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April 26, 2024

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**RE: File No. SR-FINRA-2024-001 (Proposed Rule Change to Amend FINRA Rule 3240 (Borrowing From or Lending to Customers)) – Response to Comments**

Dear Ms. Countryman:

The Financial Industry Regulatory Authority, Inc. ("FINRA") submits this letter to respond to comments the Securities and Exchange Commission ("SEC" or "Commission") received on the above-referenced rule filing (the "Proposal"). The Proposal would amend FINRA Rule 3240 (Borrowing From or Lending to Customers).

Rule 3240 generally prohibits, with exceptions, registered persons from borrowing money from or lending money to their customers. This rule was adopted originally to establish a regulatory framework to "give members greater control over, and more specific supervisory responsibilities for, lending arrangements between registered persons and their customers."[1] The rule has five tailored exceptions, available only when the registered person's member firm has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member, the borrowing or lending arrangement meets the conditions in one of the exceptions and, when required, the registered person notifies the member of a borrowing or lending arrangement, prior to entering into such arrangement, and obtains the member's pre-approval in writing.[2] As discussed in the Proposal and below, the exceptions are for

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1 See Securities Exchange Release No. 48093 (June 26, 2003), 68 FR 39608 (July 2, 2003) (Notice of Filing of File No. SR-NASD-2003-092).

2 See Rule 3240(a)(2)(A) (the "immediate family exception"); Rule 3240(a)(2)(B) (the "financial institution exception"); Rule 3240(a)(2)(C) (the "registered persons exception"); Rule 3240(a)(2)(D) (the "personal relationship exception"); Rule 3240(a)(2)(E) (the "business relationship exception"). Rule 3240(b)(1) requires notice and approval of arrangements that are within the personal relationship, business relationship, and registered persons exceptions. For the immediate family exception and financial institution exception, however, Rule 3240(b)(2) and (3) state that members' written procedures may indicate that registered

limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers. FINRA believes the limited exceptions may allow for mutually beneficial arrangements, including, for example, loans at interest rates lower than commercially available.

The Proposal would strengthen the general prohibition against borrowing and lending arrangements, narrow some of the existing exceptions to that general prohibition, modernize the immediate family exception, and enhance the requirements for giving notice to members and obtaining members' approval of such arrangements.[3]

The Commission published the Proposal for public comment in the Federal Register on January 22, 2024.[4] On February 21, 2024, FINRA consented to an extension of the time period for SEC action on the Proposal. On April 18, 2024, the Commission published an order to institute proceedings to determine whether to approve or disapprove the proposed rule change. The Commission received four comment letters on the Proposal.[5]

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persons are not required to notify the member or receive member approval either prior to or subsequent to entering into such arrangements. Thus, members may choose to require notice and approval of such arrangements.

3 Where appropriate in context, FINRA refers herein to "borrowing and lending" rather than "borrowing or lending." No references to "borrowing and lending," however, should be interpreted to mean that Rule 3240 only applies to arrangements that have both a borrowing component and a separate lending component. Rule 3240 generally prohibits registered persons from borrowing money from or lending money to a customer.

4 See Securities Exchange Act Release No. 99351 (January 16, 2024), 89 FR 3968 (January 22, 2024) (Notice of Filing of File No. SR-FINRA-2024-001).

5 See letter from William A. Jacobson, Clinical Professor of Law, Anthony Berberich & Olive Monye, Cornell Law School, to Vanessa Countryman, Secretary, SEC, dated February 12, 2024 ("Cornell"); letter from Jenice Malecki, Jacqueline Candella & Adam G. Schreck, Malecki Law, to Sherry R. Haywood, Assistant Secretary, SEC, dated February 12, 2024 ("Malecki"); letter from Claire McHenry, North American Securities Administrators Association, Inc., President and Deputy Director, Nebraska Bureau of Securities, to Sherry R. Haywood, Assistant Secretary, SEC, dated February 12, 2024 ("NASAA"); and letter from Joseph C. Peiffer, President, Public Investors Advocate Bar Association, to Vanessa Countryman, Secretary, SEC, dated February 12, 2024 ("PIABA").

The following are FINRA's responses, by topic, to the commenters' material comments.

I. General Support for Proposal

Two commenters, PIABA and Cornell, expressed general support for the Proposal. They specifically expressed support for making clear that the prohibition extends to pre-existing borrowing or lending arrangements, applying the prohibition to persons or entities related to the registered person, and narrowing the personal relationship and business relationship exceptions.[6] In addition, Cornell stated that the proposed use of the term "bona fide" to describe arrangements subject to the close personal relationship and business relationship exceptions, together with the proposed factors relevant to whether a borrowing or lending arrangement is based on a close personal relationship or a business relationship, eliminates ambiguity and establishes an objective standard for members to evaluate those exceptions. Cornell also expressed support for the proposed requirements that registered persons give notice of such arrangements in writing, and retain records of written notices, along with written approvals, for at least three years.

NASAA, which reiterated its preference for an outright prohibition against registered persons borrowing from and lending to customers without exception,[7] stated that, to the extent the Proposal would continue to permit borrowing and lending arrangements, it generally supported the proposed amendments. In particular, NASAA supported extending the rule to borrowing or lending arrangements that predate the broker-customer relationship and requiring members, upon receiving notice under the rule, to perform a reasonable assessment of the risks before approving a new borrowing or lending arrangement, or a new broker-customer relationship where there is a pre-existing borrowing or lending arrangement.

All commenters supported the proposed modernization of the immediate family definition.

II. General Opposition to Proposal

*Outright Prohibition*

NASAA reiterated many of the comments it previously submitted in response to the proposal described in FINRA Regulatory Notice 21-43 (December 2021) ("Notice

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6 While generally supporting the Proposal, PIABA reiterated its prior comment regarding the proposed definition of "customer." FINRA's response is below.

7 FINRA's response to NASAA's comment is below.

21-43"). NASAA stated that borrowing from and lending to customers should be prohibited outright because such arrangements increase the potential for serious conflicts of interest. NASAA contended that an outright prohibition would be simpler and more effective. In support of its position, NASAA pointed to examples of state laws that are aligned with NASAA's model rule concerning the unethical business practices of broker-dealers and agents.[8] NASAA also reiterated its position that an outright prohibition would be consistent with Regulation Best Interest ("Reg BI").

Similarly, Malecki reiterated her previous comment that borrowing and lending arrangements between registered persons and their customers should be strictly prohibited and noted that customers and registered persons negotiate from disparate bargaining positions. Malecki also commented that FINRA should encourage its members and associated persons to enter into borrowing and lending arrangements with banks and credit unions instead of borrowing from or lending to customers, and that FINRA should not attempt to regulate borrowing and lending transactions that FINRA was not designed to regulate.

As stated in the Proposal, FINRA considered an outright prohibition against borrowing from or lending to customers but decided against that approach for several reasons. First, Rule 3240 already contains a general prohibition that the Proposal would strengthen by extending the period over which the rule would apply, clarifying that the prohibition applies to pre-existing arrangements, and narrowing some of the exceptions. Second, FINRA believes that all the exceptions are tailored to permit arrangements for which the potential benefits outweigh related potential risks and allow for limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced. As discussed, FINRA believes that such arrangements may be mutually beneficial.

In addition, Rule 3240 contains several protections that restrict a registered person's ability to enter into an arrangement within the five exceptions (i.e., no arrangements within the exceptions are permitted absent a member's procedures allowing the borrowing or lending of money between registered persons and customers and absent the registered person's compliance with applicable notice and approval requirements). Further, FINRA proposed to strengthen the notice and approval requirements, and to require members, upon receiving notice under the rule, to conduct a reasonable assessment of the risks created by the borrowing or lending arrangement and make a reasonable determination of whether to approve it. In light of the narrow scope of the exceptions and additional protections under the rule, which the Proposal would

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8 See Dishonest or Unethical Business Practices of Broker-Dealers and Agents (adopted May 23, 1983), https://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf.

strengthen, FINRA believes that it is appropriate and preferable to continue permitting some limited exceptions to the general prohibition rather than to prohibit all borrowing and lending arrangements.

As explained in the Proposal, FINRA does not believe that NASAA's model rule warrants prohibiting all borrowing and lending arrangements outright. NASAA's model rule provides that an agent's "[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" is considered contrary to high standards of commercial honor and just and equitable principles of trade. Less than half of the states have adopted that provision of NASAA's model rule.[9] Several other states have laws or regulations concerning borrowing or lending that have exceptions and protections more similar to Rule 3240,[10] or even incorporate Rule 3240 by reference.[11] Moreover, neither NASAA nor FINRA has identified any broker-dealer laws or regulations concerning borrowing or lending arrangements in several states that have high concentrations of FINRA-registered broker-dealer firms and branches, including California, Illinois, New York and Texas, among others.[12] Accordingly, FINRA reiterates its position that Rule 3240—both currently and as proposed—is as strong if not stronger, than many states' laws.

With respect to NASAA's comments concerning Reg BI, FINRA reiterates its belief that the regulatory approach used in Rule 3240 is generally consistent with the approach the Commission took with Reg BI, which establishes a standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail

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9 See NASAA letter, Appendix (Prohibition without exception). FINRA observes that of the 23 states NASAA identified as having a prohibition without exception, three states prohibit borrowing but appear to be silent on lending. See Ark. Admin. Code § 003.14.2-308.01(p); Mo. Code Regs. Ann. tit. 15, § 30-51.170(1)(V); Tenn. Comp. R. & Regs. 0780-04-03-.02(6)(b)(1).

10 See, e.g., Connecticut (Conn. Agencies Regs. § 36b-31-15b(a)(1) (1995)); Michigan (Mich. Admin. Code r.451.4.27(3)(a) (2019)); New Jersey (N.J. Admin. Code § 13:47A-6.3(a)(43) and (44) (2017)); North Carolina (18 N.C. Admin. Code 6A.1414(c)(1) (1988)); see also NASAA letter, Appendix.

11 See, e.g., Colorado (Colo. Code Regs. 704-1 § 51-4.7(H)(2) (2019)); Florida (Fla. Admin. Code Ann. r.69W-600.013(2)(a) (2021)); Nevada (Nev. Admin. Code § 90.327(1)(d)(1) and Nev. Admin. Code § 90.321(1) (2008)); see also NASAA letter, Appendix.

12 See NASAA letter, Appendix; see generally 2023 FINRA Industry Snapshot at 22-23, https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf.

customer of any "securities transaction or investment strategy involving securities."[13] Reg BI requires broker-dealers to address conflicts of interest associated with recommendations, including through mitigation and, in certain circumstances where the Commission determined that such conflicts cannot be reasonably mitigated, elimination. Similarly, Rule 3240 eliminates many of the potential conflicts that borrowing and lending arrangements may present and has provisions that serve to mitigate other potential conflicts in limited circumstances. In this regard, Rule 3240 generally prohibits most borrowing and lending arrangements and thus, in most cases, eliminates the potential conflicts these arrangements may present. Moreover, as discussed, the Proposal would strengthen the general prohibition (e.g., by clarifying that the prohibition applies to pre-existing borrowing or lending arrangements), narrow some of the already tailored exceptions (e.g., by limiting the personal relationship exception), and enhance the rule's existing protections (e.g., by requiring members, upon receiving notice of a borrowing or lending arrangement, to conduct a reasonable assessment of the risks and make a reasonable determination of whether to approve the arrangement).[14] Reg BI does not include any provisions directly addressing borrowing from or lending to customers, and FINRA does not believe Reg BI would apply to such situations unless they involved a recommendation of a securities transaction or an investment strategy involving securities to a retail customer.

NASAA also suggests that an outright ban is necessary because broker-dealers are not subject to fiduciary duties similar to those that exist under the Investment Advisers Act of 1940 ("Advisers Act").[15] FINRA is not aware, however, of any SEC guidance prohibiting borrowing or lending arrangements between advisers and clients, provided that such borrowing and lending is consistent with an adviser's fiduciary duty.

Regarding Malecki's suggestion that FINRA should encourage its registered persons to use traditionally available avenues for lending, FINRA reiterates that Rule 3240 generally prohibits registered persons from borrowing from and lending to customers. Nothing in Rule 3240 is intended to encourage registered persons to enter into borrowing or lending arrangements with customers instead of seeking traditional

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13 See 17 CFR 240.15l-1(a)(1).

14 Moreover, the member's reasonable assessment and determination would be informed by guidance in Notice 21-43 that the member's reasonable assessment of the risks may include consideration of, among other factors, "any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer."

15 See NASAA at p. 3 ("While investment advisers' fiduciary duties help to protect their clients from the impact of such conflicts, the SEC's decision not to apply that standard to broker-dealers and their registered persons means that those persons require a different approach.").

financing arrangements. Rather, the Proposal would continue to allow for tailored exceptions in limited situations where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced, and the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers.

*Immediate Family Member Exception*

Both NASAA and Malecki raised concerns that the Proposal would not impose notification and approval requirements for immediate family member loans. NASAA stated that FINRA should impose consistent notification requirements for all of the exceptions and asserted that there is no compelling reason to treat immediate family member loans differently from loans with other customers.[16] NASAA contended that a notification and approval requirement would catch situations that are higher risk while imposing a minimal burden on members. Similarly, Malecki stated that allowing members to "opt-out" of approving loans with immediate family members is likely to cause a "head in the sand" approach.

In addition, NASAA reiterated its concerns that the conflicts of interest in borrowing and lending arrangements can be more pronounced and exacerbated for customers who are older or vulnerable. NASAA noted that family members are not immune from and may be more susceptible to exploitative activities and bad actors. Malecki raised similar concerns.

As stated in the Proposal, except for proposing to modernize the definition of "immediate family," FINRA does not propose to amend the existing immediate family exception or to require notice or approval of arrangements with immediate family members. FINRA reiterates that the narrow exceptions to the rule—including for arrangements with immediate family members—are for situations where FINRA believes the likelihood that the registered person has borrowed from or lent money to a customer by virtue of the broker-customer relationship is reduced and that the potential risks are outweighed by the potential benefits of allowing registered persons to enter into arrangements with such customers. Further, the rule contains additional protections that restrict a registered person's ability to enter into an arrangement within the exceptions.

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16 Contrary to NASAA's suggestion, there are loans besides ones between immediate family members for which members may elect not to require notice and approval. See Rule 3240(b)(3) (providing that members' procedures may indicate that registered persons are not required to notify the member or receive member approval of certain borrowing or lending arrangements within the financial institution exception).

As noted in the Proposal, there are numerous examples of mutually beneficial borrowing or lending arrangements between immediate family members, including senior family members (e.g., loans to cover medical expenses, dependent care, home repairs, etc.).[17] Permitting family members to privately lend with each other may also allow family members to obtain small or short-term loans, including at an interest rate lower than commercially available. Furthermore, FINRA continues to believe that requiring notice and approval for arrangements with immediate family members may invade legitimate privacy interests because such a requirement could interfere with or intrude upon personal or private family matters.[18] Thus, FINRA believes that the potential benefits of permitting immediate family members to privately borrow from and lend to each other outweigh the potential risks the commenters identified.

Further, as explained in the Proposal, FINRA reiterates that a registered person is prohibited from entering into a borrowing or lending arrangement with a customer who is an immediate family member, including one who is a senior investor, unless the member adopts written procedures permitting such arrangements. Members may choose to prohibit all borrowing and lending arrangements, allow only some of the exceptions, or impose limitations on the exceptions. FINRA believes that, by strengthening the general prohibition and narrowing its exceptions, the proposed rule change would further protect all investors, including senior investors.[19] Moreover, as FINRA noted in the Proposal, Rule 2010 (Standards of Commercial Honor and Principles of Trade)—which provides that a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade—protects investors from unethical behavior and is broad enough to cover a wide range of unethical conduct.

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17 FINRA notes that the statements in this section that apply to senior family members also apply to other family members who may be vulnerable adults.

18 As explained in the Proposal, FINRA previously eliminated notice and approval requirements for arrangements with immediate family members from the predecessor to Rule 3240 for privacy reasons. See Securities Exchange Act Release No. 49081 (January 14, 2004), 69 FR 3410 (January 23, 2004) (Notice of Filing of File No. SR-NASD-2004-005) (explaining, among other things, that such requirements may invade the legitimate privacy interests of customers and registered persons).

19 FINRA has maintained a longstanding commitment to protecting senior investors and continues to work to address risks facing this investor population as part of its regulatory mission, including by adopting rules that are intended to address risks related to possible financial exploitation of senior investors. See, e.g., FINRA, Protecting Senior Investors 2015-2020 (April 30, 2020); Regulatory Notice 20-34 (October 2020); Rule 2165 (Financial Exploitation of Specified Adults); Rule 4512.06 (Trusted Contact Person).

*Personal Relationship and Business Relationship Exceptions*

FINRA proposed to narrow the personal relationship exception to apply only to personal relationships that are "bona fide" and "close," and maintained outside of, and formed prior to, the broker-customer relationship. With respect to that exception, NASAA stated that close personal relationships do not confer additional protections from potentially conflicted, exploitive and abusive practices. Malecki stated that the term "bona fide" is vague and ambiguous. Malecki noted that a financial relationship could be both "bona fide" and abusive. Malecki also observed that the focus on personal relationships formed prior to the broker-customer relationship does not capture personal relationships developed after the formation of the broker-customer relationship. In addition, Malecki requested more examples of relationships that would qualify for the close personal relationship and business relationship exceptions.

As stated in the Proposal, FINRA shares some of the concerns regarding the scope of the current personal relationship exception, and therefore proposed to narrow it and provide factors that are relevant to assessing whether a relationship falls within the scope of either the close personal relationship or business relationship exception. FINRA believes that the proposal to limit the personal relationship exception to relationships that are (1) bona fide, (2) close and (3) maintained outside of, and formed prior to, the broker-customer relationship, would reduce the risk that a registered person would concoct a personal relationship with a customer for the purpose of borrowing from or lending to the customer, and it would address concerns that this exception could be exploited.

As Cornell notes, the proposed addition of the term "bona fide" shifts the focus of the analysis to the sincerity, authenticity, and legitimacy of the relationship. Further, the proposed factors for members to consider when evaluating whether a borrowing or lending arrangement is based on a close personal relationship would include when the relationship began, its duration and nature, and any facts suggesting that the relationship is not bona fide or was formed with the purpose of circumventing the purpose of Rule 3240. FINRA believes that a relationship formed for the purpose of taking advantage of a customer, including a senior or vulnerable customer, would not constitute a "bona fide" close personal relationship within the meaning of this exception.

Likewise, FINRA reiterates that relationships formed after the establishment of the broker-customer relationship would not fall within the proposed close personal relationship exception, which would apply to bona fide, close personal relationships maintained outside of and formed prior to the broker-customer relationship. Accordingly, FINRA notes that the scenario posited by NASAA, whereby an older or vulnerable customer loans money to the registered person who had befriended them after

they already formed a broker-customer relationship, would be outside the scope of the proposed close personal relationship exception, and thus, would be prohibited.[20]

With respect to the potential risks commenters have identified, FINRA believes, as explained above, that all the exceptions are tailored to permit arrangements where the likelihood that the registered person and customer entered into the borrowing or lending arrangement by virtue of the broker-customer relationship is reduced and where the potential benefits outweigh related potential risks. And as noted above, Rule 2010 protects investors from unethical behavior and is broad enough to cover a wide range of unethical conduct.

Regarding Malecki's request for more examples of close personal relationships and business relationships, FINRA believes that the examples described in the Proposal and in proposed Supplementary Material .04 add helpful clarity while giving members the flexibility to consider factors relevant to whether these exceptions apply. Regarding the close personal relationship exception, FINRA provided several examples, including a childhood or long-term friend or a godparent. FINRA intends that members may use the factors provided to determine whether a similarly close personal relationship would also fit within that exception. Regarding the business relationship exception, FINRA believes that the example provided in proposed Supplementary Material .04 adds helpful guidance about the meaning of this longstanding exception. FINRA notes that the term "bona fide" emphasizes that such relationships must be legitimate. In addition, FINRA stated in the Proposal that a loan from a customer from whom the registered person purchases non-commercial consumer goods or services, such as hair styling services, would not fit within the business relationship exception. FINRA does not believe further examples are necessary because the applicability of both exceptions ultimately depends on the facts and circumstances; however, if the SEC approves the proposed rule change, to the extent any particular scenario raises questions regarding the application of the rule, FINRA will consider issuing additional guidance on a case-by-case basis, as appropriate.

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[20] FINRA declines Malecki's suggestion that the rule text should make this more explicit, because FINRA believes that proposed Rule 3240 makes clear that the rule is, first and foremost, a general prohibition, and that any borrowing or lending arrangement that does not fit within the exceptions is prohibited.

*Supervision and Disclosure*

As discussed, in response to comments received to Notice 21-43, FINRA proposed in Supplementary Material .06 to require members, upon receiving notice under the rule, to perform a reasonable assessment of the risks and make a reasonable determination of whether to approve the borrowing or lending arrangement, or to approve the broker-customer relationship in the case of pre-existing borrowing or lending arrangements. As explained in the Proposal, FINRA expects that a member's "reasonable assessment" would take into consideration a non-exhaustive list of factors FINRA previously identified in Notice 21-43.

NASAA and Malecki commented that FINRA's expectation that members consider the factors in Notice 21-43 is insufficient. NASAA stated that the principles-based supervision requirements that members have "reasonably designed" policies and procedures "must not be an invitation for firms to establish controls according to their individual risk tolerance." NASAA further commented that "'[r]easonable' is an objective standard and it is incumbent on FINRA to clearly define common-sense boundaries to this concept," and FINRA should "require a minimum amount of disclosure and scope of evaluation, from which the firms can elevate to a higher standard[.]" Specifically, NASAA recommended requiring members to consider the factors in Notice 21-43 and to document (1) the steps the member undertook to assess the risk prior to approving the borrowing or lending arrangement; (2) the steps the member will take to minimize the conflict of interest; (3) how the member communicated to the customer the risk created by the loan agreement and repayment terms so that the customer appreciates the risk; and (4) an outline of the supervisory measures that the member will take. NASAA also reiterated its suggestion that the reasonable assessment and determination process should include an interview (preferably by a compliance officer) with the customer outside the presence of the registered person or, where that is not possible, a requirement that the member verify that the customer benefits from the loan and was not pressured into it. NASAA also reiterated its view that accounts in which there is a borrowing or lending arrangement should be subject to heightened supervision, including review of trades and transactions to ensure that the registered person's recommendations are in the customer's best interest and that, at a minimum, Rule 3240 should require such measures where the customer is elderly or vulnerable.

Likewise, Malecki suggested specific supervisory and disclosure requirements. Specifically, Malecki stated that members should be required to consult with the customer before approving the loan and to collateralize any loans they approve, which Malecki contends would incentivize members to conduct heightened due diligence on the

transaction before approval and to supervise the transaction after approval.[21] In addition, Malecki stated that members should be required to disclose to customers, in writing and on Form CRS, that borrowing and lending arrangements are "presumptively" prohibited under the language of Rule 3240, and to meet with the customer to ensure the customer receives a "full and fair disclosure" of the terms of the arrangement.

While FINRA believes that members could consider incorporating many of the suggested supervisory and disclosure requirements discussed above into their systems for supervising for compliance with Rule 3240 and other applicable securities laws, regulations and rules, FINRA is not adopting those suggestions into the proposed rule change.[22] As stated in the Proposal, the fundamental approach of FINRA's supervision rule is to require members to establish and maintain a system to supervise the activities of each associated person that is "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[23] Likewise, the written supervisory procedures required by FINRA's supervision rule must be "reasonably designed" to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[24] In the Proposal, FINRA highlighted guidance regarding the minimum that should be included in written supervisory procedures, including: (1) the specific identification of the individual(s) responsible for supervision; (2) the supervisory steps and reviews to be taken by the appropriate supervisor; (3) the frequency of such reviews; and (4) how such reviews shall be documented.[25] In light of the applicable requirements, FINRA reiterates that it is not

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21 Cornell also commented that there should be heightened supervision of accounts in which there is a borrowing or lending arrangement, including reviews on trades and transactions in the account.

22 FINRA notes, however, that it disagrees with some of Malecki's specific suggestions. For example, regarding the written disclosures Malecki suggests, it would be inaccurate to inform customers of a "presumption" against borrowing or lending arrangements. As discussed, Rule 3240 is a general prohibition against borrowing and lending arrangements, subject to several narrowly tailored exceptions available only if permitted by a member's written procedures and subject to notice and approval requirements. Regarding Malecki's suggestion that FINRA require a disclosure on Form CRS of the language of Rule 3240, Form CRS is an SEC-required form, the content of which is not for FINRA to dictate.

23 See Rule 3110(a); see also Notice to Members 99-45 (June 1999).

24 See Rule 3110(a)(1) and (b)(1).

25 See Notice to Members 98-96 (December 1998); see also Notice to Members 99-45 (regarding tailoring the supervisory system to the member's business, a member must conduct an analysis to "enable the member to design a supervisory system that is current and appropriately tailored to its specific attributes and

necessary or appropriate to prescribe specific supervisory procedures in Rule 3240.[26] FINRA notes that this approach is aligned with Rule 3241, which addresses similar conflicts of interest concerns. Furthermore, as explained in the Proposal, FINRA's supervision rule includes the longstanding obligation to follow-up on "red flags" indicating problematic activity.[27] This obligation would apply when there are red flags related to borrowing or lending arrangements between registered persons and their customers.

Moreover, FINRA believes that proposed Supplementary Material .06 addresses many of the commenters' concerns. Included in the non-exhaustive list of factors FINRA expects members to consider are, among others:

- any potential conflicts of interest in the registered person being in a borrowing or lending arrangement with a customer;
- 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, based on the facts and circumstances observed in the member'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; and
- any indicia of customer vulnerability or undue influence of the registered person over the customer.

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structure," and should take into consideration, among other things, "experience of personnel, including whether the firm employs persons who should be subject to heightened supervisory procedures due to a history of customer complaints, disciplinary actions, or arbitration proceedings").

26 Notwithstanding NASAA's contention that "it is incumbent on FINRA" to define the boundaries of reasonableness, FINRA rules concerning duties, conflicts and responsibilities related to associated persons generally do not set forth specific supervisory procedures that members must adopt to satisfy the requirements of FINRA's supervision rule. See generally Rule 2000 Series (Duties and Conflicts); Rule 3000 Series (Supervision and Responsibilities Related to Associated Persons).

27 See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41251 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-020) (explaining that Rule 3110 (Supervision) includes the "longstanding obligation to follow-up on 'red flags' indicating problematic activity"); see also Notice to Members 99-45.

With respect to the suggestion that the terms of the arrangement should be discussed with and disclosed to the customer, FINRA reiterates that it expects a member to consider the factors noted, above—several of which pertain to the terms of the arrangement and the nature of the parties—and to try to discuss the arrangement with the customer. FINRA believes that the proposed supplementary material, together with the guidance in Notice 21-43, would help members evaluate the key risks and conflicts while giving members appropriate flexibility in evaluating which factors may apply to a particular situation.

In addition, FINRA reminds members that they may choose to prohibit all borrowing and lending arrangements, allow only some of the exceptions, or impose limitations on the exceptions.

*Definition of "Customer"*

PIABA expressed support for the proposed extension of the rule's limitations to borrowing or lending arrangements entered into within six months after a broker-customer relationship terminates, but commented that the period of time used to define "customer" should be one year instead of six months, as proposed. In support of this view, PIABA noted that Rule 4111 (Restricted Firm Obligations) uses a one-year lookback period.

As stated in the Proposal, the Rule 4111 lookback periods (including, among others, the one-year lookback period that pertains to "Registered Persons In-Scope"[28]) impact how Rule 4111 identifies firms with a significant history of misconduct. FINRA, however, has proposed a six-month period of time to align proposed Rule 3240.02 with the six-month period in the definition of "customer" in Rule 3241, because Rule 3241 addresses similar potential conflicts of interest as Rule 3240. FINRA believes the six-month lookback period in proposed Rule 3240.02—like the six-month lookback period in Rule 3241—strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change and imposing requirements that are reasonable and appropriate, including reasonable requirements on members in tracking transfers of customers' accounts.[29] Further, as stated in the Proposal, FINRA

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28 See Rule 4111(i)(13).

29 As explained in the Proposal, prior to the adoption of Rule 3241, many members "prohibit[ed] or impos[ed] limitations on being named as a beneficiary or to a position of trust when there is not a familial relationship," but FINRA "observed situations where registered representatives tried to circumvent firm policies, such as resigning as a customer's registered representative [and] transferring the customer to another registered representative." See Regulatory Notice 20-38 (October 2020). "To address attempted circumvention of the restrictions (e.g., by closing or transferring a customer's account)," FINRA defined "customer" in Rule 3241 to include "any customer that has, or in the previous six months had, a

observes that there are costs associated with extending the rule's prohibition for some time after the broker-customer relationship is terminated. For example, members would start receiving notice of kinds of arrangements that they are not currently receiving and would be required to evaluate whether to approve the arrangement or a new broker-customer relationship, as applicable. Additionally, members may incur costs associated with monitoring for prohibited borrowing or lending arrangements with every customer who transfers an account away from the members' registered persons. On balance and in light of these operational challenges, FINRA believes the six-month period is appropriate and preferable to a one-year requirement.

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FINRA believes that the foregoing responds to the material issues raised by the commenters to the Proposal. If you have any questions, please contact me at (202) 728-8068, email: ilana.reid@finra.org.

Best regards,

/s/ Ilana Reid

Ilana Reid
Associate General Counsel

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securities account assigned to the registered person at any member firm." Id.; Rule 3241.01. When proposing Rule 3241, FINRA explained that the inclusion of the six-month look-back period "is important in addressing potential conflicts of interest and circumvention of the proposed rule change." See Securities Exchange Act Release No. 89218 (July 2, 2020), 85 FR 41249, 41256 (July 9, 2020) (Notice of Filing of File No. SR-FINRA-2020-020). FINRA further explained, in response to a comment suggesting that the proposed definition of "customer" include a 12-month lookback provision, that it "believes the six-month period strikes an appropriate balance between achieving the regulatory objective of addressing circumvention of the proposed rule change by transferring the customer account to another representative and imposing reasonable requirements on member firms in tracking account transfers." Id.