

Auction Rate Securities

FINRA Grants Additional, Temporary Relief from the Net Capital, Reserve Formula, Non-purpose Loan, and Maintenance Margin Requirements Applicable to Credit Extended on Auction Rate Securities to Broker-Dealers That Agree to Buy Back Auction Rate Securities

Effective Date: November 4, 2008

Executive Summary

This *Notice* advises FINRA member firms that FINRA is granting additional, temporary relief from the net capital (SEA Rule 15c3-1), reserve formula (SEA Rule 15c3-3), non-purpose loan (Regulation T 220.6), and maintenance margin requirements (NASD Rule 2520(f)(8)(A) and NYSE Rule 431(f)(8)(A)) applicable to credit extended on auction rate securities (ARS) to broker-dealers who have agreed to implement buyback programs for auction rate securities. Terms of the relief are detailed in a letter to the SEC, included as Attachment A.

Questions concerning this *Notice* should be directed to:

- Yui Chan, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8426;
- Glen Garofalo, Director, Credit Regulation, at (646) 315-8464;
- Rudolph Verra, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8811; or
- Steve Yannolo, Principal Credit Specialist, Credit Regulation, at (646) 315-8621.

November 2008

Notice Type

- Guidance

Suggested Routing

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

Key Topic(s)

- Auction Rate Securities
- Maintenance Margin Requirements
- Net Capital
- Reserve Formula

Referenced Rules & Notices

- Interpretive Letters dated April 11, 2008, and April 24, 2008
- NASD Rule 2520
- NYSE Rule 431
- Regulation T §§ 220.6
- Regulatory Notice 08-08
- SEA Rules 15c3-1 and 15c3-3

Background & Discussion

In March 2008, FINRA issued *Regulatory Notice 08-08*, which increased the margin requirements on auction rate securities (ARS), due to concerns about reduced liquidity in the market resulting from failed auctions in such securities.¹ Subsequent to *Notice 08-08*, FINRA granted temporary relief to member firms in order to provide liquidity to customers who owned auction rate preferred securities (ARPS), as detailed in letters to the Securities and Exchange Commission (SEC) dated April 11, 2008,² and April 24, 2008.³

Many broker-dealers have recently reached agreements with the SEC, FINRA and various state securities regulators that will require the broker-dealers to buy back the ARS from their customers. As a result, broker-dealers wanted to provide immediate liquidity to customers.

Based upon discussions with the staff of the SEC and staff of the Federal Reserve Board, FINRA is granting additional relief to those broker-dealers that have agreed to implement buyback programs for ARS. This relief will be available to member firms only with respect to the accounts of retail customers whose account assets do not exceed \$10 million, and to any accounts of charitable organizations.⁴

Any liquidity loans extended to such customers who ultimately do not agree to participate in the buyback offer for fixed income, non-equity ARS, will remain subject to the conditions outlined in FINRA *Notice 08-08* upon expiration of the buyback offer period. Any liquidity loans extended to retail customers who ultimately do not agree to participate in the buyback offer for ARPS will be subject to the conditions outlined in the April 11, 2008, and April 24, 2008, letters upon expiration of the buyback offer period.

Broker-dealers are reminded that they must report to FINRA, on a monthly basis, the aggregate dollar amount of credit extended to customers on all loans collateralized by ARPS.

Endnotes

1 See <http://www.finra.org/Industry/Regulation/Notices/2008/P038096>.

2 See www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p038317.pdf.

3 See www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p038387.pdf.

4 As defined in section 3(c)(10)(D)(iii) of the Investment Company Act of 1940.

ATTACHMENT A

September 18, 2008

Mr. Michael A. Macchiaroli, Esq.
Associate Director
Securities and Exchange Commission
Division of Trading and Markets
100 F Street, NE
Washington, DC 20549

Dear Mike,

This letter is a follow-up to the various discussions that have recently taken place regarding a request to provide additional, temporary relief from the net capital (SEA Rule 15c3-1), reserve formula (SEA Rule 15c3-3), non-purpose loan (FRB Regulation T) and maintenance margin requirements (NYSE Rule 431 and NASD Rule 2520) applicable to credit extended on auction rate securities (ARS).

In March 2008, FINRA issued *Regulatory Notice 08-08*, which increased the margin requirements on ARS, due to concerns about reduced liquidity in the market resulting from failed auctions in such securities.¹ In the *Notice*, firms were advised that the maintenance margin requirement for fixed income based ARS was being increased to 25 percent and were reminded that the maintenance requirement on auction rate preferred securities (ARPS) was 100 percent, as they are not margin eligible under Regulation T.

In response to the *Notice*, the Securities Industry Financial Markets Association and representatives from broker-dealers expressed a need to provide liquidity to customers who owned ARPS, and as outlined in a letter to you dated April 11, 2008,² regulatory relief from the maintenance margin, net capital and reserve formula requirements was provided. The letter stated that, based on discussions with you, the SEC staff agreed that member firms would not be required to apply a charge to their net capital for any margin deficiencies resulting from non-purpose credit extended on ARPS, nor to exclude from the customer reserve formula computation such non-purpose loans to customers, provided that the firms met certain conditions specified in the letter. One of the conditions stipulated in the April 11 letter was that broker-dealers needed to obtain a bank loan equal to the aggregate amount of non-purpose loans made to customers. The bank loans can only be collateralized by the ARPS pledged by the customers, and the bank loans must have a remaining maturity term of no less than six months at the time such credit is extended.

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Subsequent to the April 11 letter, broker-dealers found it difficult to secure bank loans collateralized by ARPS, and therefore were not able to avail themselves of the relief that was provided in the letter. As a result, the terms stipulated in the April 11 letter were revised for those broker-dealers that could not obtain bank loans for the amount of credit extended to customers collateralized by ARPS, and such agreed upon terms were communicated to you in a letter dated April 24, 2008.³

In recent weeks, many broker-dealers have reached agreements with the SEC and various state securities regulators that will require the broker-dealers to repurchase the ARS from their customers. In some cases, these settlement agreements require that the broker-dealers provide immediate liquidity to such customers, in the form of unconditional, non-recourse loans against ARS holdings, prior to the actual buyback of such holdings. As a result, several broker-dealers have requested additional net capital and maintenance margin relief from the conditions stipulated in the April 24 letter. Member firms have represented that the buyback offer period for retail customers and charitable organizations may extend through January or February 2009, while the buyback offer periods for other customers may extend well into 2010.

Based upon these recent developments and discussions with you and your staff and staff of the FRB, it has been agreed that additional relief may be granted to those broker-dealers that have agreed to implement buyback programs for ARS. This relief will be available to member firms only with respect to the accounts of retail customers whose account assets do not exceed \$10 million, and to any accounts of charitable organizations.⁴

Based on our discussions, broker-dealers must satisfy the following conditions with respect to liquidity loans collateralized by ARS securities:

Liquidity loans collateralized by fixed income, non-equity auction rate securities shall be subject to the following conditions:

- The loans may be extended as “purpose credit” under Reg T 220.6(a) and in such cases, must be made in a separate Good Faith account;
- Broker-dealers may waive the collection of the 25 percent maintenance margin requirement, as imposed by FINRA *Regulatory Notice 08-08*, and extend loans up to 100 percent of the par value of such ARS in a Good Faith account. However, in lieu of collecting the required maintenance margin, broker-dealers must deduct from net capital 25 percent of the par value of such ARS;

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- Broker-dealers may include a debit item in their customer reserve formula computation, up to 75 percent of the aggregate credit extended through such liquidity loans collateralized by fixed income, non-equity, ARS.

Any liquidity loans extended to such customers who ultimately do not agree to participate in the buyback offer for fixed income, non-equity auction rate securities, will remain subject to the conditions outlined in FINRA *Regulatory Notice 08-08* upon expiration of the buyback offer period.

Liquidity loans collateralized by auction rate preferred securities (ARPS) shall be subject to the following conditions:

- The loans may only be extended as non-purpose credit, pursuant to Reg T 220.6(e) through a separate Good Faith account. Broker-dealers need not obtain a T-4 form or other statement from customers attesting to the purpose of the loan;
- Broker-dealers may waive the 100 percent maintenance margin requirement imposed on such securities by FINRA *Regulatory Notice 08-08* and extend loans up to 100 percent of the par value of such ARPS. However, broker-dealers must deduct from net capital 25 percent of the par value of such ARPS;
- The aggregate of all such non-purpose loans shall be considered as a scheduled capital withdrawal under NYSE Rule 326 and NASD Rule 3130, unless otherwise deducted in the computation of net capital;
- The aggregate amount of credit to be extended on such loans, including those loans subject to the April 11 or April 24 letters, must not exceed 50 percent of the broker-dealer's excess net capital, computed as of the most recent month end and adjusted for any subsequent material decrease at the time such credit is extended;
- The credit extended to customers on such liquidity loans shall not be included as a debit item in the firm's customer reserve formula computation.

Any liquidity loans extended to retail customers who ultimately do not agree to participate in the buyback offer for auction rate preferred securities will be subject to the conditions outlined in the April 11 and April 24 letters upon expiration of the buyback offer period.

Broker-dealers are reminded that they must report to FINRA, on a monthly basis, the aggregate dollar amount of credit extended to customers on all loans collateralized by ARPS.

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We understand that this relief will be temporary, is based solely on the conditions as represented herein, and will be reviewed in consultation with your office for amendment or reconsideration, if and as circumstances may warrant.

Very truly yours,
Rudolph Verra

cc: Scott Holz, Federal Reserve Board
Tom McGowen, SEC, Division of Trading and Markets
Bonnie Gauch, SEC, Division of Trading and Markets

- 1 See <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038097.pdf>
- 2 See <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p038317.pdf>
- 3 See <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p038387.pdf>
- 4 As defined in section 3(c)(10)(D)(iii) of the Investment Company Act of 1940.