

## Credit Default Swaps

### SEC Approves Rule Establishing an Interim Pilot Program on Margin Requirements for Transactions in Credit Default Swaps

Effective Date: June 3, 2009

#### Executive Summary

The Securities and Exchange Commission (SEC) has approved new FINRA Rule 4240, which establishes an interim pilot program (the Interim Pilot Program) with respect to margin requirements for certain transactions in credit default swaps (CDS) and addresses related risk monitoring procedures and guidelines. The Interim Pilot Program's requirements extend to any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions are effected by the member in CDS contracts that are cleared through the central counterparty clearing services of the Chicago Mercantile Exchange (CME). The Interim Pilot Program expires on September 25, 2009.

The text of FINRA Rule 4240 is set forth in Attachment A.

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#### June 2009

##### Notice Type

- New Rule

##### Suggested Routing

- Compliance
- Legal
- Margin
- Operations
- Regulatory Reporting
- Risk Management
- Senior Management

##### Key Topic(s)

- Credit Default Swaps
- Interim Pilot Program
- Maintenance Margin Requirements
- Net Capital
- Risk Monitoring Procedures and Guidelines

##### Referenced Rules & Notices

- FINRA Rule 4240
- Incorporated NYSE Rule 431
- NASD Rule 2520
- Securities Act Rule 239T

## Background & Discussion

Regulatory authorities are adopting measures to address concerns arising from systemic risk posed by CDS, including risks to the financial system arising from the lack of a central clearing counterparty to clear and settle CDS. Historically, in the absence of a central clearing counterparty, CDS transactions have not been booked in the member, but rather in affiliated entities. In light of the rapid growth of the CDS market, and the potential inability of parties to meet their obligations as counterparties, the lack of a central clearing counterparty poses risks not only to the two parties to a CDS transaction, but also to the financial system overall because of the resulting chain of significant economic loss when one or more parties default on their obligations under a CDS transaction.

Recently, the SEC enacted interim final temporary rules, effective until September 25, 2009, that provide enumerated exemptions under the federal securities laws for certain CDS to facilitate the operation of one or more central clearing counterparties in such CDS.<sup>1</sup> Designed to be implemented concurrently with the SEC's action, FINRA is adopting FINRA Rule 4240, which establishes the Interim Pilot Program for margin requirements for CDS transactions and addresses related risk monitoring procedures and guidelines.<sup>2</sup> The Interim Pilot Program expires on September 25, 2009.

### Scope of the Interim Pilot Program

FINRA Rule 4240 applies to margin requirements for any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked),<sup>3</sup> including those in which the offsetting matching hedging transactions (referred to as matching transactions) are effected by the member in contracts that are cleared through the central clearing counterparty clearing services of the CME.

For purposes of the new FINRA rule, the term "CDS" is defined to include any "eligible credit default swap," as defined in Securities Act Rule 239T(d), as well as any other CDS that would otherwise meet that definition but for being subject to individual negotiation.<sup>4</sup> In addition, the new FINRA rule provides that the term "transaction" includes any open (ongoing) CDS position.

## Central Counterparty Clearing Arrangements

FINRA Rule 4240(b) provides that any member, prior to establishing any clearing arrangement with respect to CDS transactions that makes use of any central counterparty clearing services provided by any clearing agency, pursuant to Securities Act Rule 239T(a)(1), must notify FINRA in advance in writing. FINRA notes that it intends to review the monitoring procedures and controls established by members surrounding these transactions prior to the commencement of business. Accordingly, members must submit all relevant documentation to their FINRA Regulatory Coordinator. Such documentation should include:

- the member's procedures and controls for:
  - obtaining and reviewing the required account documentation and financial information necessary for assessing the amount of credit to be extended to customers and broker-dealers;
  - assessing the determination, review and approval of credit limits to each customer and broker-dealer, and across all customers and broker-dealers, engaging in CDS transactions;
  - monitoring credit risk exposure to the member from CDS, including the type, scope and frequency of reporting to senior management;
  - the use of stress testing of accounts containing CDS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
  - managing the impact of credit extended related to CDS contracts on the member's overall risk exposure;
  - determining the need to collect additional margin from a particular customer or broker-dealer, including whether that determination was based upon the creditworthiness of the customer or broker-dealer and/or the risk of the specific contracts;
  - monitoring the credit exposure resulting from concentrated positions within both individual accounts and across all accounts containing CDS contracts;
  - maintaining sufficient margin in each customer and broker-dealer account to protect against the default of the largest individual exposure in the account as measured by computing the largest maximum possible loss;
- copies of exception reports that will be provided to senior management to monitor broker-dealer and customer exposure to open CDS contracts; and
- an organization chart identifying those persons primarily responsible for CDS risk management and operations and the persons to whom they report.

### **Margin Requirements: CDS Cleared on the CME**

FINRA Rule 4240(c)(1) addresses customer or broker-dealer<sup>5</sup> transactions in CDS with a member in which the member executes a matching transaction that makes use of the central counterparty clearing facilities of the CME. The rule provides that members must require as a minimum for computing customer or broker-dealer margin with respect to such customer or broker-dealer transactions the applicable margin pursuant to CME rules.<sup>6</sup> Rule 4240(c)(1) requires that members must, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of the rule, determine whether the applicable CME requirements are adequate with respect to their customer and broker-dealer accounts and the positions in those accounts and, where appropriate, increase such margin in excess of the minimum margin. (For this purpose, members are permitted to use the margin requirements that are set forth in the rule's Supplementary Material, FINRA Rule 4240.01.) The aggregate amount of margin the member collects from customers and broker-dealers for transactions in CDS must equal or exceed the aggregate amount of margin the member is required to post at CME with respect to those customer and broker-dealer transactions.

### **Margin Requirements: CDS Cleared on Facilities Other Than CME or Settled Over the Counter (OTC)**

With respect to any CDS transaction that makes use of a central counterparty clearing facility other than the CME or that settles OTC, the new rule requires members to apply the minimum margin as set forth in FINRA Rule 4240.01 regardless of the type of account in which the transaction is booked. However, members must, based on the risk monitoring procedures and guidelines that are set forth in FINRA Rule 4240(d), determine whether such margin is adequate with respect to their customer and broker-dealer accounts and, where appropriate, increase the requirements.

### **Risk Monitoring Procedures and Guidelines**

FINRA Rule 4240(d) requires members to monitor the risk of any customer or broker-dealer accounts with exposure to CDS and to 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 over a specified time period. Members must employ the risk monitoring procedures and guidelines that are set forth in paragraphs (d)(1) through (8) of the rule. Further, the rule requires members to review, in accordance with their written procedures, at reasonable periodic intervals, their credit extension activities for consistency with the rule's risk monitoring procedures and guidelines. Members must determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data (i.e., the data relevant for purposes of the risk monitoring procedures and guidelines as set forth in FINRA Rule 4240(d)(1) through (8)).

## Concentrations

FINRA Rule 4240(e) addresses concentrated positions. In sum, where the current and potential future exposure with respect to the largest single name unhedged short CDS across all accounts exceeds the member's tentative net capital, the member must take a capital charge equal to the aggregate margin requirement for such accounts on the positions in such single name CDS that result in a margin deficiency after applying the margin set forth in FINRA Rule 4240.01. This additional requirement for concentrated positions reflects FINRA's concern for the possibility of a sudden default in the largest single name CDS across all accounts in respect of which a member has current or potential exposure.

### FINRA Rule 4240.01 (Supplementary Material)

FINRA Rule 4240.01 sets forth the customer and broker-dealer margin requirements that apply with respect to CDS, as appropriate, pursuant to FINRA Rule 4240(c). The term "applicable FINRA margin rules" as used in paragraph (c) of the Supplementary Material refers to requirements pursuant to NASD Rule 2520 or Incorporated NYSE Rule 431, as applicable to the member.<sup>7</sup> FINRA plans to address NASD Rule 2520 and Incorporated NYSE Rule 431 later as part of the rulebook consolidation process, and, accordingly, will amend FINRA Rule 4240.01(c) as appropriate to refer to the new, consolidated FINRA margin rule.<sup>8</sup>

## Endnotes

- 1 See Securities Act Release No. 8999 (January 14, 2009), 74 FR 3967 (January 22, 2009) (Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps). Generally, as noted by the SEC, a CDS is a bilateral contract between two parties, known as counterparties. The value of this contract is based on underlying obligations of a single entity or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities.
- 2 See Securities Exchange Act Release No. 34-59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Order Granting Accelerated Approval of Proposed Rule Change; File No. SR-FINRA-2009-012). See also Securities Exchange Act Release No. 59578 (March 13, 2009), 74 FR 11781 (March 19, 2009) (Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C.).
- 3 CDS transactions must be booked in either a securities or futures account within the broker-dealer.
- 4 FINRA notes that, because Rule 239T(d) excludes contracts that are “subject to individual negotiation,” the proposed FINRA rule would reach CDS contracts, subject to the other criteria set forth in Rule 239T(d), without regard to whether they are individually negotiated.
- 5 NASD Rule 0120(g) states that the term “customer” shall not include a broker or dealer. For purposes of the new rule, the terms “customer or broker-dealer” and “customer and broker-dealer” are intended to include any party with which a member executes a CDS transaction.
- 6 FINRA notes that the matching transactions that are cleared through the CME as the central clearing counterparty are subject to margin requirements pursuant to CME rules (sometimes referred to in such rules as a performance bond).
- 7 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms.
- 8 For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).

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## Attachment A

Below is the text of new FINRA Rule 4240.

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### 4000. FINANCIAL AND OPERATIONAL RULES

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### 4200. MARGIN

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### 4240. Margin Requirements for Credit Default Swaps

#### (a) Effective Period of Interim Pilot Program

This Rule establishes an interim pilot program (“Interim Pilot Program”) with respect to margin requirements for any transactions in credit default swaps executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions (“matching transactions”) are effected by the member in contracts that are cleared through the central counterparty clearing services of the Chicago Mercantile Exchange (“CME”). The Interim Pilot Program shall automatically expire on September 25, 2009. For purposes of this Rule, the term “credit default swap” (“CDS”) shall mean any “eligible credit default swap” as defined in Securities Act Rule 239T(d), as well as any other CDS that would otherwise meet such definition but for being subject to individual negotiation, and the term “transaction” shall include any ongoing CDS position.

#### (b) Central Counterparty Clearing Arrangements

Any member, prior to establishing any clearing arrangement with respect to CDS transactions that makes use of any central counterparty clearing services provided by any clearing agency, pursuant to Securities Act Rule 239T(a)(1), must notify FINRA in advance in writing, in such manner as may be specified by FINRA in a Regulatory Notice.

**(c) Margin Requirements****(1) CDS Cleared on the Chicago Mercantile Exchange**

Members shall require as a minimum for computing customer or broker-dealer margin, with respect to any customer or broker-dealer transaction in CDS with a member in which the member executes a matching transaction that makes use of the central counterparty clearing facilities of the CME (“CME matching customer-side transaction”), the applicable margin pursuant to CME rules (sometimes referred to in such rules as a “performance bond”) regardless of the type of account in which the transaction in CDS is booked. Members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether the applicable CME requirements are adequate with respect to their customer and broker-dealer accounts and the positions in those accounts and, where appropriate, increase such margin in excess of such minimum margin. For this purpose, members are permitted to use the margin requirements set forth in Supplementary Material .01 of this Rule.

The aggregate amount of margin the member collects from customers and broker-dealers for transactions in CDS must equal or exceed the aggregate amount of margin the member is required to post at CME with respect to those customer and broker-dealer transactions.

CME matching customer-side transactions are not subject to the provisions of paragraph (c)(2) of this Rule.

**(2) CDS That Are Cleared on Central Counterparty Clearing Facilities Other Than the CME or That Settle Over-the-Counter (“OTC”)**

Members shall require, with respect to any transaction in CDS that makes use of central counterparty clearing facilities other than the CME or that settle OTC, the applicable minimum margin as set forth in Supplementary Material .01 of this Rule regardless of the type of account in which the transaction in CDS is booked. However, members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether such margin is adequate with respect to their customer and broker-dealer accounts and, where appropriate, increase such requirements.



**(d) Risk Monitoring Procedures and Guidelines**

Members shall monitor the risk of any customer or broker-dealer accounts with exposure to CDS and shall 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 over a specified time period. For purposes of this Rule, members must employ the risk monitoring procedures and guidelines set forth in paragraphs (d)(1) through (8) of this Rule. The member must review, in accordance with the member's written procedures, at reasonable periodic intervals, the member's credit extension activities for consistency with the risk monitoring procedures and guidelines set forth in this Rule, and must determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data, including:

- (1) obtaining and reviewing the required account documentation and financial information necessary for assessing the amount of credit to be extended to customers and broker-dealers;
- (2) assessing the determination, review and approval of credit limits to each customer and broker-dealer, and across all customers and broker-dealers, engaging in CDS transactions;
- (3) monitoring credit risk exposure to the member from CDS, including the type, scope and frequency of reporting to senior management;
- (4) the use of stress testing of accounts containing CDS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
- (5) managing the impact of credit extended related to CDS contracts on the member's overall risk exposure;
- (6) determining the need to collect additional margin from a particular customer or broker-dealer, including whether that determination was based upon the creditworthiness of the customer or broker-dealer and/or the risk of the specific contracts;

(7) monitoring the credit exposure resulting from concentrated positions within both individual accounts and across all accounts containing CDS contracts; and

(8) maintaining sufficient margin in each customer and broker-dealer account to protect against the default of the largest individual exposure in the account as measured by computing the largest maximum possible loss.

**(e) Concentrations**

Where the maximum current and potential exposure with respect to the largest single name CDS across all accounts exceeds the member's tentative net capital, the member must take a capital charge equal to the aggregate margin requirement for such accounts on the positions in such single name CDS in accordance with the tables set forth in Supplementary Material .01 of this Rule. This capital charge may be reduced by the amount of excess margin held in all customer and broker-dealer accounts.

• • • **Supplementary Material:** -----

**.01 Margin Requirements for CDS.** The following customer and broker-dealer margin requirements shall apply, as appropriate, pursuant to paragraph (c) of this Rule.

**(a) Customer and Broker-Dealer Accounts That Are Short a CDS**

The following table shall be used to determine the margin that a member must collect from a customer or broker-dealer that is short a single name debt security CDS contract (sold protection). The margin is to be collected based upon the basis point spread over LIBOR of the CDS contract as well as the maturity of that contract as a percentage of the notional amount, shall be as follows:

Basis Point Spread	Length of Time to Maturity of CDS Contract			
	1 year	3 years	5 years	7 years & longer
0-100	1%	2%	4%	7%
100-300	2%	5%	7%	10%
300-500	5%	10%	15%	20%
500-700	10%	15%	20%	25%
700 and above	15%	20%	25%	30%

For those CDS contracts where the underlying obligation is a debt index, rather than a single name bond, the margin requirement as a percentage of the notional amount shall be as follows:

Index	Length of Time to Maturity of CDS Contract				
	1 year	3 years	5 years	7 years	10 years
CDX.IG	1%	1%	2%	4%	5%
CDX.HY	3%	5%	10%	12%	15%
CDX.HVOL	2%	3%	4%	5%	7%

**(b) Accounts That Are Long a CDS**

For customer or broker-dealer accounts that are long the CDS contracts (purchased protection), the margin to be collected shall be 50% of the above amounts.

**(c) Accounts That Maintain Both Long and Short CDS**

In instances where the customer or broker-dealer maintains both long and short CDS, the member may elect to collect 50% of the above margin requirements on the greater of the long or short position within the same Bloomberg CDS sector, provided those long and short positions are in the same spread and maturity bucket.

If a customer or broker-dealer is long the bond and long a CDS contract on the same underlying obligor, margin needs to be collected only on the long bond position, provided that bond can be delivered against the long CDS contract, as prescribed pursuant to applicable FINRA margin rules.

In instances where the customer or broker-dealer is short the bond and short the CDS on the same underlying obligor, margin need only be collected on the short bond, as prescribed pursuant to applicable FINRA margin rules.

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