

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66527; File No. SR-FINRA-2012-015)

March 7, 2012

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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 23, 2012, 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 substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

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

FINRA is proposing to amend FINRA Rule 4240 (Margin Requirements for Credit Default Swaps) to limit the application of the rule at this time to certain transactions in credit default swaps that are security-based swaps and to make other revisions to update the rule. FINRA Rule 4240 implements an interim pilot program with respect to margin requirements for certain transactions in credit default swaps.

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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 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,<sup>3</sup> which implements an interim pilot program ("Interim Pilot Program") with respect to margin requirements for certain transactions in credit default swaps ("CDS"). FINRA has filed a proposed rule change to extend the implementation of Rule 4240 to July 17, 2012.<sup>4</sup>

As explained in the Approval Order,<sup>5</sup> FINRA Rule 4240, coterminous with certain Commission actions,<sup>6</sup> is intended to address concerns arising from counterparty credit risk posed

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<sup>3</sup> See Securities Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1 [File No. SR-FINRA-2009-012]) ("Approval Order").

<sup>4</sup> See SR-FINRA-2012-014.

<sup>5</sup> See 74 FR 25588 through 25589.

<sup>6</sup> In early 2009, the Commission enacted interim final temporary rules providing enumerated exemptions under the federal securities laws for certain CDS to facilitate the

by CDS, including, among other things, risks to the financial system arising from credit risk resulting from bilateral CDS transactions and from a concentration of credit risk to a central counterparty that clears and settles CDS. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”),<sup>7</sup> Title VII of which established a comprehensive new regulatory framework for swaps and security-based swaps,<sup>8</sup> 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.

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operation of one or more central clearing counterparties in such CDS. See Securities Act Release No. 8999 (January 14, 2009), 74 FR 3967 (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, and Request for Comments); Securities Exchange Act Release No. 59165 (December 24, 2008), 74 FR 133 (January 2, 2009) (Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps).

<sup>7</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>8</sup> The terms “swap” and “security-based swap” are defined in Sections 721 and 761 of the Dodd-Frank Act. The Commission and the CFTC jointly have proposed to further define these terms. See Securities Exchange Act Release No. 64372 (Apr. 29, 2011), 76 FR 29818 (May 23, 2011) (Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping); Securities Exchange Act Release No. 63452 (Dec. 7, 2010), 75 FR 80174 (Dec. 21, 2010) (Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”).

As noted earlier, FINRA has filed a proposed rule change to extend the implementation of FINRA Rule 4240 to July 17, 2012.<sup>9</sup> In this filing, FINRA is proposing to make certain revisions to FINRA Rule 4240 in light of the continuing development of the CDS business within the framework of the Dodd-Frank Act.

Specifically, FINRA is limiting the application of FINRA Rule 4240 at this time to CDS that are security-based swaps under Section 3(a)(68) of the Act,<sup>10</sup> pending further development of federal regulations governing margin for swaps and security-based swaps and further consideration of potential portfolio margin methodologies for cleared CDS that include both swaps and security-based swaps. Based on these factors, FINRA may propose to extend FINRA Rule 4240 to encompass CDS that are swaps under Section 1a(47) of the Commodity Exchange Act<sup>11</sup> at a later date.

Accordingly, FINRA is revising the definition of “CDS” set forth in paragraph (a) of FINRA Rule 4240 to provide that, for purposes of the rule, the term CDS includes any product that is commonly known to the trade as a credit default swap and is a security-based swap as defined pursuant to Section 3(a)(68) of the Act or the rules and guidance of the SEC and its staff.<sup>12</sup> Consistent with this change, FINRA is eliminating the grid set forth under paragraph (a) of FINRA Rule 4240.01 as to CDS contracts where the underlying obligation is a debt index rather than a single name bond, because such grid is for broad-based indexes. As revised, the rule provides that with respect to CDS contracts where the underlying obligation is a narrow-based debt index, rather than a single name bond, the margin requirement shall be based upon a

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<sup>9</sup> See supra note 4.

<sup>10</sup> 15 U.S.C. 78c(a)(68).

<sup>11</sup> 7 U.S.C. 1a(47).

<sup>12</sup> See Exhibit 5 attached to SR-FINRA-2012-015. See also supra note 8.

margin methodology using the member's internal models the use of which has been approved by FINRA. In addition, FINRA is revising paragraphs (a), (b) and (c)(1) of the rule to remove references to derivatives clearing organizations.

Further, in the interest of regulatory clarity and efficiency, and based upon FINRA's experience in the administration of the rule, FINRA has revised the grid set forth under FINRA Rule 4240.01(a) as to CDS contracts where the underlying obligation is a single name debt security. Specifically, the revised grid sets forth more calibrated ranges with respect to the length of time to maturity of the relevant CDS contract and percentages with respect to the required margin.

FINRA has made minor edits to paragraph (e) of the rule to align the terms "current exposure" and "maximum potential exposure" with the definitions set forth in Act Rule 15c3-1e(c)(4) and to make other minor clarifications. In addition, in the interest of clarification, FINRA has replaced references to use of an "approved margin methodology" in paragraphs (a), (c)(1) and (c)(2) of the rule with "using" or "use" a "margin methodology the use of which has been approved by FINRA as announced in a Regulatory Notice."

Lastly, FINRA has made clarifying edits to paragraph (c) of Supplementary Material .01 to provide that in instances where the customer or broker-dealer maintains both long and short CDS, the member may elect to collect 50% of the relevant margin requirements on the lesser of the long or short position within the same Bloomberg CDS sector (or, if the long and short positions are equal, the long position), provided those long and short positions are in the same spread and maturity bucket, plus the relevant margin requirements on the excess long or short position, if any.

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 30th 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>14</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 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.

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

<sup>14</sup> 15 U.S.C. 78q-3(b)(6).

### III. 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-2012-015 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-2012-015. 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-2012-015 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. 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.<sup>15</sup> After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>16</sup>

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.<sup>17</sup> Specifically, as noted above, FINRA is limiting the application of FINRA Rule 4240 at this time to CDS that are security-based swaps under Section 3(a)(68) of the Act,<sup>18</sup> pending further development of federal regulations governing margin for swaps and security-based swaps and further consideration of potential portfolio margin methodologies for cleared CDS that include both swaps and security-

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

<sup>16</sup> 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).

<sup>17</sup> 15 U.S.C. 78o-3(b)(6).

<sup>18</sup> 15 U.S.C. 78c(a)(68).

based swaps. This is consistent with the goals of Title VII of the Dodd-Frank Act.<sup>19</sup> In addition, the Commission believes that the proposed alternative tables that may be used by market participants to compute the required margin will provide market participants with some flexibility in computing margin, while still permitting the continued use of the existing margin tables in FINRA Rule 4240 Supplementary Material .01.

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. Therefore, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act, for approving the proposed rule change prior to the 30<sup>th</sup> day after the date of publication of note in the Federal Register.<sup>20</sup>

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<sup>19</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>20</sup> 15 U.S.C. 78(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>21</sup> that the proposed rule change (SR-FINRA-2012-015) be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>22</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>21</sup> 15 U.S.C. 78(b)(2).

<sup>22</sup> 17 CFR 200.30-3(a)(12).