

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64892; File No. SR-FINRA-2011-034)

July 14, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Amend FINRA Rule 4240 (Margin Requirements for Credit Default Swaps)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 11, 2011, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I and II, below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposed rule change on an accelerated basis.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to extend to January 17, 2012 the implementation of FINRA Rule 4240 (Margin Requirements for Credit Default Swaps) on an interim pilot program basis and to make other revisions to update the rule. FINRA Rule 4240, as approved by the SEC on May 22, 2009, and as extended by FINRA on November 22, 2010, will expire on July 16, 2011. The rule implements an interim pilot program with respect to margin requirements for certain transactions in credit default swaps.

The text of the proposed rule change is set forth below. Proposed new language is underlined; proposed deletions are in brackets.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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4000. FINANCIAL AND OPERATIONAL RULES

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4200. MARGIN

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4240. Margin Requirements for Credit Default Swaps

(a) Effective Period of Interim Pilot Program

This Rule establishes an interim pilot program (“Interim Pilot Program”) with respect to margin requirements for any transactions in credit default swaps executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions (“matching transactions”) are effected by the member in contracts that are cleared through [the central counterparty clearing services of the Chicago Mercantile Exchange (“CME”)] a clearing agency or derivatives clearing organization that provides central counterparty clearing services using a margin methodology approved by FINRA as announced in a Regulatory Notice (“approved margin methodology”). The Interim Pilot Program shall automatically expire on [July 16, 2011] January 17, 2012. For purposes of this Rule, the term “credit default swap” (“CDS”) shall [mean any “eligible credit default swap” as defined in Securities Act Rule 239T(d), as well as any other CDS that would otherwise meet such definition but for being subject to individual negotiation,] include any product that is commonly known to the trade as a credit default swap and is a swap or security-based swap as defined pursuant to Section 1a(47) of the Commodity Exchange Act and Section 3(a)(68) of the Exchange Act, respectively, or the joint rules and guidance of the CFTC and the SEC and their staff. [and t]The term “transaction” shall include any ongoing CDS position.

(b) Central Counterparty Clearing Arrangements

Any member, prior to establishing any clearing arrangement with respect to CDS transactions that makes use of any central counterparty clearing services provided by any clearing agency or derivatives clearing organization [, pursuant to Securities Act Rule 239T(a)(1),] must notify FINRA in advance in writing, in such manner as may be specified by FINRA in a Regulatory Notice.

(c) Margin Requirements

(1) CDS Cleared [on the Chicago Mercantile Exchange] Through a Clearing Agency or Derivatives Clearing Organization Using an Approved Margin Methodology

Members shall require as a minimum for computing customer or broker-dealer margin, with respect to any customer or broker-dealer transaction in CDS with a member in which the member executes a matching transaction that makes use of the central counterparty clearing facilities of [the CME (“CME matching customer-side transaction”)] a clearing agency or derivatives clearing organization using an approved margin methodology pursuant to this Rule, the applicable margin pursuant to [CME rules (sometimes referred to in such rules as a “performance bond”)] the rules of such clearing agency or derivatives clearing organization regardless of the type of account in which the transaction in CDS is booked. Members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether the applicable [CME] clearing agency or derivatives clearing organization requirements are adequate with respect to their customer and broker-dealer accounts and the positions in those accounts and, where appropriate, increase such margin in excess of such minimum

margin. For this purpose, members are permitted to use the margin requirements set forth in Supplementary Material .01 of this Rule.

The aggregate amount of margin the member collects from customers and broker-dealers for transactions in CDS must equal or exceed the aggregate amount of margin the member is required to post at [CME] the clearing agency or derivatives clearing organization with respect to those customer and broker-dealer transactions.

[CME matching customer-side t] Transactions that are cleared through a clearing agency or derivatives clearing organization using an approved margin methodology pursuant to this Rule are not subject to the provisions of paragraph (c)(2) of this Rule.

(2) CDS That Are Cleared on Central Counterparty Clearing Facilities That Do Not Use an Approved Margin Methodology [Other Than the CME] or That Settle Over-the-Counter (“OTC”)

Members shall require, with respect to any transaction in CDS that makes use of central counterparty clearing facilities [other than the CME] that do not use an approved margin methodology pursuant to this Rule or that settle OTC, the applicable minimum margin as set forth in Supplementary Material .01 of this Rule regardless of the type of account in which the transaction in CDS is booked. However, members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether such margin is adequate with respect to their customer and broker-dealer accounts and, where appropriate, increase such requirements.

(d) through (e) No Change.

••• Supplementary Material: -----

.01 No Change.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

On May 22, 2009, the Commission approved FINRA Rule 4240,³ which implements an interim pilot program (the “Interim Pilot Program”) with respect to margin requirements for certain transactions in credit default swaps (“CDS”). On November 22, 2010, FINRA extended the implementation of Rule 4240 to July 16, 2011.⁴

As explained in the Approval Order,⁵ FINRA Rule 4240, coterminous with certain Commission actions,⁶ is intended to address concerns arising from systemic risk posed by CDS,

³ See Securities Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Notice of Approval of Proposed Rule Change; File No. SR-FINRA-2009-012) (“Approval Order”).

⁴ See Securities Exchange Act Release No. 63391 (November 30, 2010), 75 FR 75718 (December 6, 2010) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2010-063).

⁵ See 74 FR 25588 through 25589.

⁶ In early 2009 the Commission enacted interim final temporary rules (the “interim final temporary rules”) providing enumerated exemptions under the federal securities laws for certain CDS to facilitate the operation of one or more central clearing counterparties in such CDS. See Securities Act Release No. 8999 (January 14, 2009), 74 FR 3967

including, among other things, risks to the financial system arising from the lack of a central clearing counterparty to clear and settle CDS. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),⁷ Title VII of which established a comprehensive new regulatory framework for swaps and security-based swaps, including certain CDS. The new legislation was intended among other things to enhance the authority of regulators to implement new rules designed to reduce risk, increase transparency, and promote market integrity with respect to such products.

FINRA believes it is appropriate to extend the Interim Pilot Program for a limited period, to January 17, 2012, pending the final implementation of new Commodity Futures Trading Commission (“CFTC”) and SEC rules pursuant to Title VII of the Dodd-Frank Act that would provide greater regulatory clarity as to margin requirements for the products addressed by FINRA Rule 4240.

FINRA has revised the definition of “CDS” set forth in paragraph (a) of the Rule to reflect the effectiveness of the definitions of “swap” and “security-based swap” in Section 1a(47)

(January 22, 2009) (Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps); Securities Act Release No. 9063 (September 14, 2009), 74 FR 47719 (September 17, 2009) (Extension of Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps); Securities Act Release No. 9158 (November 19, 2010), 75 FR 72660 (November 26, 2010) (Extension of Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps). See also Securities Exchange Act Release No. 59578 (March 13, 2009), 74 FR 11781 (March 19, 2009) (Order Granting Temporary Exemptions in Connection with Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C. Related to Central Clearing of Credit Default Swaps); Securities Exchange Act Release No. 59165 (December 24, 2008), 74 FR 133 (January 2, 2009) (Order Granting Temporary Exemptions for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps).

⁷ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

of the Commodity Exchange Act⁸ and Section 3(a)(68) of the Act,⁹ respectively, pursuant to the Dodd-Frank Act.

FINRA has revised FINRA Rule 4240(a) to clarify that the Interim Pilot Program applies with respect to margin requirements for any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions (“matching transactions”) are effected by the member in contracts that are cleared through a clearing agency or derivatives clearing organization that provides central counterparty clearing services using a margin methodology approved by FINRA as announced in a Regulatory Notice (“approved margin methodology”). FINRA believes that this serves the interest of regulatory efficiency and is consistent with the goals set forth in the Approval Order, which noted that FINRA would consider margin methodology proposals from central clearing counterparties and would amend Rule 4240 as appropriate.¹⁰

FINRA has requested the Commission to find good cause pursuant to Section 19(b)(2) of the Act¹¹ for approving the proposed rule change prior to the 30th day after its publication in the Federal Register, such that FINRA can prevent FINRA Rule 4240 from lapsing and implement the proposed rule change on July 16, 2011. The proposed rule change will expire on January 17, 2012.

⁸ 7 U.S.C. 1a(47).

⁹ 15 U.S.C. 78c(a)(68).

¹⁰ See 74 FR 25589. FINRA has made conforming revisions to paragraphs (b), (c)(1) and (c)(2) of the Rule. See Exhibit 5.

¹¹ 15 U.S.C. 78s(b)(2).

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹² which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will further the purposes of the Act because, consistent with the goals set forth by the Commission when it adopted the interim final temporary rules with respect to the operation of central counterparties to clear and settle CDS, and pending the final implementation of new CFTC and SEC rules pursuant to Title VII of the Dodd-Frank Act, the margin requirements set forth by the proposed rule change will help to stabilize the financial markets.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments were neither solicited nor received.

III. Commission's Findings and Order Granting Accelerated Approval of a Proposed Rule Change

FINRA has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act for approving the proposed rule change prior to the 30th day after publication in the Federal Register.¹³ The Commission finds good cause for approving the proposed rule change

¹² 15 U.S.C. 78o-3(b)(6).

¹³ 15 U.S.C. 78s(b)(2).

prior to the 30th day after the date of publication of notice of filing. The accelerated approval will, consistent with the goals set forth by the Commission when it adopted the interim final temporary rules with respect to the operation of central counterparties to clear and settle CDS, and pending the final implementation of new CFTC and SEC rules pursuant to Title VII of the Dodd-Frank Act, help to stabilize the financial markets by setting forth margin requirements for certain transactions in CDS. The Commission believes the proposed revisions to paragraph (a) of FINRA Rule 4240 are consistent with the goals set forth in the Approval Order, which noted that FINRA would consider margin methodology proposals from central clearing counterparties and would amend Rule 4240 as appropriate.¹⁴

In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act, which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.¹⁵ This allows the existing pilot program to continue without interruption and extend the benefits of a pilot program that the Commission has previously approved and extended.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

¹⁴ See Section II.A.1. of this release.

¹⁵ In approving this rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2011-034 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2011-034. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-FINRA-2011-034 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶

Cathy H. Ahn
Deputy Secretary

¹⁶ 17 CFR 200.30-3(a)(12).