Regulatory Notice 12-44

Margin Requirements

SEC Approves Amendments to FINRA Rule 4210 (Margin Requirements)

Effective Dates: October 26, 2012, and January 23, 2013

Executive Summary

The SEC approved amendments to FINRA Rule 4210 (Margin Requirements)[1] related to option spread strategies, maintenance margin requirements for non-margin eligible equity securities, free-riding, "exempt accounts" and stress testing in portfolio margin accounts. The amendments related to option spread strategies become effective on October 26, 2012. All other amendments to FINRA Rule 4210 described in this *Notice* will become effective on January 23, 2013.

The amended rule text is available at *www.finra.org/notices/12-44*.

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Background and Discussion

Option Spread Strategies

In general, option spread strategies allow investors to realize limited reward in exchange for limited risk, and consist of combinations of "long" and "short" call option contracts or put option contracts or combinations of call and put option contracts. Option spreads can be paired in such ways that they offset each other in terms of risk. The total risk of the combined spreads is less than the sum of the risk of such spread positions if viewed as stand-alone strategies. FINRA amended the definition of a spread in FINRA Rule 4210(f)(2)

Financial Industry Regulatory Authority

October 2012

Notice Type

- Rule Amendment

Suggested Routing

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

Key Topics

- Day Trading
- Designated Accounts
- Exempt Accounts
- Free-Riding
- Maintenance Margin
- Margin Requirements
- Non-Margin Eligible Equity Securities
- Option Spread Strategies
- Portfolio Margin

Referenced Rules & Notices

- FINRA Rule 4110
- FINRA Rule 4210
- Regulation T
- Regulatory Notice 11-16
- Regulatory Notice 11-30
- SEA Rule 15c3-1

(A)(xxxii) to mean a "long" and "short" position in different call option series, different put option series, or a combination of call and put option series, that collectively have a limited risk/reward profile. These must meet the following conditions:

1. all options must have the same underlying security or instrument;
2. all "long" and "short" option contracts must be either all American-style or all European-style;[2]
3. all "long" and "short" option contracts must be either all listed or all OTC;[3]
4. the aggregate underlying contract value of "long" versus "short" contracts within option type(s) must be equal; and
5. the "short" option(s) must expire on or before the expiration date of the "long" option(s).

FINRA amended the definitions for the specific option spread strategies currently recognized in the rule, along with the specific margin requirements associated with each spread, with the exception of a "long" box spread consisting of European-style options.[4] The amendments retain this strategy in FINRA Rule 4210 with a maintenance margin requirement equal to 50 percent of the aggregate difference in the exercise prices.[5]

The revised margin requirements are set forth in FINRA Rule 4210(f)(2)(H) and require that the "long" option contracts within such spreads must be paid for in full. The margin required for the "short" option contracts within such spreads is the lesser of: (1) the margin requirements pursuant to FINRA Rule 4210(f)(2)(E); or (2) the maximum potential loss. The maximum potential loss is determined by computing the intrinsic value (*i.e.*, the in-the-money amount) of the options at price points for the underlying security or instrument that are set to correspond to every exercise price present in the spread. The intrinsic values are netted at each price point, and the maximum potential loss is the greatest loss, if any. The proceeds of the "short" options may be applied towards the cost of the "long" options and any margin requirement. FINRA Rule 4210(f)(2)(H)(iv) also makes clear that OTC option contracts that compose a spread must be issued and guaranteed by the same carrying broker-dealer and the carrying broker-dealer must also be a FINRA member. If the OTC option contracts are not issued and guaranteed by the same carrying broker-dealer, or if the carrying broker-dealer is not a FINRA member firm, then the "short" option contracts must be margined separately pursuant to FINRA Rule 4210(f)(2)(E)(iii) or (E)(iv).

In addition, FINRA amended paragraph (f)(2)(N) of FINRA Rule 4210 to similarly conform the margin requirements for spreads that are permitted in a cash account.

The following example illustrates how the maximum loss is determined:

Option Type	Quantity	Expiration	Exercise Price	Stock Price			
				50	55	60	65
Call	10	Dec-2012	50	0	5,000	10,000	15,000
Call	-10	Dec-2012	55	0	0	-5,000	-10,000
Call	-10	Dec-2012	55	0	0	-5,000	-10,000
Call	10	Dec-2012	65	0	0	0	0
Maximum loss: 5,000							

Non-Margin Eligible Equity Securities

The amendments also clarify the maintenance margin requirement for non-margin eligible equity securities. FINRA amended FINRA Rule 4210(c)(1) regarding securities held "long" to clarify that the maintenance margin requirement of 25 percent of the current market value would apply only to margin securities as defined in Regulation T.[6] In addition, consistent with the requirement outlined in *Regulatory Notice 11-16*, FINRA Rule 4210(c)(6) specifies that the maintenance margin requirement for non-margin eligible equity securities held "long" is equal to 100 percent of the current market value.[7]

However, FINRA notes that the amendments supersede two provisions of *Regulatory Notice 11-16*. Firms may no longer extend maintenance loan value on non-margin eligible equity securities either to satisfy maintenance margin deficiencies or when used to collateralize non-purpose loans, except as otherwise provided by FINRA in writing. To this end, FINRA will allow a firm to extend credit on a non-margin eligible equity security only to the extent: (1) the equity security is collateralizing a non-purpose loan debit; and (2) such equity security can be liquidated in a period not exceeding 20 business days, based on a rolling 20 business day median trading volume.

The maintenance loan value for the non-margin eligible equity security will be calculated based on the applicable maintenance margin requirements for a margin eligible equity security. If the equity security fails to meet the trading volume requirement, then the equity security would no longer be entitled to maintenance loan value, and a 100 percent maintenance margin requirement would be applied together with a deduction to net capital pursuant to SEA Rule 15c3-1 and, if applicable, FINRA Rule 4110(a). Notwithstanding the foregoing, FINRA will allow, in the case of offshore mutual funds, a firm to extend maintenance loan value, based on a 25 percent maintenance margin requirement, to collateralize a non-purpose loan, provided that the fund has an affiliation with a U.S.-based fund registered with the SEC under the Investment Company Act of 1940, and the fund shares can be liquidated or redeemed daily.

Similar to the treatment above, FINRA amended FINRA Rule 4210(f)(8)(B)(iii) to clarify that the special maintenance margin requirement for day traders, based on the cost of all day trades made during the day, is equal to 25 percent of the current market value for margin eligible equity securities, and 100 percent of current market value for non-margin eligible equity securities.[8]

In addition, FINRA adopted FINRA Rule 4210(g)(7)(E) for non-margin eligible equity securities held "long" and "short" in a portfolio margin account. Consistent with the margin treatment above, the maintenance margin requirement for non-margin eligible equity securities held "long" in a portfolio margin account is equal to 100 percent of the current market value at all times.[9] The maintenance margin requirement for non-margin eligible equity securities held "short" in a portfolio margin account is equal to 50 percent of the current market value at all times.[10]

FINRA also amended FINRA Rule 4210(g)(7)(D) to clarify that, although non-margin eligible equity securities are not eligible for portfolio margin treatment, such securities may be carried in a portfolio margin account, provided that the member firm applies strategy-based margin requirements, unless such securities are subject to other provisions of paragraph (g). For example, non-margin eligible equity securities may be carried in a portfolio margin account, but the amendment clarifies that they would be subject to the margin treatment set forth in FINRA Rule 4210(g)(7)(E), rather than FINRA Rule 4210(c).

Free-Riding

FINRA amended FINRA Rule 4210(f)(9) (Free-Riding in Cash Accounts Prohibited) to eliminate the exemption for a "designated account"[11] consistent with Regulation T.

Exempt Accounts

FINRA amended FINRA Rule 4210(f)(2)(E)(iv) to eliminate an outdated definition of "exempt account" that specifies reduced maintenance margin requirements for OTC put and call options on certain U.S. Government and U.S. Government Agency debt securities. An "exempt account" must satisfy the definition in FINRA Rule 4210(a)(13) to qualify for the reduced margin on such securities.

Stress Testing

FINRA deleted the monitoring requirement in FINRA Rule 4210(g)(1)(D) to stress test portfolio margin accounts in the aggregate. Firms must continue to stress test each individual portfolio margin account.

Technical Changes

Finally, FINRA amended FINRA Rule 4210 to make non-substantive technical and stylistic changes to encourage consistency throughout the rule and enhance readability.

Endnotes

1. *See* Securities Exchange Act Release No. 67751 (August 29, 2012), 77 FR 54636 (September 5, 2012) (SEC Order Approving File No. FINRA-2012-024).

2. American-style options can be exercised or assigned at any time during the life of the contract. European-style options can only be exercised or assigned at the time of expiration.

3. Listed (defined in FINRA Rule 4210(f)(2)(A)(xxiv)) as used with reference to a call or put option contract means an option contract that is traded on a national securities exchange and issued and guaranteed by a registered clearing agency. OTC (defined in FINRA Rule 4210(f)(2)(A)(xxvii)) as used with reference to a call or put option contract means an over-the-counter option contract that is not traded on a national securities exchange and is issued and guaranteed by a carrying broker-dealer.

4. A box spread (defined in FINRA Rule 4210(f)(2)(A)(vi)) means an aggregation of positions in a "long" call and "short" put with the same exercise price ("buy side") coupled with a "long" put and "short" call with the same exercise price ("sell side") structured as: (A) a "long box spread" in which the sell side exercise price exceeds the buy side exercise price, or (B) a "short box spread" in which the buy side exercise price exceeds the sell exercise price, all of which have the same contract size, underlying component or index and time of expiration, and are based on the same aggregate current underlying value.

5. *See* FINRA Rule 4210(f)(2)(H)(v)e.

6. *See* Section 220.2 of Regulation T for the definition of margin security.

7. *See* *Regulatory Notice 11-16* (April 2011) and *Regulatory Notice 11-30* (June 2011), which delayed the effective date of *Regulatory Notice 11-16* until October 3, 2011.

8. The special maintenance margin requirement for non-margin eligible equity securities for day traders is consistent with the margin requirements outlined in *Regulatory Notice 11-16.*

9. The maintenance margin requirement for non-margin eligible equity securities held "long" in a portfolio margin account is consistent with the margin requirements outlined in *Regulatory Notice 11-16*. In addition, this margin treatment is consistent with current interpretation 4210(g)(6)(B)(i)/01, which will be deleted in light of the amended rule text.

10. The maintenance margin requirement for "short" non-margin eligible equity securities held in a portfolio margin account supersedes the maintenance margin requirement for such securities specified in *Regulatory Notice 11-16*.

11. *See* FINRA Rule 4210(a)(4) for the definition of designated account.