Regulatory Notice 10-53

Margin Requirements

Margin Requirements for Exempted Securities Mutual Funds and Exempted Securities ETFs

Effective Date: October 26, 2010

Executive Summary

Effective October 26, 2010, FINRA is advising firms of customer margin requirements for exempted securities mutual funds and exempted securities exchange traded funds (ETFs) in Regulation T margin accounts. FINRA is also reminding firms of customer margin requirements for money market mutual funds.

Questions concerning this *Notice* should be directed to:

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Background & Discussion

An exempted securities mutual fund is defined in Section 220.2 of Regulation T, as "any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C.80a-8), provided that the company has at least 95% of its assets continuously invested in exempt securities (as defined in section 3(a)(12) of the [Exchange] Act."

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Financial Industry Regulatory Authority

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Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Margin Department
- Operations
- Regulatory Reporting
- Risk Management
- Senior Management

Key Topics
- Exchange Traded Funds (ETFs)
- Exempted Securities ETFs
- Exempted Securities Mutual Funds
- Leveraged Exempted Securities ETFs
- Margin Requirements
- Money Market Mutual Funds

Referenced Rules & Notices
- Incorporated NYSE Rule 431
- Investment Company Act of 1940
- NASD Rule 2520
- Regulation T
- Regulatory Notice 08-60
- Regulatory Notice 09-31
- Regulatory Notice 09-53
- SEA Section 3(a)(12)

ETFs are typically registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index. Some ETFs, similar to exempted securities mutual funds discussed above, have at least 95 percent of their assets continuously invested in exempt securities (exempted securities ETFs). Further, some exempted securities ETFs are leveraged ETFs that are designed to generate multiples (*e.g.*, 200 percent, 300 percent or greater) of the performance of the underlying benchmark they track. FINRA reminded firms of the sales practice obligations with respect to leveraged ETFs in *Regulatory Notice 09-31* (June 2009).

Margin Requirements for Exempted Securities Mutual Funds and Exempted Securities ETFs

Regulation T, issued by the Board of Governors of the Federal Reserve Board pursuant to the Exchange Act, among other things, sets the initial amount of margin required for equity securities.[1] Regulation T excepts from this initial margin requirement selected types of securities, including exempted securities, money market mutual funds and exempted securities mutual funds, and provides that the margin for such products may be established by the creditor in good faith or by the regulatory authority, whichever is greater.[2] Pursuant to Regulation T, NASD Rule 2520(e)(2)(A) and (B) and Incorporated NYSE Rule 431(e)(2)(A) and (B) prescribe margin requirements for obligations for selected exempted securities (specifically for (1) government debt securities and (2) all other exempted securities).

FINRA has received several inquiries requesting clarification on the appropriate margin treatment for exempted securities mutual funds and exempted securities ETFs. Firms have questioned whether such products may be margined as equity securities or exempted securities.

Pursuant to NASD Rule 2520(f)(8)(A) and Incorporated NYSE Rule 431(f)(8)(A), FINRA is advising firms that the margin requirement for an exempted securities mutual fund and exempted securities ETF shall be commensurate with the margin requirements for other exempted securities. Accordingly, effective October 26, 2010, exempted securities mutual funds and exempted securities ETFs shall have an initial and maintenance requirement of 7 percent of the current market value for Regulation T margin accounts. In the case of a leveraged, exempted securities ETF, the initial and maintenance margin requirement in a Regulation T margin account shall increase by a percentage commensurate with the leverage of the ETF. For example, a 200 percent leveraged exempted securities ETF will have a maintenance requirement of 14 percent (2 x 7 percent). FINRA notes that it increased the maintenance margin requirements for leveraged ETFs as prescribed in *Regulatory Notice 09-53* that became effective on December 1, 2009.

FINRA believes that this margin treatment is appropriate in Regulation T margin accounts as such products are treated similarly in portfolio margin accounts. FINRA notes in portfolio margin accounts The Options Clearing Corporation applies comparable stress ranges for exempted securities ETFs. For example, ETFs comprised of U.S. Treasury and municipal debt securities are stressed +/- 7 percent.[3]

Money Market Mutual Funds Requirements

FINRA reminds firms that a money market mutual fund, as defined in Section 220.2 of Regulation T and excepted from Regulation T,[4] has an initial and maintenance requirement of 1 percent of the current market value for both Regulation T margin accounts and portfolio margin accounts, provided the net asset value (NAV) of the fund is not below $1.00 per share.[5] If the NAV of a money market mutual fund falls below $1.00 (*i.e.,* "breaks the buck"), firms must abide by the provisions promulgated in *Regulatory Notice 08-60*.

FINRA also reminds firms that before extending credit on money market mutual funds, they must ensure that (1) the customer waives any right to redeem the shares without the firm's consent, (2) the firm (or if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem the shares for cash upon request and (3) the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed for cash promptly upon request.[6]

Endnotes

1 *See* Regulation T Section 220.12(a).

2 *See* Regulation T Section 220.12(b).

3 For a list of ETFs, please see *www.optionsclearing.com/components/docs/risk-management/rbh/bond_treasury_debt_etfs.pdf*

4 A money market mutual fund means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) that is considered a money market mutual fund under SEC Rule 2a-7 (17 CFR 270.2a-7).

5 *See Regulatory Notice 08-60* (Money Market Mutual Funds).

6 *See* NASD Rule 2520(g)(7)(D) and Incorporated NYSE Rule 431(g)(7)(D).