Securities-Based Lending
By
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In this paper I review the types of lending in which broker-dealers engage, describes how Securities-Based Lending ("SBL") is regulated and marketed, and points out the considerable risk borne by a customer who borrows against his savings. I use the October 2014 Settlement Agreement between the Office of the Commissioner of Financial Institutions for the Commonwealth of Puerto Rico ("OCFI") and UBS Financial Services Incorporated of Puerto Rico ("UBSPR") ("Settlement Agreement") to cite examples of abusive sales practices and supervisory violations related to the recommendation and sale of SBLs.

Introduction

In the current euphoric market environment, with portfolio values soaring and borrowing rates historically low, lending to customers has become "Wall Street's hottest business."[2] However, the proliferation of securities-based lending ("SBLs") is cause for serious concern. While securities-based lending is a low-risk and very profitable business for the broker-dealer, the same cannot be said for the borrower. Broker-dealer lending creates serious conflicts of interest, saddling the customer with risks and potential long-term consequences he or she may not fully understand until the next bear market arrives.

This paper reviews the types of lending in which broker-dealers engage, describes how SBL is regulated and marketed, and points out the considerable risks borne by a customer who borrows against his savings. The October 2014 Settlement Agreement between the Office of the Commissioner of Financial Institutions for the Commonwealth of Puerto Rico ("the OCFI") and UBS Financial Services Incorporated of Puerto Rico ("UBSPR") ("Settlement Agreement") is cited to provide examples of abusive sales practices and supervisory violations related to the recommendation and sale of SBLs.

The securities industry has long targeted the liability side of the customer's balance sheet as an opportunity to cross-sell banking products, increase wallet share, and diversify revenue streams away from cyclical trading commissions. Thanks to aggressive marketing

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[2] Joshua Brown, *The Rise of Rich Man's Subprime,* Fortune.com, December 10, 2014.

by broker-dealers, investors are borrowing against their securities portfolios at a furious pace. At Morgan Stanley, SBLs totaled almost $38 billion at the end of 2014, a 70% increase in just two years.[3] UBS's SBLs increased 54% over the same period. Most of this growth has come from non-purpose lending. Total margin debt, as reported by the New York Stock Exchange, is at an all-time high of $507 billion.[4] With $16 trillion worth of client assets in street name, [5] there is still a lot of potential collateral waiting to be encumbered.

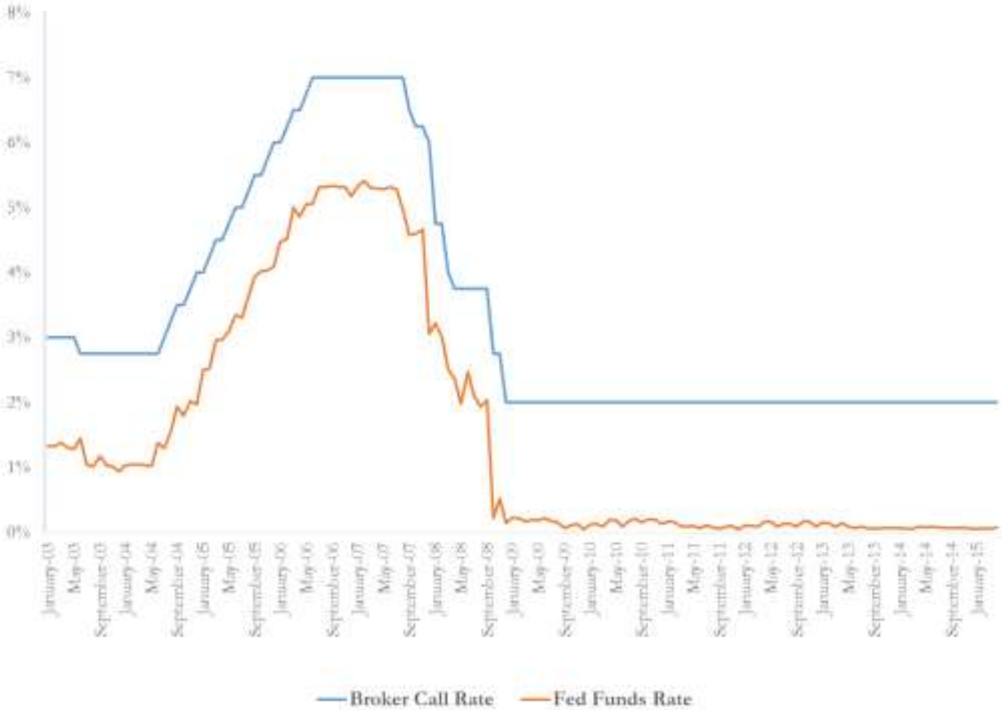
Substantial profit margins in the lending business make SBLs a lucrative product for broker-dealers. Last year alone Morgan Stanley and UBS earned a combined $4 billion in net interest income just by opening their doors for business. Brokers fund much of their operation by borrowing in the overnight repo market, [6] where the Federal Funds Rate has been less than 0.15% for the past two years. See Figure 1. The difference between the Broker Call Rate and the Fed Funds Rate averaged 1.66% in 2003 and has grown to 1.93% in 2014 despite the dramatic decline in interest rates. Most loan customers are charged a variable interest rate pegged to a spread over LIBOR, allowing the broker to charge higher rates if its cost of funds increases.[7] Spreads between the cost of funds and loan rates generally range from 200 basis points (for loans up to $10 million) to 500 basis points (for smaller loans),[8] and the revenue is predictable and recurring.

[3] James P. Gorman, Chairman and Chief Executive Officer, Morgan Stanley, *Strategic Update,* January 20, 2015.
[4] NYSEData.com (April 2015).
[5] Securities Industry and Financial Markets Association ("SIFMA"), *2014 Year In Review.*
[6] Eric S. Rosengren, President & Chief Executive Officer, Federal Reserve Bank of Boston, *Keynote Remarks: Conference on the Risks of Wholesale Funding*, sponsored by the Federal Reserve Banks of Boston and New York (August 13, 2014), "Short-term collateralized loans called repurchase agreements are a major source of funding for [broker-dealers]."

[7] *Putting Stocks in Hock: Securities Are Backing for More Big Loans,* Wall Street Journal, March 4, 2013, "Non-purpose loans, by contrast, can typically be completed in a few days requiring little paperwork beyond a credit report and a financial statement." "Another big benefit: For wealthier investors, interest rates on non-purpose loans can be attractive compared with alternatives. At UBS, for instance, investors borrowing between $1 million and $2.5 million pay 2.95% based on the latest London interbank offered rate. By contrast, the national average rate for a home-equity line of credit is 5.15% and for a 30-year "private" jumbo mortgage it is 4.08%, according to HSH.com, which tracks the data."

[8] James P. Gorman, Chairman and Chief Executive Officer, Morgan Stanley, *Strategic Update,* January 20, 2015, Morgan Stanley currently enjoys a 280 basis point spread between its cost of funds and its interest income. They believe that spread will increase to almost 400 basis points in 2015.

Figure 1: Broker Call Rate and Fed Funds Rate



Regulation of broker-dealer lending

The Securities Exchange Act of 1934, Section 7, gives the Federal Reserve Board overall authority to regulate the extension of credit by broker-dealers. The Federal Reserve implements this authority under its Regulation T, more commonly known as "Reg. T."[9] Reg. T specifies the minimum amount of equity that must be on deposit at the time a security is purchased (the initial margin requirement). Reg. T also identifies acceptable collateral by defining "margin securities"[10] and including certain exempted securities like government or municipal bonds.

In addition to regulation by the Federal Reserve, self-regulatory organizations ("SROs") like the Financial Industry Regulatory Authority and the New York Stock

[9] There are two companion Federal Reserve regulations: Regulation U governs extensions of credit by banks and other non-broker-dealers; Regulation X covers foreign lenders.

[10] Regulation T, §220.2, "Margin security means: (1) Any security registered or having unlisted trading privileges on a national securities exchange; (2) After January 1, 1999, any security listed on the NASDAQ Stock Market; (3) Any non-equity security; (4) Any security issued by either an open-end investment company or unit investment trust which is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); (5) Any foreign margin stock; (6) Any debt security convertible into a margin security,"

Exchange have their own policies regarding the extension of credit to customers.[11] The SROs set maintenance requirements (generally 25% for equities), leaving broker-dealers free to set a higher requirement.

An important restriction on the extension of credit applies to the purchase of new issues. Under Exchange Act Section 11(d)(1), a broker-dealer that is part of an underwriting group may not extend credit for the purpose of buying a new issue for 30 days following the offering. Because open-end mutual funds issue shares in a continuous new offering, this prohibition extends to them, as well. Both margin loans and non-purpose loans are subject to this restriction.

Purpose vs. non-purpose loans

There are two types of SBLs. The more familiar is the margin (or purpose) loan. Margin loans are "credit extended for the purpose of buying, carrying, or trading in securities."[12] Securities in the customer's account serve as collateral. The term "margin" refers to the equity that secures the loan. It is the broker's "margin of safety" should the value of the collateral decline. Broker-dealers are also permitted to extend credit, generally secured by a customer's marketable securities, for purposes other than buying or carrying securities.[13] These loans are known as good faith or non-purpose loans.

Margin loans and non-purpose loans are similar in many ways. The underwriting for either loan gives little or no consideration to the borrower's credit rating, income, or debt ratios. The amount of credit extended primarily is a function of the value of the collateral securities, the liquidity and volatility of those securities, and the extent to which there is any concentration in a single security. Establishing either type of loan involves relatively little documentation compared to other types of lending. Each loan requires a minimum level of equity (loan-to-value) at inception and is subject to calls for additional capital if the value of the collateral falls below a stated minimum. Most SBLs charge

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[11] *See* NYSE Rule 431 and FINRA Rule 4210.

[12] Regulation T, §220.2.

[13] *See*, FINRA Rule 4210(e)(7), "In a nonsecurities credit account, a member may extend and maintain nonpurpose credit to or for any customer without collateral or on any collateral whatever;" "The term 'nonpurpose credit' means an extension of credit other than 'purpose credit' as defined in Section 220.2 of Regulation T;" see also, Regulation T, §220.6.

variable interest rates at a spread pegged to either 30-day LIBOR (in the case of a non-purpose loan) or the broker call rate (in the case of a margin loan). Neither type of loan requires a fixed repayment schedule. Instead, interest is charged monthly and added to the loan balance.

Table 1: Comparison of Margin Loans and Non-purpose Loans

	Margin Loan	**Non-purpose Loan**
Permissible Use of Loan Proceeds	Purchase or carry securities	Any purpose **other than** purchase or carrying securities
Eligible Collateral	Marginable securities	Any collateral acceptable to the lender
Release Rates	50% for equities; up to 95% bonds	Generally higher than for a margin loan
Interest Rate Charged	Variable; priced as a spread to Broker Call Rate; based on amount borrowed	Variable; priced at a spread to 30-day LIBOR; based on qualifying amount
Interest payment terms	Charged monthly; no cash payment required; interest added to loan balance	Charged monthly; no cash payment required; interest added to loan balance
Repayment Terms	May be repaid in whole or in part at any time without penalty	May be repaid in whole or in part at any time without penalty
Call Features	Callable anytime	Callable anytime

In spite of these similarities, non-purpose loans are different from margin loans (and other conventional loans) in important ways. The primary difference is that a non-purpose loan may not be used to purchase or carry securities. Instead, these loans are often recommended to finance real estate transactions, buy automobiles or boats, or fund businesses. Brokers also recommend non-purpose loans to pay taxes,[14] take a vacation, pay for a wedding, even to replace retirement account withdrawals in years when the equity markets are down.[15] Release rates[16] for non-purpose loans are generally higher than for margin loans, allowing the customer to borrow more money against his portfolio. Like a margin loan, most non-purpose loans have variable rates. One important difference,

[14] *See for example* Morgan Stanley, *Tax Payment Strategies: Portfolio Loan Account.*
[15] *See* Investment News, *The hazards of securities-based lending as a source of retirement income,* February 11, 2015, Michael Crook, head of portfolio planning and research, UBS, says an SBL can be used in lieu of cash withdrawals as a source of retirement income.
[16] The release rate is the amount available to borrow, expressed as a percentage of the value of the collateral.

however, is that a non-purpose loan is priced on the client's ability to borrow (his credit limit) rather than on the amount actually borrowed.

SBLs are sometimes cloaked in derivative structures such as variable prepaid forward contracts ("VPF"s). In a VPF, the investor signs a term sheet that embeds the pledge of a concentrated stock position with an option collar (a long put option and a short call option) and a deferred interest loan. The collared securities position is collateral for the loan. A VPF contract can be used to increase the taxable income from a concentrated stock position if the loan proceeds are used to buy bonds. Doing so though commits the investor to ultimately sell the concentrated stock position since the bond portfolio won't be sufficient to repay the embedded loan at the maturity of the VPF.[17]

Aggressive marketing of SBLs

To market these loans, broker-dealers use advertising – disguised as client education – that is often misleading, one-sided, and not fairly balanced with disclosure of the risks associated with SBLs.[18] UBS, for example, extols the wisdom of "borrowing with a vision for your future"[19] and "maximizing the power of your invested assets."[20] Morgan Stanley portrays borrowing as a way to "unlock the value of [the customer's] portfolio."[21] It claims that borrowing "puts the value of [the customer's] assets to work."[22] Merrill

[17] This was the case in In The Matter of the Trust of Carolyn S. Buford in which the Oklahoma District Court in Tulsa, OK ordered JP Morgan Chase Bank to pay the Burford Trust $18,122,644 plus attorneys' fees and punitive damages. The award compensated the Trust for the diminution in value resulting from JP Morgan engaging in a series of variable prepaid forward contracts with the Trust. I testified about the pressures to sell in-house products and services including SBLs without regard for the interests of investors.

[18] *See generally* FINRA Rule 2210(d)(1)(A), Communications with the Public, Content Standards, "All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading;" *see also,* Morgan Stanley publishes a 1600-word brochure, Securities-Based Lending: Portfolio Loan Account, that devotes only eight words to the risk of leverage in a portfolio: "market conditions can magnify any potential for loss;" *see also*, FINRA Regulatory and Examinations Priorities Letter (2015), FINRA "is concerned about how [SBLs] are marketed."

[19] https://onlineservices.ubs.com/OLS/jsp/HomePage.jsp, January 13, 2015.

[20] *Ibid.*

[21] Morgan Stanley, *Securities-Based Lending: Portfolio Loan Account.*

[22] *Ibid.*

Lynch tells clients that borrowing money will “keep [their] investment strategy on track.”[23] After reading these characterizations of borrowing, a customer cannot not be blamed for concluding that he is imprudent if he is not borrowing against his portfolio.

Since adviser behavior is driven by personal financial considerations, broker-dealers offer meaningful incentives to their brokers for recommending SBLs. Morgan Stanley’s compensation plan is typical. The broker earns an annual gross commission of 0.40% to 0.50% of his clients’ loan balances outstanding. Morgan Stanley also pays its Financial Advisors based on growth in the volume of loans made to clients. For example, a broker who recommends $25 million in new loans is paid a cash bonus (deferred for only five years) of over $100,000. At UBS brokers are also paid based on the total value of the loans their clients have taken on. UBS even rewards secretaries suggesting SBLs as an alternative to customers who are calling to withdraw money from their accounts.

Broker-dealers offer these payments despite multiple warnings from regulators that such incentives could be harmful to customers.[24] For example, FINRA has cautioned:

> “margin loans can be very profitable for your brokerage firm. They can also be highly profitable for your broker. Your broker may receive fees based on the amount of your margin loans. This may take the form of a percentage of the interest you pay on an ongoing basis.”[25]

The marketing of SBLs is not limited to full-service firms. Broker-dealers that provide custody and clearing services to registered investment advisers (“RIAs”) have started targeting the assets those RIAs control. Pershing Advisor Solutions has made $1 billion in SBLs in just over a year.[26] Fidelity Investments has increased by 63% the volume of SBLs it has made through the 3,000 RIAs that use its services.[27] RIAs are not

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[23] Merrill Lynch, *LMA account.*
[24] Joint Statement by NYSE and NASD On the Continuing Growth In Investor Margin Debt, February 24, 2000, “Any Account Executive incentive programs that would promote the solicitation of margin accounts should be carefully reviewed and curtailed if appropriate.”
[25] FINRA, *Investing with Borrowed Funds: No “Margin” for Error.*
[26] Mason Braswell, “RIAs join brokers in promoting securities-backed lending,” Investment News, June 11, 2015.
[27] *Ibid.*

compensated directly for recommending SBLs to their clients, but the loans allow the adviser to keep the assets under management and generating fees.

Suitability of SBLs

The importance of performing a diligent suitability analysis before recommending an SBL is highlighted by the Settlement Agreement, part of which involves SBL-related sales practices OCFI observed during its examination of UBSPR. The Settlement Agreement emphasizes some basic tenants of suitability, namely that a recommendation must be consistent with "the customers' financial objectives, risk tolerance, and needs."[28] FINRA's suitability rules lie at the heart of broker regulation[29] and are "critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices."[30] The suitability doctrine places on the broker, not the customer, the responsibility for making appropriate investment choices. Suitability applies both to individual transactions and overall investment strategies[31] and requires that any recommendation, including the recommendation of an SBL,[32] be consistent with the interests of the customer.[33] Even if a customer wishes to take out an SBL, the broker may not make that recommendation if the loan would not be suitable.

Margin loans and non-purpose loans have investment implications that subject

[28] Settlement Agreement, pp. 1-2; the Settlement Agreement also points out that concentration in a single security or group of similar securities is not suitable.
[29] "Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment;" *see also,* FINRA Rules 2090, "Every member shall use diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer;" *see also*, U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers,* January 2011 ("Dodd-Frank Study"), p. iv, "An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of the customer."
[30] FINRA Regulatory Notice 11-02, *Know Your Customer and Suitability.*
[31] The concept of investment strategy "is to be interpreted broadly," FINRA Rule 2111, Supplementary Material.
[32] Office of the Comptroller of the Currency, *Comptroller's Handbook, Retail Non-deposit Investment Products,* January 2015, "Margin credit, however, is not suitable for all clients due to the associated risks and requirements with having margin in an account."
[33] See, for example, FINRA 2015 Regulatory and Exam Priorities Letter, "A central failing FINRA has observed is firms not putting customers' interests first. This principle should be observed whether the firm "must meet a suitability or fiduciary standard."

them to the suitability rules. First, margin leverage increases a portfolio's risks.[34] Consider a simple example. Two investors each invest $100,000. Each invests $100,000 but the second investor borrows $100,000 and buys $200,000 worth of stock and holds. Both hold the investment for one year.

At the end of a year the stock has increased 25%. The cash buyer has an increase in equity of $25,000 to $125,000 while the margin buyer's equity is up $45,000 or 45% (after paying margin interest). However, if the value of the stock declines 25%, the cash investor has suffered a loss of $25,000 while the margin buyer's equity has declined $55,000 or 55%. Leverage magnifies the gross gains and losses and then lowers the gross gain or loss by the interest costs.

[34] Joint Statement By NYSE and NASD On the Continuing Growth In Investor Margin Debt, Feb 24, 2000, "However, the increasing use of margin borrowings is not without risk. In the event of a severe market contraction, some investors may not be in a position to sustain the leveraging and will be required to liquidate their positions under unfavorable market conditions;" Sales managers and account executives should be advised of the appropriate steps to be taken when and if individual investors significantly change their levels of margin borrowings;" *see also,* in re Stephen Thorlief Rangen, Securities Exchange Act of 1934 Rel. No. 38486 (April 8, 1997), "Furthermore, Rangen's use of margin in these accounts was inappropriate. Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently, giving rise to a margin call in the account. Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain. At the same time, using margin permitted the customers to purchase greater amounts of securities, thereby generating increased commissions for Rangen. We consider, under the circumstances, that the extent to which Rangen used margin to effect transactions in the accounts was unsuitably risky for customers with the level of experience and the stated investment objectives of these customers."

Table 2: The Arithmetic of Margin

Initial Positions

	Cash Investor	**Margin Investor**
Equity Invested	100,000	100,000
Total Purchase Price	100,000	200,000
Amount Borrowed	0	-100,000

Stock Goes Up 25%

Gross Sales Proceeds	125,000	250,000
Margin Balance	-	-105,000
Net Proceeds	125,000	245,000
% Increase in Equity	25%	45%

Stock Goes Down 25%

Gross Sales Proceeds	75,000	150,000
Margin Balance	-	-105,000
Net Proceeds	75,000	45,000
% Decrease in Equity	-25%	-55%

SBLs must be considered part of an investment strategy and subject to FINRA Rules 2090 and 2111. Money market funds are never bought on margin because the value of the asset (the money market fund) will equal the value of the debt (the margin loan), but investors pay a higher interest on the loan than they expect receive from the fund. Similarly, retail accounts do not hold leveraged portfolios of short term treasury securities. Investing with borrowed funds only makes sense if the expected returns net of the borrowing costs are sufficient to warrant the risks of the additional investments. For low risk, low return investments, SBLs give investors certain but negative returns. For higher risk, higher return investments, SBLs give investors small positive expected returns but expose them to substantial losses.

Central to the overwhelming case for diversification is the observation that competition among investors bids up the prices of securities so that the expected returns to portfolios of stocks and bonds exceed the risk free rate of interest by just enough to compensate for the risks of those portfolios. The expected return to making additional investments on margin, for investors who pay more than the risk free rate to buy securities, is therefore less than what the market requires for bearing those risks. For example, with risk free rates around 2% and the equity risk premium about 6%, if an investor borrows at 5% the expected net return is only 3% (2% + 6% - 5%) for bearing risk investors in the aggregate demand 6% net returns.

As the above examples illustrate, whenever securities are purchased with borrowed funds it is critical that the borrowing costs be minimized. Given the secondary market availability of closed-end funds which borrow at extremely low rates to leverage a broad range of security types any SBL that charges meaningful spreads above LIBOR should receive strict scrutiny.

Leverage and borrowing costs are not the only suitability considerations associated with SBLs. Unlike home mortgages or car loans, which require the borrower to make a monthly payment, most SBLs simply add each month's interest charge to the loan balance, thus compounding the interest expense.[35] In addition to the financial risks, SBL borrowers have no protection from actions taken by broker-dealers to preserve their collateral. Loan accounts are susceptible to forced liquidation at unfavorable prices because, as the value of the securities declines, the borrower must either deposit additional collateral (which he often does not have) or sell multiples of the amount of his margin call.[36] Furthermore, the broker can effect these sales without contacting or seeking the permission of the borrower.[37] The broker can even choose unilaterally which securities it wishes to sell. A customer with no means of meeting margin calls other than by selling the collateral is generally not suitable for an SBL.

Adherence to the suitability rule calls for the broker to exercise "reasonable diligence"[38] in obtaining enough information about his client to make a suitable recommendation. When recommending an SBL, the broker must consider virtually all aspects of the client's financial condition: income, which would determine ability to service

[35] Merrill Lynch calls this feature "flexible repayment options," Merrill Lynch, *Loan Management Account*.
[36] *See* FINRA, *Investing with Borrowed Funds: No "Margin" for Error*, "Investors who cannot satisfy margin calls can have large portions of their accounts liquidated under unfavorable market conditions. These liquidations can create substantial losses for investors."
[37] *See generally* FINRA Margin Disclosure Statement.
[38] FINRA Rule 2111.

the debt; other assets, liquid and illiquid; other debt outstanding; and the client's ability (and willingness) to tolerate the risks of an SBL.

Once the broker has all of the client's pertinent financial information, several questions should be considered before recommending an SBL:

- How much debt (from all sources) does the client currently carry?
- Will this loan create more debt than is justified by the client's financial circumstances?
- What are the client's liquid assets, apart from the collateral securities? Does the client have sufficient liquidity to meet margin calls?
- Is the additional risk created by the financial leverage suitable for the client?
- Does the client understand <u>all</u> the risks of an SBL?
- To what purpose is the loan being applied? Will the client have a means of repaying the loan?
- Are asset sales a better alternative?

Non-purpose loans, by definition, are not invested in liquid securities. In fact, many non-purpose loans are not used to purchase assets of any kind; the funds are simply consumed by taxes, vacation costs, or similar consumption expenditures. This situation raises a major red flag for the recommending broker because it suggests the customer does not have the capacity to meet margin calls other than by liquidating the collateral securities. In those circumstances the broker would have a difficult time justifying as suitable the recommendation of a non-purpose loan because the borrower's "financial ability to meet such a commitment"[39] is in doubt.

The risks of SBL lending have not escaped the notice of regulators. In its 2015 Annual Regulatory and Examination Priorities Letter, FINRA includes securities-based loans as a priority. FINRA Chairman and CEO, Richard Ketchum, has said that the risks associated with SBLs are "exactly the risk[s] we are focused on."[40] "Banks are pushing their wealth management divisions to get their clients to take out more of the loans against

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[39] Rule 2111.06.

[40] Matthias Rieker, *"Finra to Examine Brokers' Securities-Backed Lending Practices – Update,"* January 6, 2015, Dow Jones News Service.

their growing portfolios, rather than investors selling their securities to raise cash."[41]

Disclosure, misrepresentation, and omission of material facts

Securities laws and regulations are built on a foundation of full and honest disclosure. Broker-dealers are required to provide clients with such disclosures regarding any recommendation.[42] The necessity of full disclosure is also highlighted in the Settlement Agreement. After interviewing customers of UBSPR, the Commission concluded, "certain purchases [made by those customers] may have been induced by misrepresentations or omissions of material facts."[43] Brokers must also disclose "material adverse facts"[44] about the products they recommend. Disclaimers alone, however, do not discharge suitability obligations. "A member cannot avoid or discharge its suitability obligation through a disclaimer where the particular communication reasonably would be viewed as a 'recommendation' given its content, context, and presentation."[45]

The suitability doctrine goes beyond mere disclosure by requiring the broker-dealer to make reasonable efforts to ensure that the customer fully understands the main characteristics of the recommendation, especially its risks.[46] This principle is clearly stated in a 2003 SEC Initial Decision Release:

> **NASD Rule 2860 requires that a registered representative make sure that the client has not only read the disclosure documents for an investment, but also that he understood them**. It is a deviation from industry standard to do otherwise. Thus, it is not enough just to provide a copy of prospectus to the customer. While the customer has an obligation to read disclosure documents provided by the registered representative, his failure to do so does not relieve the registered representative from his duty as a licensed individual. **The registered representative cannot simply assume that because the customer has signed a form, he actually read**

[41] *Ibid.*
[42] *See* Exchange Act Rules 10b-16 and 15c2-5; FINRA Rule 2264; Notice to Members 01-31, *Margin Disclosure.*
[43] Settlement Agreement.
[44] In re Richmark Capital Corp., Exchange Act Release No. 48758 (November 7, 2003), "When a securities dealer recommends a stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware."
[45] Notice To Members 01-23, *Online Suitability*; *see also*, Dodd-Frank Study, p. 50, "A broker-dealer's obligations to meet minimum business conduct requirements cannot be satisfied through disclosure to the customer: in other words, a customer cannot waive or contract away these obligations.
[46] In re James B. Chase, Securities Exchange Act of 1934, Rel. No. 47476, March 10, 2003, citing, Patrick G. Keel, 51 S.E.C. 282, 284 (1993), A registered representative must "be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks," see also, Notice to Members 99-33, "disclosures help to ensure that the customer understands the terms and conditions of the margin loan."

> **and understood it.** Instead, the registered representative must satisfy himself by communicating with the customer [emphasis added].[47]

Supervision of securities-based lending

Effective supervision of broker-dealer sales practices is a "cornerstone of self-regulation"[48] and an essential component of the regulatory mandate to protect investors from unethical sales practices. The Settlement Agreement demonstrates the seriousness of this obligation. The OCFI uncovered major problems with the way UBSPR was supervising the sale SBLs, in terms of both unsuitability and the misuse of loan proceeds. Their conclusions are summarized in an October 9, 2014 press release:

> After analyzing the data collected, OCFI became aware . . . that UBS may have permitted or recommended such clients the use of "Non-purpose" loans for the purchase of additional PRCEF, an ineligible activity for "non-purpose" loans.

Where the supervision of the sale of SBLs is concerned, the broker-dealer is required to have in place policies and procedures to ensure such loans are suitable for the clients to whom they are being recommended. Firms must also take great care to be sure that the proceeds of non-purpose loans are not being used to buy or carry securities.

Conflicts of interest

Securities-based lending presents some of the most serious conflicts of interest in the broker/client relationship. It puts brokers and RIAs, who are supposed to be investment professionals, in the position of recommending an action that often is detrimental to their clients' long-term goals of wealth preservation and capital growth. Almost two-thirds of American households headed by someone age 55 or older are already in debt.[49] Debt is a drag on net worth and a lien on future income. Debt inhibits the client's ability to accumulate retirement savings. Reducing debt, on the other hand, increases net worth and improves cash flow.

FINRA Regulatory Notice 11-02 makes the common sense observation that

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[47] In re Dale E. Frey, et al., SEC Initial Decision Release No. 221 (February 5, 2003).
[48] Notice to Members 98-96, *NASD Elaborates On Member Firms' Supervision Responsibilities For Trade Reporting And Market-Making Activities*.
[49] Craig Copeland, Ph.D., *Debt of the Elderly and Near Elderly, 1992-2013*, Employee Benefit Research Institute.

"customers may rely on firms' and firms' associated persons investment expertise and knowledge."[50] A responsible and knowledgeable adviser should be counseling clients to reduce the amount of debt they carry, not increase it. However, brokers and RIAs often will recommend securities-based loans as a way to keep their client's assets in house, generating management fees, commissions, and asset-based bonuses.[51]

Conclusion

Each bull market develops its own excesses, thus planting the seeds for the next correction. Or, to paraphrase Warren Buffett, you do not know who is skinny dipping until they drain the pool. Investors with already illiquid balance sheets are flocking to SBLs today in unprecedented numbers, due in no small part to the aggressive marketing of SBLs and the attractive financial incentives offered to brokers who recommend them. One way or another, however, these loans will eventually come due. For too many borrowers that due date will come near the bottom of the next bear market. These customers will be the last ones out, and the effects will be financially devastating.

[50] Regulatory Notice 11-02, *Know Your Customer and Suitability*.
[51] *See* FINRA, *Stock-Based Loan Programs: What Investors Need to Know*, "Be aware of the possibility that a broker or other financial professional might recommend a stock-based loan program to generate commissions on the new products you purchase with the loan proceeds."