

# Notice to Members

OCTOBER 2003

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Senior Management

## KEY TOPICS

Margin Requirements  
Regulation T  
Rule 2520

## Amendments to NASD Rules Regarding Margin Requirements

SEC Approves Proposed Changes to NASD Rule 2520;  
**Effective Date: December 1, 2003**

### Executive Summary

On August 25, 2003, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 2520.<sup>1</sup> As amended, Rule 2520 (1) reduces the customer maintenance margin requirements for certain non-equity securities; and (2) redefines "exempt account" and permits the extension of good faith margin treatment to certain non-equity securities held in "exempt accounts"; and (3) limits the amount of capital charges a broker/dealer may take in lieu of collecting marked to the market losses.<sup>2</sup>

The amendments become effective on December 1, 2003. The text of the amendments is provided in Attachment A.

### Questions/Further Information

Questions concerning this *Notice* may be directed to Susan M. DeMando, Director, Financial Operations, Department of Member Regulation, at (202) 728-8411.

### Background And Discussion

Regulation T of the Federal Reserve Board establishes initial margin requirements for securities transactions effected in margin accounts. Regulation T also establishes margin requirements for transactions in non-equity securities held in "good faith" accounts. Such transactions are subject to the margin required by the creditor in "good faith" or the percentage set by the regulatory authority where the trade occurs, whichever is greater.<sup>3</sup> Consequently, the margin requirements of NASD Rule 2520 apply to non-equity positions maintained in customers' accounts.

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The amendments to Rule 2520 provide for margin requirements for non-equity securities that are commensurate with the risk associated with positions in such securities held by customers. In particular, for positions not maintained in “exempt accounts,” Rule 2520, as amended, reduces the customer maintenance margin requirement for certain non-equity securities and establishes a customer maintenance margin requirement of 20% of current market value for other marginable non-equity securities. The amended Rule 2520 also permits the extension of good faith margin to certain non-equity securities held in “exempt accounts” and limits the amount of capital charges a broker/dealer may take in lieu of collecting marked to the market losses.

## Definitional Changes

### Designated Account

The term “designated account” means the account of: a bank (as defined in Section 3(a)(6) of the Securities Exchange Act of 1934 (Act)); a savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), the deposits of which are insured by the Federal Deposit Insurance Corporation; an insurance company (as defined in Section 2(a)(17) of the Investment Company Act of 1940); an investment company registered with the SEC under the Investment Company Act; a state or political subdivision thereof; or a pension or profit sharing plan subject to Employee Retirement Income Security Act (ERISA) or of an agency of the United States or of a state or a political subdivision thereof.

### Highly Rated Foreign Sovereign Debt Securities

The term “highly rated foreign sovereign debt securities” means any debt securities (including major foreign sovereign debt securities) issued or guaranteed by the government of a foreign country, its provinces, state or cities, or a supranational entity, 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 two rating categories by at least one nationally recognized statistical rating organization.

### Investment Grade Debt Securities

The term “investment grade debt securities” means any debt securities (including those issued by the government of a foreign country, its provinces, states, or cities, or a supranational entity), 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.

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### **Major Foreign Sovereign Debt**

The term “major foreign sovereign debt” means any debt securities issued or guaranteed by the government of a foreign country or a supranational entity, 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 the top rating category by at least one nationally recognized statistical rating organization.

### **Mortgage-Related Securities**

The term “mortgage-related securities” means securities falling within the definition in Section 3(a)(41) of the Act.

### **Exempt Account**

The term “exempt account” means a member, non-member broker/dealer registered as a broker or dealer under the Act, or “designated account.” In addition, an “exempt account” may be any person who has a net worth of at least \$45 million and financial assets of at least \$40 million for purposes of subparagraphs (e)(2)(F) and (e)(2)(G) and either: (1) has securities registered pursuant to Section 12 of the Act and has been subject to the reporting requirements of Section 13 of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or (2) has securities registered pursuant to the Securities Act of 1933, has been subject to the reporting requirements of Section 15(d) of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports); or (3) if such person is not subject to Section 13 or 15(d) of the Act, it is a person with respect to which there is publicly available the information specified in paragraphs (a)(5)(i) to (xiv), inclusive, of Rule 15c2-11 under the Act; or (4) furnishes information to the SEC as required by Rule 12g3-2(b) of the Act; or (5) makes available to the member such current information regarding such person’s ownership, business, operations, and financial condition (including such person’s current audited statement of financial condition, statement of income, and statement of changes in stockholder’s equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person.

### **Non-Equity Securities**

The term “non-equity securities” means any securities other than equity securities as defined in Section 3(a)(11) of the Act.

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### **Listed Non-Equity Securities**

The term “listed non-equity securities” means any non-equity securities that are listed on a national securities exchange or have unlisted trading privileges on a national securities exchange.

### **Other Marginable Non-Equity Securities**

The term “other marginable non-equity securities” means any debt securities not traded on a national securities exchange meeting all of the following requirements: (1) at the time of the original issue, a principal amount of not less than \$25,000,000 of the issue was outstanding; (2) the issue was registered under Section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to Section 13(a) or 15(d) of the Act or is an insurance company that meets all of the conditions specified in Section 12(g)(2)(G) of the Act; and (3) 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, “other marginable non-equity securities” means any private pass-through securities (not guaranteed by any agency of the U.S. government) meeting all of the following requirements: (1) an aggregate principal amount of not less than \$25,000,000 (which may be issued in series) was issued pursuant to a registration statement filed with the SEC under Section 5 of the Securities Act of 1933; (2) current reports relating to the issue have been filed with the SEC; and (3) 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.

### **Reduced Customer Maintenance Margin Requirements For Non-Equity Securities Held By Other Than Exempt Accounts**

Amended Rule 2520 establishes margin requirements for investment-grade debt securities and exempted securities other than U.S. debt securities that are comparable to the highest haircut percentages under the SEC’s Net Capital Rule for proprietary positions in similar securities. The margin requirements for retail customers for non-equity securities that are not held in exempt accounts are as follows:

- ◆ For investment-grade non-equity securities—reduced from 20% of current market value to 10% of current market value;
- ◆ For exempted securities other than U.S. government debt—reduced from 15% of the current market value to 7% of current market value;

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- ▶ For highly rated foreign sovereign debt—the amounts specified for U.S. debt securities (1% to 6% of current market value, depending on the time to maturity);
  - ▶ For all other listed non-equity securities and other marginable non-equity securities—the percentage remains at 20% of current market value or 7% of the principal amount, whichever is greater.

#### **Good Faith Margin Treatment For Certain Non-Equity Securities Held By Exempt Accounts**

Rule 2520(2)(e)(F), as amended, will permit broker/dealers to effect transactions by persons or entities that qualify as “exempt accounts” without being required to collect either margin or marked to the market losses on exempted securities, mortgage-related securities, or major foreign sovereign debt securities. However, a broker/dealer must take a capital charge for any uncollected marked to the market losses on exempt account positions in these securities.

Rule 2520(e)(2)(G), as amended, establishes a margin requirement of:

- ▶ 0.5% for transactions in exempt accounts involving highly rated foreign sovereign debt; and
- ▶ 3% for transactions in investment-grade debt.

Although a broker/dealer is not required to collect this margin, it must take a capital charge for any uncollected margin subject to the limitations provided in Rule 2520(e)(2)(H).

#### **Limitation on Capital Charges**

Rule 2520(e)(2)(H) limits the amount of capital charges a broker/dealer may take in lieu of collecting marked to the market losses. Specifically, when marked to market losses exceed either: (1) 5% of the broker/dealer’s tentative net capital on any one account or group of commonly controlled accounts; or (2) 25% of the broker/dealer’s tentative net capital on all accounts combined continue to exist on the fifth business day after they were incurred, the member must provide NASD with written notification and may not enter into any new transactions that would result in an increase in the amount of the excess.

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## Written Risk Analysis

Rule 2520(e)(2)(H) requires members to establish and maintain a “written risk analysis methodology” when extending margin on “good faith” securities transactions in “exempt accounts.” This written risk methodology should include the following:

- ◆ Procedures for obtaining and reviewing the appropriate customer account documentation and the customer financial information necessary to determine exempt account status for the extension of credit under the Rule.
- ◆ Procedures and guidelines for the determination, review, and approval of credit limits to customers and across all customers who qualify as exempt accounts under the Rule.
- ◆ Procedures and guidelines for monitoring credit risk exposure to the organization relating to exempt account customers.
- ◆ Procedures and guidelines for the use of stress testing of exempt accounts in order to monitor market risk exposure from exempt accounts individually and in the aggregate.
- ◆ Procedures providing for the regular review and testing of these risk management procedures by an independent unit such as internal audit, risk management, or other comparable group.

## Endnotes

- 1 See Release No. 34-48407 (File No. SR-NASD-2000-08 (August 25, 2003), 68 Federal Register 52259 (Sept. 2, 2003).
- 2 The provisions of the proposed rule change are consistent with revisions to New York Stock Exchange (NYSE) Rule 431 that were approved on by the SEC on August 19, 2003 (Exchange Act Rel. No. 34-48365).
- 3 Regulation T defines “good faith” margin as the amount of margin that a broker/dealer would require in exercising sound credit judgment.

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## ATTACHMENT A

Additions are underlined; deletions are in brackets.

### 2520. Margin Requirements

#### (a) Definitions

For purposes of this paragraph, the following terms shall have the meanings specified below:

(1) through (3) No Change

(4) The term "designated account" means the account of: [a bank, trust company, insurance company, investment trust, state or political subdivision thereof, charitable or nonprofit educational institution regulated under the laws of the United States or any state, or pension or profit sharing plan subject to ERISA or of any agency of the United States or of a state or a political subdivision thereof.]

(A) a bank (as defined in Section 3(a)(6) of the Act),

(B) a savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), the deposits of which are insured by the Federal Deposit Insurance Corporation,

(C) an insurance company (as defined in Section 2(a)(17) of the Investment Company Act of 1940),

(D) an investment company registered with the Securities and Exchange Commission (SEC) under the Investment Company Act,

(E) a state or political subdivision thereof, or

(F) a pension or profit sharing plan subject to Employee Retirement Income Security Act (ERISA) or of an agency of the United States or of a state or a political subdivision thereof.

(5) through (8) No Change

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(9) The term “highly rated foreign sovereign debt securities” means any debt securities (including major foreign sovereign debt securities) issued or guaranteed by the government of a foreign country, its provinces, state or cities, or a supranational entity, 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 two rating categories by at least one nationally recognized statistical rating organization.

(10) The term “investment grade debt securities” means any debt securities (including those issued by the government of a foreign country, its provinces, states or cities, or a supranational entity), 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.

(11) The term “major foreign sovereign debt” means any debt securities issued or guaranteed by the government of a foreign country or a supranational entity, 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 the top rating category by at least one nationally recognized statistical rating organization.

(12) The term “mortgage related securities” means securities falling within the definition in Section 3(a)(41) of the Act.

(13) The term “exempt account” means: [a member, non-member broker/dealer registered as a broker or dealer under the Act, “designated account,” or any person having a net worth of at least forty-five million dollars and financial assets of at least forty-million dollars.]

(A) a member, non-member broker/dealer registered as a broker or dealer under the Act, a “designated account,” or



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(B) any person that:

(i) has a net worth of at least forty-five million dollars and financial assets of at least forty-million dollars for purposes of subparagraphs (e)(2)(F) and (e)(2)(G), and

(ii) either:

a. has securities registered pursuant to Section 12 of the Act, has been subject to the reporting requirements of Section 13 of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or

b. has securities registered pursuant to the Securities Act of 1933, has been subject to the reporting requirements of Section 15(d) of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or

c. if such person is not subject to Section 13 or 15(d) of the Act, is a person with respect to which there is publicly available the information specified in paragraphs (a)(5)(i) to (xiv), inclusive, of Rule 15c2-11 under the Act, or

d. furnishes information to the Securities and Exchange Commission as required by Rule 12g3-2(b) of the Act, or

e. makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person.

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(14) The term “non-equity securities” means any securities other than equity securities as defined in Section 3(a)(11) of the Act.

(15) The term “listed non-equity securities” means any non-equity securities that: (A) are listed on a national securities exchange; or (B) have unlisted trading privileges on a national securities exchange.

(16) The term “other marginable non-equity securities” means:

(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 \$25,000,000 of the issue was outstanding;

(ii) The issue was registered under Section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to Section 13(a) or 15(d) of the Act or is an insurance company which meets all of the conditions specified in Section 12(g)(2)(G) of the 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 \$25,000,000 (which may be issued in series) was issued pursuant to a registration statement filed with the SEC under Section 5 of the Securities Act of 1933;

(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.

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(b)(1) through (e)(1) No change.

**(e)(2) Exempted Securities, [Marginable Corporate Debt Securities] Non-equity Securities and Baskets**

(A) Obligations of the United States and Highly Rated Foreign Sovereign Debt Securities

On net "long" or net "short" positions in obligations (including zero coupon bonds, i.e., bonds with coupons detached or non-interest bearing bonds) issued or guaranteed as to principal or interest by the United States Government or [issued or guaranteed] by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury, or in obligations that are highly rated foreign sovereign debt securities, the margin to be maintained shall be the percentage of the current market value of such obligations as specified in the applicable category below:

- (i) Less than one year to maturity - 1 percent
- (ii) One year but less than three years to maturity - 2 percent
- (iii) Three years but less than five years to maturity - 3 percent
- (iv) Five years but less than ten years to maturity - 4 percent
- (v) Ten years but less than twenty years to maturity - 5 percent[,  
or]
- (vi) Twenty years or more to maturity - 6 percent

Notwithstanding the above, on zero coupon bonds with five years or more to maturity the margin to be maintained shall not be less than 3 percent of the principal amount of the obligation.

When such obligations other than United States Treasury bills are due to mature in thirty calendar days or less, a member, at its discretion, may permit the customer to substitute another such obligation for the maturing obligation and use the margin held on the maturing obligation to reduce the margin required on the new obligation, provided the customer has given the member irrevocable instructions to redeem the maturing obligation.

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(B) All Other Exempted Securities

On any positions in exempted securities other than obligations of the United States, the margin to be maintained shall be [15] 7 percent of the current market value [or 7 percent of the principal amount of such obligation, whichever amount is greater].

(C) [Non-Convertible Corporate Debt] Non-Equity Securities

On any positions in [non-convertible corporate debt] non-equity securities, [which are listed or traded on a registered national securities exchange or qualify as an "OTC margin bond," as defined in Section 220.2(t) of Regulation T of the Board of Governors of the Federal Reserve System], the margin to be maintained (except where a lesser requirement is imposed by other provisions of this Rule) shall be:

(i) 10 percent of the current market value in the case of investment grade debt securities; and

(ii) 20 percent of the current market value or 7 percent of the principal amount, whichever amount is greater, in the case of all other listed non-equity securities, and all other marginable non-equity securities as defined in paragraph (a)(16) of this Rule [except on mortgage related securities as defined in Section 3(a)(41) of the Act the margin to be maintained for an exempt account shall be 5 percent of the current market value. For purposes of this subparagraph, an exempt account shall be defined as a member, non-member broker/dealer, "designated account" or any person having net tangible assets of at least sixteen million dollars].

(D) and (E) No Change.

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(F) [Cash] Transactions With [Customers] Exempt Accounts Involving Certain "Good Faith" Securities

[When a customer purchases an issued exempted security from or through a member in a cash account, full payment shall be made promptly. If, however, delivery or payment therefor is not made promptly after the trade date, a deposit shall be required as if it were a margin transaction, unless it is a transaction with a "designated account."]

On any position resulting from a transaction [in issued] involving exempted securities, mortgage related securities, or major foreign sovereign debt securities [made for a member, or a non-member broker/dealer, or] made for or with [a "designated] an "exempt account," no margin need be required and any marked to the market loss on such position need not be [marked to the market] collected. However, [where such position is not marked to the market, an amount equal to the loss at the market in such position] the amount of any uncollected marked to the market loss shall be [charged against] deducted in computing the member's net capital as provided in SEC Rule 15c3-1, subject to the limits provided in paragraph (e)(2)(H) below.

(G) Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities

On any position resulting from a transaction made for or with an "exempt account" (other than a position subject to paragraph (e)(2)(F)), the margin to be maintained on highly rated foreign sovereign debt and investment grade debt securities shall be, in lieu of any greater requirements imposed under this Rule, (i) 0.5 percent of current market value in the case of highly rated foreign sovereign debt securities, and (ii) 3 percent of current market value in the case of all other investment grade debt securities. The member need not collect any such margin, provided the amount equal to the margin required shall be deducted in computing the member's net capital as provided in SEC Rule 15c3-1, subject to the limits provided in paragraph (e)(2)(H) below.

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(H) Limits on Net Capital Deductions for Exempt Accounts

(i) Members [organizations] shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraphs (e)(2)(F) and (e)(2)(G) which shall be made available to the Association upon request.

(ii) In the event that the deductions of securities positions from net capital deductions taken by a member as a result of marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) (exclusive of the percentage requirements established thereunder) exceed:

a. on any one account or group of commonly controlled accounts, 5 percent of the member's tentative net capital, or

b. on all accounts combined, 25 percent of the member's tentative net capital, and, such excess exists on the fifth business day after it was incurred, the member shall give prompt written notice to the Association and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F) or (e)(2)(G) that would result in an increase in the amount of such excess under, as applicable, subparagraph a. or b. above.

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