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Via Electronic Mail February 12, 2024

Sherry R. Haywood
Assistant Secretary, Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F St., NE
Washington, D.C. 20549

RE: SR – FINRA – 2024 – 001

Dear Ms. Haywood,

The office of Malecki Law writes in response to the U.S. Securities and Exchange Commission's (the "SEC") request for comment on the proposed rule change to Financial Industry Regulatory Authority ("FINRA") Rule 3240 (Borrowing From or Lending to Customers) ("Rule 3240"). As the proposed rule changes currently stand, there remains considerable latitude for registered persons of member firms to take advantage of unsuspecting customers through improper lending arrangements. While clarifying Rule 3240's presumptive prohibition on borrowing from or lending to customers represents a step in the right direction, FINRA should take this opportunity to strengthen Rule 3240 even more so in furtherance of the organization's ultimate goal: investor protection.

Lending Arrangements with Customers Should be Strictly Prohibited

At the outset, Malecki Law would like to reiterate its stance that lending arrangements between registered representatives and their customers should be strictly prohibited. Transactions amongst registered representatives and customers inherently involve parties negotiating from disparate bargaining positions. On one hand, registered representatives are charged with and compensated for their knowledge of financial markets and financial products. On the other hand, customers generally enter into brokerage agreements with registered representatives because they do not have the sophistication, experience, knowledge, and/or time to acquire the financial acumen required to manage their own portfolio. Parties are often coming from drastically different backgrounds such as these cannot negotiate an arm's length financial arrangement.

Next, we would like to point out that the regulation of the financial industry is segmented for legitimate reasons. The regulation of financial products and services calls for arguably the most complicated regulatory scheme in the country, involving numerous federal regulators, self-regulatory organizations, and state regulators. Securities are regulated differently than derivative products, which are regulated differently than insurance products, which are all regulated differently than banking products. The complex nature and the expanse of financial products necessarily requires such a regulatory scheme. As such, FINRA should avoid "commingling" the regulation and responsibilities of brokers with those of banks and other credit institutions. The Banking Sector has already implemented measures needed to ensure that public customers are appropriately protected when entering into lending and/or borrowing relationships with financial institutions, such as FDIC insurance and usuary prohibitions. FINRA should encourage its members and registered representatives to utilize traditionally available avenues (i.e., banks, credit unions, etc.) for lending instead of attempting to regulate transactions that FINRA was not designed to regulate.

Moreover, the market has never been as saturated with financing, credit, and lending products and institutions as it is today, leading to few instances where registered representative/customer lending arrangements are necessary. As online banking has risen in popularity, so too has the prevalence of non-traditional credit institutions and products. As one example, Social Finance Inc. ("SoFi"), an online bank based in San Francisco, California, has issued over $73 billion in loans since the company was founded in 2011.[1] As another example, Upstart Holdings ("Upstart") is a lending platform that connects financial institutions to borrowers and predicts creditworthiness based on non-traditional factors, like education or employment, which makes financing more readily available to underserved segments of the population. In today's market, credit and financing options available to the public are abundant and brokers should not have to rely on their customers for loans.

If FINRA continues to allow registered representatives to enter lending arrangements with their customers, as it seems destined to do, FINRA should implement a requirement on member firms to collateralize any loans that such member firms approve between a registered representative and customer. A collateralization requirement would serve two distinct purposes. First, collateralization would ensure that FINRA abides by its chief mandate: investor protection. As detailed by FINRA in

[1] *See* https://www.usatoday.com/money/blueprint/student-loans/sofi-student-loan-review/.

the Federal Register Notice for Rule 3240, of the 58 enforcement actions related to Rule 3240 between 2018 and 2021, 57 of such actions involved a registered representative borrowing from a customer. Customers are clearly disproportionately harmed when entering into lending arrangements with their broker. Aside from strictly prohibiting lending arrangements, the only way FINRA can ensure that a customer is not harmed in a lending arrangement with their registered representative is to require member firms to have "skin" in such arrangements.

Second, a collateralization requirement on member firms would cause far fewer lending arrangements between a registered representative and customer to be approved, indirectly achieving the goal of Rule 3240's "presumptive prohibition." Further, member firms who are forced to secure the loans of their registered representatives will be incentivized to conduct heightened due diligence on the transaction before approval and to supervise the transaction more appropriately after approval.

The "Immediate Family" Exception Remains Too Broad

While FINRA should be commended for its modernization of the "Immediate Family" Exception to Rule 3240, FINRA appears to have disregarded important considerations about the perpetrators of financial fraud in amending Rule 3240.[2] Although Malecki Law recognizes the privacy concerns that must be taken into account under this exception, this office finds it necessary to highlight that a significant portion of financial frauds are undertaken by someone with a relationship to the victim. As the United States Office for Victims of Crime has noted:

> [M]ost fraud perpetrators are not slinky, shady characters who perpetrate their crimes under the cover of night… Many fraud perpetrators use their community and professional credibility and respectability to con, swindle, and deceive **family members, friends, business colleagues, and other members of the community with whom they have formed a relationship**.[3]

Clearly, an "immediate" familial relationship is not a barrier to committing fraud generally, and it should not be used as an exception for allowing lending arrangements between registered representatives and their customers. While it would be wonderful if all families were in sync, we know that is not the case, particularly when certain family members become elderly, lose cognitive

[3] *See* https://www.ncjrs.gov/ovc_archives/reports/fraud/psvf/chap1.htm (emphasis added).

functions and cannot take the stress of saying "no" to a family member. This senior population is ripe for abuse, particularly those who know their wealth and may feel entitlement.

Moreover, "immediate family" members are typically privy to information that gives rise to predatory lending relationships. Predatory lenders generally "prey on people who need immediate cash for emergencies…"[4] Family members and friends are more likely to know about a customer's emergency, like unexpected medical bills, unforeseen home/auto repairs, or the sudden loss of a job, and will be better positioned to use such emergency to the detriment of the customer.

The Personal and Business Relationship Exceptions Should be Narrowed

Another part of the proposal offered by FINRA is to narrow the scope of the "Personal Relationship" and "Business Relationship" exceptions, respectively. Malecki Law agrees with the overarching intent behind this specific rule change proposal. However, Malecki Law disagrees with the drafting of the updated exceptions, as they do not seem to meet the intent behind the proposal itself.

Currently, the Personal Relationship Exception is defined as "[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 relation outside of the broker-customer relationship." The Business Relationship Exception is defined as "[a] business relationship outside of the broker-customer relationship." In its proposal, FINRA acknowledged concerns about how personal relationships can be "exploited" and further indicated that it desired to make the definitions clearer as to the types of relationships that fall under the respective exceptions. To meet this intent, FINRA proposes to change the language of each exception, which includes, but is not limited to, utilizing the term "bona fide." One can have a "bona fide" and abusive financial relationship.

The proposed updated Personal Relationship Exception is defined as "[a] bona fide, close personal relationship between the registered person and the customer maintained outside of, and formed prior to, the broker-customer relationship." The proposed updated Business Relationship Exception is defined as "[a] bona fide business relationship outside of the broker-customer relationship." In Footnote 16, FINRA indicated that it "proposes to add the term 'bona fide'… to

[4] *See* https://www.debt.org/credit/predatory-lending/.

emphasize that for either of these exceptions to apply, the close personal relationship or business relationship must be **legitimate**." Utilizing the term "bona fide" would likely not help reach the intent of this proposal because it is vague and ambiguous. Specifically, it would require a subjective assessment of whether a personal or business relationship is "legitimate." In FINRA's proposal, there is no explanation or test to discern what constitutes a relationship as legitimate. Thus, it might lead to confusion in the interpretation of the exceptions, and allow for more customer-broker transactions, than fewer.

As it relates to the Personal Relationship Exception, the newly drafted exception would fail to capture or identify close relationships amongst brokers and customers that developed ***after*** the broker-customer relationship was established, as it states, "…maintained outside of and formed **prior** to, the broker-customer relationship." Meanwhile, the current language, which would be discarded, covers personal relationships formed at any time, "…maintained a relationship outside of the broker-customer relationship." This is an important point because one of the key drivers of fraud is trust. Trust can be, and usually is, built over the course of a broker-customer relationship. This rule change would fail to consider and protect an investor who gained trust for their broker over time and then chose to borrow from or lend to their broker years into the broker-customer relationship. If the intent is to prohibit these types of transactions amongst brokers and customers, *after* they establish the broker-customer relationship, the Rule should explicitly state so.

FINRA's proposal offers a limited number of examples that could fall under the updated exceptions. These examples offer very particular scenarios that may not be relatable to most broker-customer relationships, and thus, it fails to consider a wide range of scenarios the general public likely could relate to, which would help interpret whether an exception applies. As to close personal relationships, the proposal suggests the following examples, "a childhood or long-term friend, a godparent, and other similarly close relationships." The first two examples do not provide enough clarity to understand what could fall under "similarly close relationships." As to business relationships, the proposal suggests the following example, "a loan from a registered person to a small outside business that the registered person co-owned for years for the sole purpose of providing the business with additional operating capital." This seems like a very specific scenario in which many broker-customer pairs may not relate to. Malecki Law understands that this is merely an example,

however, it is the only one illustrated in the proposal. Additional examples that would consider a wider range of situations would be helpful to understand and interpret the exceptions themselves.

Notice and Approval Requirements

FINRA also proposes to extend provisions under Rule 3240(b)(2)-(3), which would allow for member firms to draft "procedures… [that] indicate that registered persons are not required to notify the member or receive member approval of such arrangements either prior to or subsequent to initiating a broker-customer relationship." Malecki Law believes that member firms should not be able to "opt-out" of reviewing and/or approving these types of lending/borrowing transactions with customers, through their own firm procedures, as it defeats the purpose of and intent behind Rule 3240 itself. Further, it is likely to cause a "head in the sand" approach for member firms, as they do not know what they do not see. If this is the case, these types of transactions cannot be monitored, which could incentivize illegitimate transactions in the marketplace. This is not in the customers' best interest, and therefore not aligned with the mission of investor protection. As mentioned before, trust is a key driver for fraud. Another key driver for fraud is arguably a mixture of politeness and pressure, as it is hard to say no to the same broker who is managing your finances. A broker requesting that a customer enter into a lending/borrowing arrangement might inspire fear in the customer, where they feel compelled to say yes, reluctantly. Based on the foregoing, Malecki Law disagrees with the concept of allowing member firms to create this carve out.

Notice and Disclosure to the Customer Should Not Be Disregarded

FINRA's revised Rule 3240 should put a heightened emphasis on notice and disclosure provided to the customer. "Disclosure" is the core of all securities laws and paramount in protecting investors. As revised Rule 3240 currently stands, registered representatives are not required to disclose to customers the types of lending arrangements that are permitted between a registered representative and a customer. Although Rule 3240's revised title should help put customers on notice of the general "prohibition" against these kinds of arrangements, more affirmative disclosures are needed.

To properly protect customers from predatory or fraudulent lending arrangements, Rule 3240 should follow the lead of Regulation Best Interest's Disclosure Obligation, which requires "full and

fair disclosure of [a]ll material facts relating to the scope and terms of the relationship..." When entering into a lending arrangement with a customer, a registered representative should be required to disclose to the customer, in writing, that such arrangements are presumptively prohibited and to document the exception under which the lending arrangement falls. Further, member firms should be **required** to consult the customer before approving a lending arrangement ("expect[ing] a member to try to discuss the arrangement with the customer" is not enough) to ensure the customer receives a full and fair disclosure about the terms of the arrangement. Lastly, member firms should be required to disclose the language of Rule 3240 and that lending arrangements between customers and registered representatives are presumptively prohibited on their Forms CRS.

Conclusion

Lending arrangements between registered representatives and customers give rise to a plethora of situations where public investors are left unprotected and such arrangements should be strictly prohibited. Financial professionals have access to private financial information and could use that to their advantage. Unfortunately, a driver of victimization is often using discomforting pressure tactics, coupled with investors that are too polite and feel trapped between a rock and a hard place: "Will my financial professional, friend, or relative be upset if I do not give them the loan, and will they take it out on my account?" Or "Will they take too much risk to make it up to me and will I suffer losses?" These are positions we should not put average investors in at any time. Should FINRA continue to allow lending arrangements between registered representatives and customers, Rule 3240 should be narrowed to only permit arrangements that are fully and fairly disclosed to the customer and that are collateralized by the associated member firm.

Respectfully,

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