approved to enter into the loan agreement;
- the steps that the member firm will take to minimize the conflict of interest;
- how the member firm communicated to the customer the risk created by the loan agreement and repayment terms so that the customer appreciates the risk; and
- an outline of the supervisory measures that will be taken by the member firm.

These measures should be required in addition to the non-exclusive list of potential factors suggested by FINRA. Requiring defined disclosures and assessment considerations would allow regulators to assess and compare approval and supervision practices across firms. In guidance or

---

[11] Proposal at 10-11. FINRA suggests that firms consider:

- the length and type of relationship between the customer and registered person;
- the material terms of the borrowing or lending arrangement;
- the customer's or the registered person's ability to repay the loan;
- the customer's age;
- whether the registered person has been a party to other borrowing or lending arrangements with customers;
- whether, based on the facts and circumstances observed in the member firm's business relationship with the customer, the customer has a mental or physical impairment that renders the customer unable to protect his or her own interests;
- any disciplinary history or indicia of improper activity or conduct with respect to the customer or the customer's account (*e.g.*, excessive trading); and
- any indicia of customer vulnerability or undue influence of the registered person over the customer.

NASAA strongly supports documentation and disclosure regarding age, mental capacity, or other arrangements the broker has entered that may show a pattern or practice of participating in loan agreements with customers.

otherwise, FINRA should make it clear that firms are free to impose more stringent controls up to and including a flat prohibition on such arrangements.

A reasonable assessment and determination process should also include an interview (preferably by a compliance officer in the firm) with the customer outside of the presence of the registered person. This practice would help ensure that the customer understands the terms of the loan agreement, has not been coerced, and does not show indicia of vulnerability or undue influence. Where it is not possible to interview the customer (either in person or online), the firm should at least be required to verify that the customer benefits from and entered into the loan of his or her own volition and did not feel pressure to do so.

The Proposal points out the similarities between Rule 3240 and Rule 3241 and similar potential conflicts of interest.[12] NASAA commented on Proposed Rule 3241 and FINRA Regulatory Notice 19-36, recommending heightened scrutiny of accounts where brokers hold a position of trust.[13] We believe a similar requirement, where firms must closely monitor the account where formal conditions are imposed by the firm, would significantly benefit investor protection. However, if the final rule does not require a firm to impose formal conditions, heightened scrutiny should be applied to these accounts on an ongoing, annual review basis.

In any situation where there is a loan agreement between a client and registered person, the firm should put the registered person on heightened supervision due to conflicts of interest and place additional reviews on trades and transactions in the account to ensure that the registered person is making suitable recommendations. As the senior population in the United States grows, instances of isolated senior investors will continue to increase. While these relationships can start with good intentions, they have the potential to become exploitative. In more malevolent cases, a registered person may "groom" a customer with the goal of exploitation.[14]

To that end, the proposal seeks comment on whether a six-month look-back period is sufficient for determining whether an individual was a registered person's "customer" prior to entering into a lending or borrowing arrangement.[15] Predatory lending practices or the inability to repay a loan could be detrimental to an investor's financial wellbeing. We believe that a 12-month period would significantly curtail attempts to circumvent the purpose of Proposed Rule 3240 and would inure to the benefit of investors. When accounting for the books and records requirements for much of the same data, which can run from three to six years, NASAA does not believe that a 12-month look-back period is overly burdensome. In a similar context, FINRA Rule 4111 uses a one-year lookback period for restricted firm obligations and "registered person[s] in scope." When

---

12 *Id.* at 10.

13 Letter from Chris Gerold, NASAA President, to Jennifer Piorko Michelle, FINRA Office of the Corporate Secretary, *Re: Regulatory Notice 19-36: Rule to Limit a Registered Person from Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer* (Jan. 24, 2020), *available at* https://www.nasaa.org/wpcontent/uploads/2020/01/NASAA-Comment-Letter-re-Finra-Reg-Notice-19-36.pdf.

14 *Id.* at 4.

15 Proposal at 13.

attempting to protect investors from potential fraud or abuse, which could lead to Rule 4111 restrictions, a similar 12-month look-back provision would be appropriate.

Finally, the Proposal notes that FINRA does not plan to implement this rule with a retroactive application.[16] NASAA understands the argument that applying this rule to pre-existing loan agreements may constitute a significant undertaking.[17] We also appreciate that most agreements fall under the current, less stringent iteration of Rule 3420. However, the costs associated with applying the new rule retroactively could provide benefits to investors by identifying potential ongoing abuses, high-risk registered persons or firms that were close to the line under the old rule, and areas of concern for regulators. By requiring retroactive disclosure of these agreements, FINRA and regulators will be informed of the number of potentially problematic loan agreements and firms that may require further review. In those instances where brokers or firms have a high concentration of loan agreements, further action or requirements may be warranted.[18]

III. Conclusion

NASAA appreciates the opportunity to comment on the Proposal. In summary, NASAA believes that borrowing from or lending to customers should not be permitted. Should FINRA decide to move forward with allowing such arrangements as proposed, it should establish clear standards for firms by laying a foundation for the information that registered persons must provide and more specific guidelines on considerations for firm approval. In addition, the accounts in question should be subject to heightened supervision to ensure that the conditions and restrictions are met. Finally, the resulting final rule should be applied to both current and future customers.

Thank you for considering these views. NASAA looks forward to continuing to work with FINRA in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

Melanie Senter Lubin
NASAA President
Maryland Securities Commissioner

---

16 *Id.* at 7.

17 Subject to the other concerns noted in this letter, NASAA generally supports the position that pre-existing loans when a broker joins a firm must be documented, disclosed, and remediated before entering the broker-customer relationship.

18 *See, e.g.,* FINRA Rule 4111 – Restricted Firm Obligations.