

FINRA Settlements Focus on Disclosure and Appropriateness in Retail Customer Fully Paid Lending Arrangements

December 12, 2023

On December 6, 2023, the Financial Industry Regulatory Authority, Inc. (FINRA), announced settlements with four broker-dealers relating to their fully paid securities lending products. The settlements originated from a FINRA examination of firms offering fully paid securities lending to retail customers. Without admitting or denying the allegations, the firms agreed to be censured and to pay \$1.6 million in total fines related to supervisory and customer communications violations as well as over \$1 million in restitution to retail customers enrolled in fully paid lending.

According to the letters of acceptance, waiver, and consent (AWCs),¹ the four firms offered retail customers the ability to lend their fully paid or excess margin securities through a program offered by their clearing firm (FPL Program). While the customers who enrolled in the FPL Program signed a master securities loan agreement (MSLA) directly with the clearing firm, and the clearing firm borrowed the securities in accordance with U.S. Securities and Exchange Commission (SEC) Rule 15c3-3(b)(3), each of the four firms was responsible pursuant to the firms' agreements with the clearing firm for setting the criteria for, and determining, which of their customers could participate in the FPL Program (this "appropriateness" determination is required under FINRA Rule 4330, not SEC Rule 15c3-3(b)(3)). The firms also were responsible for providing written disclosures to their customers describing the features and risks of participating in the FPL Program (another requirement under Rule 4330) and for determining the compensation paid to customers in connection with their securities loans.

The four firms required all of their customers to enroll in the FPL Program and sign an MSLA as a condition of opening an account, although the customers were permitted to withdraw from the FPL Program at any time. Additionally, while the written disclosures the firms provided to their customers stated that the customers would receive a portion of the loan fee paid on their securities loans, the AWCs state that the customers did not actually receive *any* money for lending their shares in connection with the FPL Program.

FINRA charged the firms with failing to establish, maintain, and enforce a supervisory system, including written supervisory procedures, reasonably designed to supervise their fully paid securities lending products, in violation of FINRA Rule 3110(a) and (b) (FINRA's primary supervisory rule). In particular, FINRA noted that although the firms agreed to determine which of their customers could participate in the FPL Program, the firms did not establish any criteria for customer participation or take any steps to

make appropriateness determinations prior to enrollment but instead autoenrolled all new customers at account opening. FINRA further noted that while the firms received millions of dollars in revenue from the FPL Program, that revenue was not shared with the customers. Furthermore, FINRA noted that some of the customers that participated in the FPL Program had securities that were lent out over a dividend date and thus received cash payments in lieu of dividends that were taxed at higher rate; the firms were required to pay restitution to compensate these customers. FINRA also charged the firms with failing to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business, in violation of FINRA Rule 2010.

Additionally, FINRA charged the firms with failing to comply with certain content standards applicable to member communications, in violation of FINRA Rule 2210(d)(1)(B)² and Rule 2010. FINRA stated that the MSLA and written disclosures that the firms provided to customers when they were enrolled in the FPL Program — which were created and provided to the firms by their clearing firm — contained false and misleading statements, including misrepresentations regarding the compensation that customers would receive from lending their securities.

Notably, FINRA did not charge the firms with directly violating Rule 4330 or the SEC's customer protection rule, Rule 15c3-3, but instead focused on supervisory, policy and procedure, and communications deficiencies under the aforesaid FINRA rules.

What This Means to You

The charges in these AWCs involve key aspects of broker-dealers' compliance with applicable FINRA Rules in offering fully paid and excess margin securities lending that were highlighted by FINRA in the 2023 Report on FINRA's Examination and Risk Monitoring Program, specifically

- where the firm distributes or makes available communications that promote or recommend revenue sharing programs to retail investors (such as fully paid lending), whether the communications accurately and clearly disclose the terms and conditions of the program, including the portion of fees customers would receive
- where the firm engages in a program that enrolls retail customers, (i) how the firm determines whether the program is appropriate for the customer (particularly if customers are autoenrolled in the program) and (ii) whether the firm accurately discloses the portion of fees generated on loaned shares that the customer would receive³

Firms offering fully paid lending to their customers can expect that FINRA will be focused on

- whether the firm has implemented and maintains a supervisory system, including written supervisory procedures, to evaluate each customer and determine whether fully paid lending is appropriate for that customer before the customer is enrolled (where the firm has autoenroll customers, or presumptively treats all customers as eligible to enroll, FINRA may have additional questions for the firm)⁴
- whether the firm's MSLA, written disclosures,⁵ and other documents and customer communications accurately reflect the terms and conditions of participating in fully paid lending — in particular, the compensation the customer will receive for their securities loans

¹ News Release, FINRA, FINRA Orders Four Firms to Pay \$2.6 Million for Violations Relating to Fully Paid Securities Lending (December 6, 2023), available [here](#).

² Notably, Rule 2210(d)(1)(B) states: “No member may make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication. No member may publish, circulate or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.”

³ FINRA, 2023 Report on FINRA’s Examination and Risk Monitoring Program (January 2023), available [here](#).

⁴ See FINRA Rule 4330(b)(2)(A).

⁵ See FINRA Rule 4330(b)(2)(B).

CONTACTS

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