Regulatory Notice 08-08

Auction Rate Securities

FINRA Temporarily Increases Margin Maintenance Requirements on Auction Rate Securities Backed by Fixed Income Products

Effective Date: March 6, 2008

Executive Summary

The purpose of this *Notice* is to advise FINRA member firms that FINRA is temporarily increasing the maintenance margin requirements for auction rate securities pursuant to NYSE Rule 431(f)(8)(A) and NASD Rule 2520(f)(8)(A). Effective immediately, all auction rate securities that are backed by fixed income products (*e.g.*, municipal bonds, collateralized debt obligations, etc.) will have a 25 percent maintenance requirement.

Questions regarding this *Notice* may be directed to:

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Background and Discussion

Auction rate securities are long-term, variable rate bonds generally issued through a Dutch auction, with interest rates that reset at short-term intervals—usually 7, 28 or 35 days. Although they are issued as long-term bonds, auction rate securities are priced and traded similarly to short-term instruments due to the liquidity that has been provided as a result of the interest rate resets. Most auction rate securities are rated AAA.

March 2008

Suggested Routing

- Compliance
- Legal
- Margin Department
- Operations
- Senior Management

Key Topic(s)

- Auction Rate Securities
- Maintenance Margin Requirements

Referenced Rules & Notices

- NASD Rule 2520
- NYSE Rule 431

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Recently, the auctions for these securities have been failing, as investors, concerned about the current credit market environment, have not been willing to participate in the auction. As a result, holders of these securities have not been able to liquidate their positions. In order to provide liquidity to their customers, several member firms have asked FINRA whether margin can be extended to these securities.

Margin Eligibility

Pursuant to NYSE Rule 431 and NASD Rule 2520, fixed income auction rate securities that carry an investment grade rating are categorized as "investment grade debt securities," as defined in NYSE Rule 431(a)(10) and NASD Rule 2520(a)(10), and normally would require equity of 10 percent of the current market value. Fixed income auction rate securities that are below investment grade are categorized as "other marginable non-equity securities" that are defined in NYSE Rule 431(a)(16) and NASD Rule 2520(a)(16) as follows:

(1) 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 Securities Exchange Act of 1934 or is an insurance company which meets all of the conditions specified in Section 12(g)(2)(G) of the Act of 1934; and
- (iii) At the time of the extension of credit, the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments; or

(2) Any private pass-through securities (not guaranteed by an 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 Securities and Exchange Commission under Section 5 of the Securities Act of 1933;
- (ii) Current reports relating to the issue have been filed with the Securities and Exchange Commission; 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.

Fixed income auction rate securities categorized as "other marginable non-equity securities" normally require equity of 20 percent of the current market value or 7 percent of the principal amount, whichever is greater.

However, as a result of the reduced liquidity in these securities, member firms will be required to impose a regulatory maintenance requirement of 25 percent of the current market value for all fixed income auction rate securities, irrespective of whether or not the security is investment grade.

If fixed income auction rate securities are used as collateral for non-purpose credit to any customer, firms are reminded that they must also consider the 25 percent maintenance requirement when determining any maintenance excess or deficiency, and pursuant to NYSE Rule 431(e)(7)(C) and NASD Rule 2520(e)(7)(C), the amount of any deficiency between the equity in the account and the margin required shall be deducted in computing the firm's Net Capital.

Firms are reminded that, pursuant to NYSE Rule 431(d) and NASD Rule 2520(d), they should consider the need to institute higher margin requirements if deemed appropriate.

Firms are also reminded that auction rate preferred securities issued by closed-end funds are not marginable.

Classification on Customer Statements

In light of the recent events in the marketplace, member firms should give careful consideration to the classification of these securities on customer statements as cash or cash equivalents. Firms are also encouraged to review any references and characterization of these securities on the firm's Web site as short-term securities.