Regulatory Notice 19-21

Exchange-Traded Notes

Margin Requirements for Exchange-Traded Notes

Summary

Pursuant to FINRA Rule 4210(f)(8)(A), FINRA is establishing higher strategy-based margin requirements for exchange-traded notes (ETNs) and options on ETNs in light of the complex nature of these products. The new requirements for initial and maintenance margin are detailed below.

In addition, FINRA is clarifying that ETNs and options on ETNs are not eligible for portfolio margining under FINRA Rule 4210(g).

If these measures would result in undue hardship to a firm or its customers, the firm may submit a written request to FINRA for additional time to comply with this *Notice*.

Questions concerning this *Notice* should be directed to:

- Adam Rodriguez, Director, Credit Regulation, at (646) 315-8572 or *adam.rodriguez@finra.org*;
- Joseph David, Principal Specialist, at (646) 315-8444 or *joseph.david@finra.org*; or
- Kathryn Moore, Associate General Counsel, Office of General Counsel, at (202) 728-8200 or *kathryn.moore@finra.org*.

Background & Discussion

An ETN is an unsecured obligation of its issuer, typically a bank or other financial institution. However, ETNs are different from typical corporate bonds as, among other things, they do not pay interest and pay principal based on the performance of a reference index or benchmark. For this reason, an investment in an ETN can have a return similar to an investment in an exchange-traded fund (ETF) that is designed to track the performance of the index or benchmark referenced by the ETN.

July 1, 2019

Notice Type
- Guidance

Suggested Routing
- Compliance
- Institutional
- Legal
- Margin
- Operations
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- Trading

Key Topics
- Exchange-Traded Notes
- Portfolio Margin
- Strategy-Based Margin

Referenced Rules & Notices
- Regulatory Notice 09-53
- Rule 4210

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Though these products are also structured products that trade on an exchange, they differ in a few respects. For example, ETFs are generally equity products: an investor in an ETF, which is typically a registered investment company, owns shares of a fund, which represents an ownership interest in an underlying portfolio of assets. In contrast, as noted above, ETNs are unsecured debt, typically of a financial institution. Unlike ETFs, ETNs do not reflect ownership of an underlying portfolio of assets, and this feature exposes holders of an ETN to the creditworthiness of the issuer in addition to the risk of the reference index or benchmark. ETNs may also have "knock-out" features or give their issuers early redemption rights, which can cause the return on an ETN investment to further diverge from the return on an investment in an ETF that tracks the same index.[1]

Increase in Strategy-Based Margin

The maintenance margin requirements on all "margin securities," which include debt securities, are generally set by FINRA Rule 4210(c). The rule requires strategy-based accounts to maintain equity equal to 25% of the current market value of all margin securities long in the account, and the greater of 5% of the principal amount or 30% of the current market value of debt securities short in the account.

As an exception to this general rule, reduced margin requirements for investment grade debt securities,[2] listed non-equity securities[3] and "other margin eligible non-equity securities"[4] are set out in Rule 4210(e)(2)(C).[5] Although ETNs may technically qualify for these reduced margin requirements (because they are listed on national securities exchanges and their issuers are generally rated investment-grade), they have materially different risk profiles than typical debt securities. Typical debt securities expose investors to issuer credit risk and a greater or lesser degree of interest rate risk, while ETN investors are exposed to issuer credit risk and also the risk of the reference index or benchmark. Because of the significance of the reference index or benchmark risk to an ETN position, FINRA believes that the exceptions provided by Rule 4210(e)(2)(C) should not apply to ETN positions in strategy-based accounts.

Pursuant to FINRA Rule 4210(f)(8)(A),[6] FINRA is excluding ETNs from the exceptions available for positions in ordinary investment grade debt securities, listed non-equity securities and "other margin eligible non-equity securities," and establishing for them:

- an initial and maintenance margin requirement of 25% of the current market value for ETNs held long in an account, and 30% of the current market value for ETNs held short; and
- an initial and maintenance margin requirement on listed options on ETNs of 20% of the underlying current market value of the ETN, and a minimum margin requirement of 10% of the underlying current market value of the ETN, in each case for purposes of the listed options and warrants requirements chart in Rule 4210(f)(2)(E)(i).[7]

Further, similar to the approach taken in *Regulatory Notice 09-53* with respect to leveraged ETFs, FINRA is increasing the margin requirements (including day trading requirements) for leveraged ETNs and their associated uncovered options by a factor commensurate with their leverage.[8] The margin requirement on a leveraged ETN held long in an account is capped at 100% of its value; however, no such cap applies for a leveraged ETN held short.

Portfolio Margin Treatment

As an alternative to the strategy-based margin requirements specified in FINRA Rule 4210(c)-(f), FINRA Rule 4210(g) permits members to margin certain products according to a prescribed portfolio margin methodology that is based on the Options Clearing Corporation's (OCC) Theoretical Intermarket Margining System (TIMS) model.[9] Portfolio margin is a risk-based margin methodology that was created to align margin requirements for equity securities with the overall risk of the portfolio. Portfolio margin usually results in lower margin requirements on hedged positions than strategy-based margin rules would impose on such hedged positions.

ETNs and options on ETNs historically have been included in the TIMS file provided by the OCC, and as a result some firms have provided portfolio margin treatment to ETNs and options on ETNs when such products have been included in customer portfolio margin accounts. However, ETNs are not on the list of products that are eligible to be included in portfolio margin as provided in FINRA Rule 4210(g)(6).[10] Therefore, firms may not apply the portfolio margin requirements provided by the TIMS model for positions in ETNs and options on ETNs held in portfolio margin accounts.[11]

Effective on August 16, 2019, the OCC will be removing all ETNs and related options that are currently in the TIMS file.[12]

Hardship Extension

If the foregoing measures would result in undue hardship to a firm or its customers, the firm may submit a written request to FINRA for additional time to comply with this *Notice*. Such requests must include an explanation of the specific circumstances leading to the request and must be received by FINRA no later than July 26, 2019. Requests regarding margin may be directed to Adam Rodriguez or Joe David at the contact information stated at the top of this *Notice*.

Endnotes

1. *See, e.g.*, SEC Investor Bulletin, Exchange Traded Notes (ETNs) and FINRA Investor Alert, Exchange-Traded Notes—Avoid Unpleasant Surprises.

2. Rule 4210(a)(10) defines "investment grade debt securities" as "any debt securities … if at the time of the extension of credit the issue, the issuer or guarantor, or any other outstanding obligation of the issuer or guarantor ranked junior to or on a parity with the issue or the guarantee is assigned a rating (implicitly or explicitly) in one of the top four rating categories by at least one nationally recognized statistical rating organization."

3. Rule 4210(a)(15) defines "listed non-equity securities" as "any non-equity securities that: (A) are listed on a national securities exchange; or (B) have unlisted trading privileges on a national securities exchange."

4. Rule 4210(a)(16) limits the term "other margin eligible non-equity securities" to:

   A. Any debt securities not traded on a national securities exchange meeting all of the following requirements:

      i. At the time of the original issue, a principal amount of not less than $25 million of the issue was outstanding;

      ii. The issue was registered under Section 5 of the Securities Act and the issuer either files periodic reports pursuant to Section 13(a) or 15(d) of the Exchange Act or is an insurance company which meets all of the conditions specified in Section 12(g)(2)(G) of the Exchange Act; and

      iii. At the time of the extensions of credit, the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments; or

   B. Any private pass-through securities (not guaranteed by any agency of the U.S. government) meeting all of the following requirements:

      i. An aggregate principal amount of not less than $25 million (which may be issued in series) was issued pursuant to a registration statement filed with the SEC under Section 5 of the Securities Act;

      ii. Current reports relating to the issue have been filed with the SEC; and

      iii. At the time of the credit extension, the creditor has a reasonable basis for believing that mortgage interest, principal payments and other distributions are being passed through as required and that the servicing agent is meeting its material obligations under the terms of the offering.

5. The reduced requirements are 10% of the current market value of investment grade debt securities long or short in the accounts and the greater of 20% of the current market value or 7% of the principal amount of any other listed non-equity securities or other margin eligible non-equity securities long or short in the account.

6. FINRA Rule 4210(f)(8)(A) authorizes FINRA to prescribe higher initial and maintenance margin requirements, and such other terms and conditions as FINRA deems appropriate relating to such requirements, whenever it determines that market conditions so warrant. This provision has been used to raise or clarify the margin requirements for several products. *See, e.g., Regulatory Notice 10-53* (exempted securities mutual funds and exempted securities ETFs), *Regulatory Notice 09-53* (non-traditional ETFs) and *Regulatory Notice 08-08* (certain auction rate securities).

7. The listed option margin requirements in Rule 4210(f)(2)(E) do not contemplate listed options on debt securities other than U.S. treasury and GNMA obligations. The initial and maintenance requirements we are prescribing for listed options on ETNs are a 5% over the requirements for OTC options on listed non-equity securities under Rule 4210(f)(2)(E)(iii) and are equal to the initial and maintenance margin requirements on listed options on stock and convertible corporate debt securities.

8. *See Regulatory Notice 09-53* (August 2009) detailing increased margin requirements for leveraged ETFs and associated uncovered options.

9. FINRA Rule 4210(g)(3) requires that theoretical pricing models must be approved by the Securities and Exchange Commission (SEC). The OCC's TIMS model is the only model so approved.

10. The eligible products listed in FINRA Rule 4210(g)(6)(B) consist of: (1) a margin equity security (including a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a "ready market" under SEA Rule 15c3-1 or a "no-action" position issued thereunder, and a control or restricted security, provided the security has met the requirements in a manner consistent with Securities Act Rule 144 or an SEC "no-action" position issued thereunder, sufficient enough to permit the sale of the security, upon exercise or assignment of any listed option or unlisted derivative written or held against it, without restriction); (2) a listed option on an equity security or index of equity securities; (3) a security futures product; (4) an unlisted derivative on an equity security or index of equity securities; (5) a warrant on an equity security or index of equity securities; and (6) a related instrument as defined in paragraph (g)(2)(D) of FINRA Rule 4210.

11. Consistent with FINRA Rule 4210(g)(7)(D), positions on ETNs and options on ETNs may be retained in portfolio margin accounts so long as the strategy-based requirement, as specified in this *Notice*, is applied.

12. *See* OCC Information Memo #45304: *ETN Removal from Customer Portfolio Margin Theoretical Output File*.