Regulatory Notice 08-41

August 2008

Notice Type
- Rule Amendment

Suggested Routing
- Compliance
- Legal
- Margin
- Risk
- Senior Management

Key Topics
- Portfolio Margin

Referenced Rules & Notices
- NASD Rule 2520
- NTM 07-11
- NYSE Rule 431

Portfolio Margin Program

FINRA Announces Amendments to Make Permanent the Portfolio Margin Pilot Program

Effective Date: August 1, 2008

Executive Summary

Effective August 1, 2008, the portfolio margin pilot program set forth in NASD Rule 2520(g) and Incorporated NYSE Rule 431(g)[1] became permanent.[2] In addition, effective August 1, 2008, NASD Rule 2520(g) and Incorporated NYSE Rule 431(g) were amended to codify certain FINRA interpretations related to concentrated equity positions and day trading.[3]

NASD Rule 2520(g) and Incorporated NYSE Rule 431(g), as amended, are set forth in Attachment A of this *Notice*.

Questions regarding this *Notice* should be directed to:

- Rudolph Verra, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8811;
- Glen Garofalo, Director, Credit Regulation, at (646) 315-8464; or
- Steve Yannolo, Principal Credit Specialist, Credit Regulation, at (646) 315-8621.

Background & Discussion

Portfolio margin is a methodology that computes margin requirements for an account based on the greatest projected net loss of all positions in a product class or group, and uses computer modeling to perform risk analysis using multiple pricing scenarios. The pricing scenarios are designed to measure the theoretical loss of the positions, given changes in the underlying price and implied volatility inputs to the model. Accordingly, the margin required is based on the greatest loss that would be incurred in a portfolio if the value of its components move up or down by a predetermined amount.[4]

FINRA™

Financial Industry Regulatory Authority

The portfolio margin program set forth in NASD Rule 2520(g) and Incorporated NYSE Rule 431(g) was initially established as a pilot and was scheduled to expire on July 31, 2008. Effective August 1, 2008, the portfolio margin program became permanent.[5]

In addition, FINRA has codified its interpretation of NASD Rule 2520(g) and Incorporated NYSE Rule 431(g) regarding (1) monitoring concentrated equity positions and (2) the timing of day trading margin calls.

Concentrated Equity Positions

FINRA has codified its interpretation regarding concentrated equity positions. NASD Rule 2520(g)(1) and Incorporated NYSE Rule 431(g)(1) outline various procedural guidelines that firms are required to meet in order to offer portfolio margin to customers. FINRA has issued interpretive guidance in its frequently asked questions, available on its Web site,[6] regarding its expectation that, among other things, firms develop reports that identify a concentration of any individual security in both individual portfolio margin accounts and across all portfolio margin accounts. Firms are permitted to establish their own criteria as to what constitutes a concentrated position. FINRA expects that firms will impose a higher maintenance margin requirement on any identified concentrated positions.

Day Trading

FINRA has also codified its interpretation regarding timing of day trade margin calls. NASD Rule 2520(g)(13) and Incorporated NYSE Rule 431(g)(13) require firms to monitor accounts that do not maintain $5 million minimum equity to ensure that day trading requirements promulgated under NASD Rule 2520(e)(8)(B) and Incorporated NYSE Rule 431(e)(8)(B) are applied. Customers are permitted to engage in day trading provided they day trade within a specific dollar limit (*i.e.,* day trading buying power). Customers that day trade in excess of their day trading buying power are required to deposit additional funds and/or securities to meet this special maintenance margin deficiency, or day trade margin call. In a strategy-based margin account, day trade margin calls are due within five business days.[7] Since maintenance margin deficiencies in portfolio margin accounts are due within three business days,[8] FINRA requires day trade margin calls incurred in portfolio margin accounts also to be met within three business days.[9]

Endnotes

1 The current FINRA rulebook consists of two sets of rules: (1) NASD Rules and (2) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to members of both FINRA and the NYSE, referred to as Dual Members.

2 *See* Securities Exchange Act Release No. 58251 (July 30, 2008) 73 FR 45506 (August 5, 2008) (Notice of Filing and Immediate Effectiveness of SR-FINRA-2008-041).

3 *See* Securities Exchange Act Release No. 58236 (July 30, 2008) 73 FR 46111 (August 7, 2008) (Notice of Filing and Immediate Effectiveness of SR-FINRA-2008-042).

4 *See NASD NTM 07-11* (February 2007) for additional discussion about the portfolio margin program.

5 *See* Securities Exchange Act Release No. 58251 (July 30, 2008) 73 FR 45506 (August 5, 2008) (Notice of Filing and Immediate Effectiveness of SR-FINRA-2008-041).

6 *See* FINRA's frequently asked questions at *www.finra.org/portfoliomargin/faq* under "Margin Requirements."

7 *See* NASD Rule 2520(f)(8)(C) and Incorporated NYSE Rule 431(f)(8)(C).

8 *See* NASD Rule 2520(g)(10(A) and Incorporated NYSE Rule 431(g)(10)(A).

9 *See* FINRA's frequently asked questions at *www.finra.org/portfoliomargin/faq* under "Day Trading."

Attachment A

New language is underlined; deletions are in brackets.

* * * * *

2500. SPECIAL ACCOUNTS

* * * * *

2520. Margin Requirements

(a) through (f) No Change.

(g) Portfolio Margin

As an alternative to the "strategy-based" margin requirements set forth in paragraphs (a) through (f) of this Rule, members may elect to apply the portfolio margin requirements set forth in this paragraph (g) to all margin equity securities,[1] listed options, security futures products (as defined in Section 3(a)(56) of the Exchange Act), unlisted derivatives, warrants, index warrants and related instruments, provided that the requirements of paragraph (g)(6)(B)(i) of this Rule are met.

In addition, a member, provided that it is a Futures Commission Merchant ("FCM") and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this paragraph (g) to combine an eligible participant's related instruments as defined in paragraph (g)(2)(D), with listed index options, unlisted derivatives, options on exchange traded funds ("ETF"), index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis.

The portfolio margin provisions of this Rule shall not apply to Individual Retirement Accounts ("IRAs").

(1) Monitoring. — Members must monitor the risk of portfolio margin accounts and maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member's capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology must be filed with NASD, or the member's designated examining authority ("DEA") if other than NASD, and submitted to the Commission prior to the implementation of portfolio margining. In performing the risk analysis of portfolio margin accounts required by this Rule, each member shall include in the written risk analysis methodology procedures and guidelines for:

(A) through (F) No Change.

(G) the appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded; [and]

(H) determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product[.]<u>; and</u>

<u>(I) monitoring the credit exposure resulting from concentrated positions within both individual portfolio margin accounts and across all portfolio margin accounts.</u>

Moreover, management must periodically review, in accordance with written procedures, the member's credit extension activities for consistency with these guidelines. Management must periodically determine if the data necessary to apply this paragraph (g) is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

(2) through (12) No Change.

(13) Day Trading Requirements. — The day trading restrictions promulgated under paragraph (f)(8)(B) of this Rule shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided that a member has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under paragraph (f)(8)(B) of this Rule, provided the member has the ability to apply the applicable day trading requirement under this Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A "hedge strategy" for purposes of this Rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Members are expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements. <u>In the event day trades executed in a portfolio margin account exceed the day trading buying power, the day trade margin deficiency that is created must be met by the deposit of cash and/or securities within three business days.</u>

(14) through (15) No Change.

---

[1] For purposes of this paragraph (g) of the Rule, the term "margin equity security" utilizes the definition at Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.

* * * * *

Rule 431. Margin Requirements

(a) through (f) No Change.

(g) Portfolio Margin

As an alternative to the "strategy-based" margin requirements set forth in sections (a) through (f) of this Rule, members organizations may elect to apply the portfolio margin requirements set forth in this section (g) to all margin equity securities,[1] listed options, unlisted derivatives, and security futures products (as defined in Section 3(a)(56) of the Securities Exchange Act of 1934 (the "Exchange Act")), provided that the requirements of section (g)(6)(B)(1) of this Rule are met.

In addition, a member organization, provided that it is a Futures Commission Merchant ("FCM") and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this section (g) to combine an eligible participant's related instruments as defined in section (g)(2)(E), with listed index options, options on exchange traded funds ("ETF"), index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis.

The portfolio margin provisions of this Rule shall not apply to Individual Retirement Accounts ("IRAs").

(1) Member organizations must monitor the risk of portfolio margin accounts and maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member organization's capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology must be filed with the New York Stock Exchange (the "Exchange"), or the member organization's designated examining authority ("DEA") if other than the Exchange, and submitted to the Securities and Exchange Commission ("SEC") prior to the implementation of portfolio margining. In performing the risk analysis of portfolio margin accounts required by this Rule, each member organization shall include in the written risk analysis methodology procedures and guidelines for:

(A) through (F) No Change.

(G) the appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded, [and]

(H) determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product[.]<u>, and</u>

<u>(I) monitoring the credit exposure resulting from concentrated positions within both individual portfolio margin accounts and across all portfolio margin accounts.</u>

Moreover, management must periodically review, in accordance with written procedures, the member organization's credit extension activities for consistency with these guidelines. Management must periodically determine if the data necessary to apply this section (g) is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

(2) through (12) No Change.

(13) Day Trading Requirements. — The day trading restrictions promulgated under section (f)(8)(B) of this Rule shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided a member organization has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under section (f)(8)(B), provided the member organization has the ability to apply the applicable day trading requirement under this Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A "hedge strategy" for purposes of this Rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Member organizations are expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements. In the event day trades executed in a portfolio margin account exceed the day trading buying power, the day trade margin deficiency that is created must be met by the deposit of cash and/or securities within three business days.

(14) through (15) No Change.

---

[1] For purposes of this section (g) of the Rule, the term "margin equity security" utilizes the definition at Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System, excluding a nonequity security.

* * * * *