

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-67088; File No. SR-FINRA-2012-024)

May 31, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to FINRA Rule 4210 Margin Requirements

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 May 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, II and III 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.

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

FINRA is proposing to amend FINRA Rule 4210 (Margin Requirements) to: (1) revise the definitions and margin treatment of option spread strategies; (2) clarify the maintenance margin requirement for non-margin eligible equity securities; (3) clarify the maintenance margin requirements for non-equity securities; (4) eliminate the current exemption from the free-riding prohibition for designated accounts; (5) conform the definition of “exempt account”; and (6) eliminate the requirement to stress test portfolio margin accounts in the aggregate. In addition, the proposed rule change would amend FINRA Rule 4210 to make non-substantive technical and stylistic changes.

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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

The proposed rule change would amend FINRA Rule 4210 (Margin Requirements) to: (1) revise the definitions and margin treatment of option spread strategies; (2) clarify the maintenance margin requirement for non-margin eligible equity securities; (3) clarify the maintenance margin requirements for non-equity securities; (4) eliminate the current exemption from the free-riding prohibition for designated accounts; (5) conform the definition of "exempt account"; and (6) eliminate the requirement to stress test portfolio margin accounts in the aggregate. In addition, the proposed rule change would amend FINRA Rule 4210 to make non-substantive technical and stylistic changes.

Option Spread Strategies

Basic option spreads can be paired in such ways that they offset each other in terms of risk. The total risk of the combined spreads is less than the sum of the risk of both spread

positions if viewed as stand-alone strategies. FINRA Rule 4210(f)(2) currently recognizes several specific option spread strategies.<sup>3</sup> These strategies consist of either a “long” and a “short” option contract or two “long” and two “short” option contracts. The “long” and “short” option contracts have the same underlying security or instrument and the “long” option contracts must expire on or after the expiration of the “short” option contracts.

While the strategies recognized under FINRA Rule 4210 are the most common types of option spread strategies used by investors, there are other combinations of calls and/or puts that are similar in terms of their risk profile. Accordingly, FINRA proposes a broader definition of a spread in FINRA Rule 4210(f)(2)(A)(xxxii) to mean a “long” and “short” position in different call option series, different put option series, or a combination of call and put option series, that collectively have a limited risk/reward profile, and meet the following conditions: (1) all options must have the same underlying security or instrument; (2) all “long” and “short” option contracts must be either all American-style or all European-style;<sup>4</sup> (3) all “long” and “short” option contracts must be either all listed or all OTC;<sup>5</sup> (4) the aggregate underlying contract value of

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<sup>3</sup> See FINRA Rule 4210(f)(2)(A) that currently recognizes the following spread strategies: box spread, butterfly spread, calendar (or time) spread, “long” calendar butterfly spread, “long” calendar condor spread, “long” condor spread, “short” calendar iron butterfly spread, “short” calendar iron condor spread, “short” iron butterfly spread and “short” iron condor spread.

<sup>4</sup> American-style options can be exercised or assigned at any time during the life of the contract. European-style options can only be exercised or assigned at the time of expiration.

<sup>5</sup> See FINRA Rule 4210(f)(2)(A)(xxvi) (renumbered as 4210(f)(2)(A)(xxiv)) that defines a listed option as an option contract that is traded on a national securities exchange and is issued and guaranteed by a registered clearing agency. See also FINRA Rule 4210(f)(2)(A)(xxxii) (renumbered as 4210(f)(2)(A)(xxvii)) that defines an OTC option as an over-the-counter option contract that is not traded on a national securities exchange and is issued and guaranteed by the carrying broker-dealer.

“long” versus “short” contracts within option type(s) must be equal; and (5) the “short” option (s) must expire on or before the expiration date of the “long” option(s).

The proposed revised margin requirements are set forth in FINRA Rule 4210(f)(2)(H) and would require that the “long” option contracts within such spreads must be paid for in full. The margin required for the “short” option contracts within such spreads would be the lesser of: (1) the margin required pursuant to FINRA Rule 4210(f)(2)(E); or (2) the maximum potential loss. The maximum potential loss would be determined by computing the intrinsic value of the options at price points for the underlying security or instrument that are set to correspond to every exercise price present in the spread. The intrinsic values are netted at each price point, and the maximum potential loss is the greatest loss, if any. The proceeds of the “short” options may be applied towards the cost of the “long” options and/or any margin requirement. FINRA Rule 4210(f)(2)(H)(iv) would also make clear that OTC option contracts that comprise a spread must be issued and guaranteed by the same carrying broker-dealer and the carrying broker-dealer must also be a FINRA member. If the OTC option contracts are not issued and guaranteed by the same carrying broker-dealer, or if the carrying broker-dealer is not a FINRA member, then the “short” option contracts must be margined separately pursuant to FINRA Rule 4210(f)(2)(E)(iii) or (E)(iv). In addition, FINRA proposes to amend FINRA Rule 4210(f)(2)(N) to similarly conform the margin requirements for spreads that are permitted in a cash account.

FINRA proposes to eliminate the definitions for the option spread strategies currently recognized within the rule, along with the specific margin requirements associated with each spread, with the exception of a “long” box spread consisting of European-style options.<sup>6</sup> FINRA

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<sup>6</sup> See FINRA Rule 4210(f)(2)(A)(vi). A box spread means an aggregation of positions in a “long” call and “short” put with the same exercise price (“buy side”) coupled with a “long” put and “short” call with the same exercise price (“sell side”) structured as: (1) a

Rule 4210(f)(2)(H)(v)g.<sup>7</sup> currently allows a margin requirement equal to 50% of the aggregate difference in the exercise prices. This is the only spread strategy that allows loan value, and FINRA believes that retaining this provision is appropriate.

#### Non-Margin Eligible Equity Securities

FINRA proposes to clarify the maintenance margin requirement for non-margin eligible equity securities. FINRA Rule 4210(c)(1) prescribes a maintenance margin requirement of 25% of the current market value of all securities (except for security futures contracts) held “long” in an account. FINRA believes that non-margin eligible equity securities should be subject to more stringent margin requirements in light of the nature of such securities. Accordingly, FINRA proposes to amend FINRA Rule 4210(c)(1) regarding securities held “long” to clarify that the maintenance margin requirement of 25% of the current market value would apply only to margin securities as defined in Regulation T.<sup>8</sup> Consequently, non-margin eligible equity securities would be excluded from such margin treatment and the maintenance margin requirement for non-margin eligible equity securities would be 100% of the current market value.<sup>9</sup> This maintenance margin requirement of 100% for non-margin eligible equity securities is consistent with the requirement outlined in Regulatory Notice 11-16. However, FINRA notes that two

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“long” box spread in which the sell side exercise price exceeds the buy side exercise price; or (2) a “short” box spread in which the buy side exercise price exceeds the sell side exercise price, all of which have the same contract size, underlying component or index and time of expiration, and are based on the same aggregate current underlying value.

<sup>7</sup> FINRA Rule 4210(f)(2)(H)(v)g. would be renumbered as FINRA Rule 4210(f)(2)(H)(v)e.

<sup>8</sup> See Regulation T section 200.2 for the definition of margin security.

<sup>9</sup> See Regulatory Notice 11-16 (April 2011) and Regulatory Notice 11-30 (June 2011) (Regulatory Notice 11-30 delayed the effective date of Regulatory Notice 11-16 until October 3, 2011).

provisions of Regulatory Notice 11-16 would be superseded. Firms may no longer extend maintenance loan value on non-margin eligible equity securities either to satisfy maintenance margin deficiencies or when used to collateralize non-purpose loans, except as otherwise provided by FINRA in writing. To this end, FINRA intends to allow a firm to extend credit on a non-margin eligible security<sup>10</sup> only to the extent: (1) the security is collateralizing a non-purpose loan debit; and (2) such security can be liquidated in a period not exceeding 20 business days, based on a rolling 20 business day median trading volume. The maintenance loan value for the non-margin eligible security would be calculated based on the applicable maintenance margin requirements for a margin eligible security. If the security fails to meet the trading volume requirement, then the security would no longer be entitled to maintenance loan value, and a 100% maintenance margin requirement would be applied together with a deduction to net capital pursuant to Rule 15c3-1 and, if applicable, FINRA Rule 4110(a). Notwithstanding the foregoing, FINRA intends to allow that in the case of offshore mutual funds, a firm may extend maintenance loan value, based on a 25% maintenance margin requirement, to collateralize a non-purpose loan, provided that the fund has an affiliation with a U.S.-based fund registered with the SEC under the Investment Company Act of 1940, and the fund shares can be liquidated or redeemed daily.

Similar to the treatment above, FINRA also proposes to amend Rule 4210(f)(8)(B)(iii) to clarify that the special maintenance margin requirement for day traders, based on the cost of all

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<sup>10</sup> The exception to permit firms to extend maintenance loan value would apply to both equity and non-equity non-margin eligible securities.

day trades made during the day, would be 25% for margin eligible equity securities, and 100% for non-margin eligible equity securities.<sup>11</sup>

In addition, FINRA proposes to adopt new paragraph (g)(7)(E) of FINRA Rule 4210 regarding the margin requirements for non-margin eligible equity securities held in a portfolio margin account. Consistent with the margin treatment above, the provision would clarify that non-margin eligible equity securities held “long” in a portfolio margin account would have a maintenance margin requirement equal to 100% of the current market value at all times.<sup>12</sup>

Paragraph (g)(7)(E) would also provide that non-margin eligible equity securities held “short” in a portfolio margin account would have a maintenance margin requirement equal to 50% of the current market value at all times.<sup>13</sup> FINRA believes that setting this specific requirement is necessary to help ensure that customers do not attempt to circumvent the initial margin requirements of Regulation T and place all short sales in a portfolio margin account to obtain lower margin requirements.<sup>14</sup>

FINRA also proposes to amend paragraph (g)(7)(D) of FINRA Rule 4210 to clarify that although non-margin eligible equity securities are not eligible for portfolio margin treatment, they may be carried in a portfolio margin account, provided that the member uses strategy-based

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<sup>11</sup> The special maintenance margin requirement for non-margin eligible equity securities for day traders is consistent with the margin requirements outlined in Regulatory Notice 11-16.

<sup>12</sup> The maintenance margin requirement for non-margin eligible equity securities held “long” in a portfolio margin account is consistent with the margin requirements outlined in Regulatory Notice 11-16.

<sup>13</sup> The maintenance margin requirement for “short” non-margin eligible equity securities held in a portfolio margin account would supersede the maintenance margin requirement for such securities specified in Regulatory Notice 11-16.

<sup>14</sup> See Rule 4210(g)(7).

margin requirements unless such securities are subject to other provisions of paragraph (g). For example, non-margin eligible equity securities may be carried in a portfolio margin account, but the amendment would clarify that they would be subject to the margin treatment set forth in FINRA Rule 4210(g)(7)(E), rather than FINRA Rule 4210(c).

### Non-Equity Securities

FINRA proposes to further amend FINRA Rule 4210 to clarify the appropriate maintenance margin requirement for non-equity securities in a margin account. Paragraph (c)(4) stipulates a maintenance margin requirement for each bond held “short” in a margin account. Paragraph (e)(2)(C) stipulates the maintenance margin requirements on any positions in specified non-equity securities<sup>15</sup> that are inconsistent with the requirements in paragraph (c)(4). FINRA received several inquiries as to the appropriate maintenance margin requirement for any “short” non-equity security. Accordingly, FINRA proposes to amend FINRA Rule 4210 to clarify that the margin requirements in paragraph (c)(4) would apply to non-margin eligible, non-equity securities held “short”<sup>16</sup> while the margin requirements in paragraph (e)(2)(C) would apply to the specified margin-eligible non-equity securities held “short” or “long.”<sup>17</sup> FINRA also proposes to add a reference to “short” or “long” to each of paragraphs (e)(2)(B), (F) and (G) to further clarify that such provisions apply to securities held short or long.

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<sup>15</sup> Paragraph (e)(2)(C) provides the maintenance margin requirements for (1) investment grade debt securities and (2) all other listed non-equity securities and all other margin eligible non-equity securities as defined in FINRA Rule 4210(a)(16).

<sup>16</sup> Non-margin eligible non-equity securities held “long” would be excluded from such margin treatment, and the maintenance margin requirement for such securities would be 100% of the current market value.

<sup>17</sup> See also FINRA Rule 4210(e)(2)(A), which establishes the maintenance margin requirements for long or short positions on obligations issued or guaranteed by the United States or obligations that are highly rated foreign sovereign debt securities.



### “Free-Riding”

“Free-riding” is the purchase of a security and the selling of the same security in the cash account, using the proceeds of the sale to satisfy the purchase. Such activity is prohibited under section 220.8(a)(1)(ii) of Regulation T. FINRA Rule 4210(f)(9) addresses free-riding in the cash account and currently exempts broker-dealers and “designated accounts.”<sup>18</sup> While the term “designated account” generally includes banks, savings associations, insurance companies, investment companies, states or political subdivisions, and ERISA pension or profit sharing plans, FINRA believes that it is appropriate to treat such accounts as any other customer regarding this activity. Accordingly, FINRA proposes to eliminate this exemption for designated accounts consistent with Regulation T.

### “Exempt Account”

Certain non-equity securities such as exempted securities, mortgage related securities, highly rated foreign sovereign debt securities, and investment grade debt securities may be subject to reduced maintenance margin requirements (or require no margin be deposited) for an “exempt account,” as defined in FINRA Rule 4210(a)(13).<sup>19</sup> FINRA notes that FINRA Rule 4210(f)(2)(E)(iv) regarding reduced maintenance margin requirements for OTC put and call options on certain U.S. Government and U.S. Government Agency debt securities retained an earlier definition of “exempt account” that was not updated in 2003 when the NYSE and NASD amended the definition of “exempt account” by raising the dollar threshold in paragraph (a)(13)

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<sup>18</sup> See FINRA Rule 4210(a)(4) for the definition of “designated account.”

<sup>19</sup> See FINRA Rule 4210(e)(2)(F), (G) and (H).

for all other purposes in their respective margin rules.<sup>20</sup> The definition of “exempt account” currently referenced in paragraph (f)(2)(E)(iv) was retained as a result of comment letters received by the SEC in 2003, expressing concern that customers who no longer qualified as “exempt accounts” in the amended paragraph (a)(13) definition would be subject to higher maintenance margin requirements for the securities addressed in paragraph (f)(2)(E)(iv). Therefore, such definition was maintained only for the provision in paragraph (f)(2)(E)(iv) to allow existing customers to continue to avail themselves of the reduced margin requirements. However, the SEC noted that exempt accounts that met the requirements for exempt account status would be “grandfathered” on the existing credit transactions but that the new requirements (the current paragraph (a)(13) “exempt account” requirements) would apply to any new credit transactions or roll-overs of existing transactions.<sup>21</sup> In light of the application of the 2003 exempt account definition to new and roll-over transactions and the significant passage of time, FINRA believes that maintaining these separate definitions is no longer necessary and proposes to delete the definition of “exempt account” contained in paragraph (f)(2)(E)(iv) and require an exempt account to satisfy the definition of “exempt account” in paragraph (a)(13) to qualify for the reduced margin on such options.

### Portfolio Margin

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<sup>20</sup> See Securities Exchange Act Release No. 48407 (August 25, 2003), 68 FR 52259 (September 2, 2003) (Order Approving File No. SR-NASD-2000-08) (“NASD Order”); Securities Exchange Act Release No. 48365 (August 19, 2003), 68 FR 51314 (August 26, 2003) (Order Approving File No. SR-NYSE-98-14); and Securities Exchange Act Release No. 48133 (July 7, 2003), 68 FR 41672 (July 14, 2003) (Notice of Filing of File No. SR-NYSE-98-14) (“NYSE Notice of Filing”).

<sup>21</sup> See note 20, page 52261 of the NASD Order and page 41676 of NYSE Notice of Filing.

FINRA proposes to eliminate the monitoring requirement contained in FINRA Rule 4210(g)(1)(D) that stress testing of accounts must be done in the aggregate for portfolio margin accounts. The rule would continue to require firms to stress test portfolio margin accounts on an individual account basis. FINRA has been reviewing the portfolio margin program and believes that the stress testing on an individual account basis is sufficient from a risk perspective.

#### Technical Changes

Finally, the proposed rule change amends FINRA Rule 4210 to make non-substantive technical and stylistic changes to encourage consistency throughout the rule and enhance readability.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 90 days following publication of the Regulatory Notice announcing Commission approval.

#### 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>22</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 regarding the options spread strategies would set margin requirements commensurate with the risk of options spread strategies. FINRA further believes that the proposed rule change would clarify the margin requirements for non-margin eligible equity securities and non-equity securities to ensure consistent regulation regarding the margin

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<sup>22</sup> 15 U.S.C. 78q-3(b)(6).

treatment for such securities and strategies. FINRA also believes that the proposed rule change regarding conforming the definition of “exempt accounts” would ensure consistent regulation regarding such accounts. In addition, FINRA believes that the proposed rule change regarding eliminating the exemption from the “free-riding” provision for “designated accounts” is consistent with Regulation T. Finally, FINRA believes that the proposed rule change regarding stress testing of individual portfolio margin accounts is reflective of the risk of such accounts.

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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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:

- 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 2012-024 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-2012-024. 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-2012-024 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.<sup>23</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).