

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69089; File No. SR-FINRA-2013-017)

March 8, 2013

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 8, 2013, 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 substantially have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to approve 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 amend FINRA Rule 4240 to permit a member to require, with respect to credit default swaps that are security-based swaps (“CDS”) held in an account subject to an approved portfolio margining program, the amount of margin determined by the member’s portfolio margin methodology, subject to specified requirements. In addition, the proposed rule change makes other revisions to FINRA Rule 4240 to clarify and update the rule.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

The text of the proposed rule change is available on FINRA's website at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

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 V 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

Portfolio Margining

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") into law.<sup>3</sup> Title VII of the Dodd-Frank Act ("Title VII") establishes a regulatory regime applicable to the over-the-counter derivatives markets. Title VII provides the SEC and the CFTC with tools to oversee these markets.<sup>4</sup> Under the comprehensive framework established in Title VII, the SEC is given regulatory authority over security-based swaps, and the CFTC is given

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<sup>3</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> Subtitle A of Title VII creates and relates to the regulatory regime for swaps, while Subtitle B of Title VII creates and relates to the regulatory regime for security-based swaps.

regulatory authority over swaps.<sup>5</sup> The Dodd-Frank Act contemplates certain self-regulatory organization responsibilities in this area as well.<sup>6</sup> Section 713(a) of the Dodd-Frank Act amended the Exchange Act to generally permit a broker-dealer that is also registered as a futures commission merchant (“FCM”) under the CEA to hold cash and securities in a portfolio margining account that is carried as a futures account, pursuant to a portfolio margining program that is approved by the CFTC. Reciprocally, Section 713(b) of the Dodd-Frank Act amended the CEA to generally permit an FCM that is also registered as a broker-dealer to hold futures contracts and options on futures contracts (as well as money, securities or other property received from a customer to margin, guarantee or secure such contracts, or accruing to a customer as a result of such contracts) in a portfolio margining account that is carried as a securities account pursuant to a portfolio margining program that is approved by the SEC.

The SEC and the CFTC have recently acted to grant specific exemptions to facilitate portfolio margining of swaps and security-based swaps.<sup>7</sup> To help facilitate

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<sup>5</sup> See Section 3(a)(68) of the Exchange Act, 15 U.S.C. § 78c(a)(68) (as added by Section 761(a)(6) of the Dodd-Frank Act) and Section 1a(47) of the Commodity Exchange Act (“CEA”), 7 U.S.C. § 1a(47) (as added by Section 721(a) of the Dodd-Frank Act) for the definitions of security-based swap and swap, respectively. See also Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48207 (August 13, 2012) (Joint Final Rule with the CFTC: Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Agreement Recordkeeping), further defining the terms swap and security-based swap.

<sup>6</sup> See, e.g., Sections 712 and 763 of the Dodd-Frank Act.

<sup>7</sup> See Exchange Act Release No. 68433 (Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps) (December 14, 2012), 77 FR 75211 (Dec. 19, 2012); see also CFTC Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps (January

portfolio margining pursuant to this regulatory relief, FINRA proposes to amend FINRA Rule 4240, which implements an interim pilot program (the “Interim Pilot Program”) with respect to margin requirements for certain transactions in CDS.<sup>8</sup> Specifically, proposed new FINRA Rule 4240(c)(3) provides that, in lieu of the requirements set forth in paragraphs (c)(1) and (c)(2) of the rule,<sup>9</sup> a member may require, with respect to CDS held in an account subject to an approved portfolio margining program, the amount of margin determined by the member’s portfolio margin methodology, provided that, prior to margining CDS on a portfolio margin basis, the member shall notify FINRA in advance in writing of its intent to operate under the portfolio margin program.

Additional Amendments to FINRA Rule 4240

FINRA proposes to amend the margin requirements set forth in paragraph (c)(2) and Supplementary Material .01<sup>10</sup> of FINRA Rule 4240 to clarify that, in addition to requiring the applicable minimum margin (“initial margin”), a member must collect daily from each customer or broker-dealer counterparty an amount at least equal to the

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14, 2013) available at:  
<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf>.

<sup>8</sup> On July 13, 2012, FINRA extended the implementation of the Interim Pilot Program to July 17, 2013. See Exchange Act Release No. 67449 (July 17, 2012), 77 FR 43128 (July 23, 2012) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2012-035).

<sup>9</sup> FINRA Rule 4240(c)(1) addresses transactions in CDS that make use of the central counterparty clearing facilities of a clearing agency using a margin methodology the use of which has been approved by FINRA as announced in a Regulatory Notice. FINRA Rule 4240(c)(2) addresses transactions making use of facilities that do not use such a methodology, or that settle over-the-counter.

<sup>10</sup> Supplementary Material .01 of FINRA Rule 4240 sets forth the rule’s specific margin requirements.

member's current exposure, as defined in Exchange Act Rule 15c3-1e(c)(4) (provided, however, that members not otherwise subject to Exchange Act Rule 15c3-1e are not required to take into account paragraph (c)(4)(v)(G) of such Rule),<sup>11</sup> arising from the daily mark to market of the CDS ("variation margin"). FINRA notes that collection of variation margin has been implicitly required by the administration of Rule 4240; the amendments would be designed to make this variation margin requirement clear.

FINRA proposes to amend the reference to "largest maximum possible loss" in paragraph (d)(8) of the rule by adding the phrase "(that is, the notional amount of the CDS less the estimated recovery given default)." FINRA believes that the proposed language, by providing members a reference point for computing the largest maximum possible loss pursuant to the rule, lessens the potential burdens from higher capital charges that could result absent the proposed language.

FINRA proposes to clarify the first sentence of paragraph (a) of the rule and the first sentence of paragraph (c)(1) by removing the references to "matching transactions" and making other conforming edits so as to streamline the rule language. Also in the first

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<sup>11</sup> FINRA is similarly revising the reference to Exchange Act Rule 15c3-1e(c)(4) in paragraph (e) of Rule 4240. Specifically, as revised, the reference would read "SEA Rule 15c3-1e(c)(4) (provided, however, that members not otherwise subject to SEA Rule 15c3-1e are not required to take into account paragraph (c)(4)(v)(G) of such Rule)." Under Exchange Act Rule 15c3-1e(c)(4)(v)(G), a broker-dealer, when calculating maximum potential exposure and current exposure to a counterparty, is permitted to take into account the fair market value of collateral pledged and held provided, in part, that the Commission has approved the broker's or dealer's use of a VaR model to calculate deductions for market risk for the type of collateral in accordance with Exchange Act Rule 15c3-1e. FINRA believes that the proposed rule change is a useful clarification for members that do not operate pursuant to Exchange Act Rule 15c3-1e other than, for purposes of Rule 4240, to utilize the specified definitions under Exchange Act Rule 15c3-1e(c)(4).

sentence of paragraph (a), FINRA proposes to amend the phrase “transactions in [CDS] executed by a member” to read “transactions in [CDS] held in an account at a member” so as to clarify the rule’s scope and conform with the remainder of the rule.

Finally, FINRA proposes to amend paragraphs (c)(2) and (e)<sup>12</sup> and Supplementary Material .01 of Rule 4240 by adding the phrase “Unless otherwise permitted by FINRA in writing.” FINRA anticipates that members may need more flexibility to prepare for and respond to regulatory requirements pursuant to the Dodd-Frank Act in connection with CDS. Accordingly, FINRA believes that this language will make the rule’s administration more flexible and efficient, and facilitate the transition to such new requirements, by enabling FINRA staff to, for example, permit members, where appropriate, to take capital charges in lieu of collecting the margin required by the rule.

The proposed rule change will become effective upon approval by the SEC. FINRA has requested the Commission to find good cause pursuant to Section 19(b)(2) of the Act<sup>13</sup> for approving the proposed rule change prior to the 30<sup>th</sup> day after its publication in the Federal Register.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>26</sup> 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

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<sup>12</sup> FINRA Rule 4240(e) addresses requirements with respect to concentrations.

<sup>13</sup> 15 U.S.C. 78s(b)(2).

<sup>26</sup> 15 U.S.C. 78q-3(b)(6).

interest. FINRA believes that the proposed rule change will further the purposes of the Act by permitting a member to require, with respect to CDS held in an account subject to an approved portfolio margining program, the amount of margin determined by the member's portfolio margin methodology, subject to specified requirements. The proposed rule change will clarify and update provisions of FINRA Rule 4240 with respect to margin requirements for CDS. These changes will facilitate members' compliance with the Act and help to stabilize the financial markets by requiring margin commensurate to the risks of the portfolio.

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. FINRA believes that the proposed rule change with respect to FINRA Rule 4240(c)(3) would reduce burdens on all members with customers using margin on multiple products by permitting a member to require, with respect to CDS held in an account subject to an approved portfolio margining program, the amount of margin determined by the member's portfolio margin methodology, subject to specified requirements. With respect to the additional proposed amendments to FINRA Rule 4240, FINRA believes the proposed rule change will, by streamlining and clarifying the rule, facilitate the rule's orderly administration, thereby reducing burdens on members.

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

After careful consideration of the proposed rule change, the Commission finds that the proposed rule change is consistent with the requirements of the Act.<sup>27</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act, which requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission finds that the proposed rule change will further the purposes of the Exchange Act by permitting a FINRA member to require from a CDS customer, with respect to CDS held in an account subject to an approved portfolio margining program, the amount of margin determined by the member's portfolio margin methodology, subject to specified requirements. More specifically, the proposed rule change will facilitate portfolio margining treatment for customer-related positions in cleared CDS that are security-based swaps for FINRA member firms under an approved portfolio margining program. Currently, the only portfolio margining program approved by the Commission, under which FINRA member firms may operate, is the program established by the conditional exemptive relief granted by the Commission, on December 14, 2012.<sup>28</sup> The Commission's Order provides for conditional exemptive relief from certain

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<sup>27</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>28</sup> See supra note 7.

provisions of the Exchange Act to allow any dually-registered clearing agency/derivatives clearing organization and its members that are broker-dealer/FCMs to, among other things, (1) hold customer assets used to margin, secure, or guarantee customer positions consisting of cleared CDS, which include both swaps and security-based swaps, in a commingled customer account subject to Section 4d(f) of the CEA; and (2) calculate margin for this commingled customer account on a portfolio margin basis. Absent such relief, CDS that are swaps would be required to be held in a Section 4d(f) account under the CEA, while CDS that are security-based swaps would be required to be held separately in a securities account governed by the Commission's customer protection requirements.

The proposed rule change also will clarify and update provisions of FINRA Rule 4240 with respect to margin requirements for CDS. These changes will facilitate FINRA member firms' compliance with the Exchange Act and help to stabilize the financial markets by requiring margin commensurate to the risks of the portfolio.

The Commission 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. The proposed rule change with respect to FINRA Rule 4240(c)(3) will reduce burdens on FINRA member firms by permitting them to operate under an approved portfolio margining program if the firm notifies FINRA in advance in writing. Under such a portfolio margining arrangement, FINRA member firms may be able to maintain reduced levels of margin that are commensurate with the risks of the portfolio based on correlations in a member's cleared CDS positions consisting of both swaps and security-based swaps. With respect to the additional proposed amendments to FINRA Rule 4240,

the proposed rule change will, by streamlining and clarifying the rule, facilitate Rule 4240's orderly administration, thereby reducing burdens on FINRA member firms.

IV. Accelerated Approval

The Commission finds good cause, pursuant to Rule 19(b)(2)<sup>29</sup> of the Act, for approving the proposed rule change prior to the 30th day after the date of publication in the Federal Register. On March 11, 2013, the CFTC's mandatory clearing requirement for certain index CDS will begin to take effect.<sup>30</sup> The proposed rule change facilitates portfolio margining programs for CDS that are required to be cleared beginning on March 11, 2013, under the CFTC's clearing mandate, by permitting a FINRA member, under FINRA Rule 4240, to require from a CDS customer, with respect to CDS that are security-based swaps held in an account subject to an approved portfolio margining program, the amount of margin determined by the member's portfolio margin methodology, subject to specified requirements.<sup>31</sup> Because a CDS customer, subject to the CFTC's clearing mandate,<sup>32</sup> would need to commingle swaps and security-based swaps in a single account to receive portfolio margin benefits, the Commission believes that accelerated approval of the proposed rule change is necessary to prevent the potential disruption of customer portfolio CDS activities. In addition, accelerated approval will

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<sup>29</sup> 15 U.S.C. 78s(b)(2)

<sup>30</sup> CFTC, "Clearing Requirement Determination under Section 2(h) of the CEA", 77 FR 74284 (December 13, 2012), which is a final rule establishing the first mandatory clearing compliance date of March 11, 2013, for certain classes of CDS and interest rate swaps.

<sup>31</sup> Id.; see also supra note 7.

<sup>32</sup> See supra note 30.

help ensure that FINRA member firms may participate in an approved portfolio margining program without unnecessary delay. Accordingly, the Commission finds that good cause exists to approve the proposed rule change on an accelerated basis.

V. 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:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2013-017 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-2013-017. 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-2013-017 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2)<sup>33</sup> of the Act, that the proposed rule change (SR-FINRA-2013-017) be and hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>34</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>33</sup> 15 U.S.C. 78s(b)(2).

<sup>34</sup> See 17 CFR 200.30-3(a)(12).