Regulatory Notice 09-53

Non-Traditional ETFs

Increased Margin Requirements for Leveraged Exchange-Traded Funds and Associated Uncovered Options

Effective Date: December 1, 2009

Executive Summary

Effective December 1, 2009, FINRA is implementing increased customer margin requirements for leveraged ETFs and uncovered options overlying leveraged ETFs, in accordance with NASD Rule 2520 and Incorporated NYSE Rule 431.

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Background & Discussion

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.[1] However, some ETFs that invest in commodities, currencies, or commodity—or currency—based instruments are not registered as investment companies. Unlike traditional UITs or mutual funds, shares of ETFs typically trade throughout the day on an exchange at prices established by the market.

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Notice Type

- Special Alert

Suggested Routing

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

Key Topics

- ETFs
- Leveraged ETFs
- Margin Requirements
- Uncovered Options on Leveraged ETFs

Referenced Rules & Notices

- Incorporated NYSE Rule 431
- NASD Rule 2520
- Regulatory Notice 09-31

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Leveraged ETFs are a subset of ETFs that are designed to generate multiples (*e.g.*, 200%, 300% or greater) of the performance of the underlying index or benchmark they track. Some leveraged ETFs are "inverse" or "short" funds, meaning they seek to deliver the opposite of the performance of the index or benchmark they track. FINRA recently reminded firms of their sales practice obligations with respect to leveraged and inverse ETFs, including the risks caused by the fact that most of these funds are designed to achieve their stated performance on a daily basis.[2]

Leveraged ETFs may include among their holdings derivative instruments such as options, futures or swaps. Leveraged ETFs are inherently more volatile than their underlying benchmark or index.

NASD Rule 2520(f)(8)(A) and Incorporated NYSE Rule 431(f)(8)(A) permit FINRA—in response to market conditions—to prescribe higher initial and maintenance margin requirements. In view of the increased volatility of leveraged ETFs compared to their non-leveraged counterparts, FINRA believes higher margin levels are necessary.

Strategy-Based Margin Account

In general, FINRA is increasing the maintenance margin requirements for leveraged ETFs and associated uncovered options by a factor commensurate with their leverage.

In a strategy-based margin account, the current maintenance margin requirement for any long ETF is 25% of the market value, and for any short ETF, the current maintenance margin requirement is generally 30% of the market value.[3] Effective December 1, 2009, these maintenance margin requirements will increase by a percentage commensurate with the leverage of the ETF, not to exceed 100% of the value of the ETF, as detailed in the following examples:

> Long 100 shares ABC ETF @ 28.00 (200% leverage)
> Market Value: 2,800
> Maintenance Requirement: 2 x .25 = .50
> 2,800 x .50 = 1,400
>
> Short 100 shares DEF ETF @ 26.00 (300% leverage)
> Market Value: 2,600
> Maintenance Requirement: 3 x .30 = .90
> 2,600 x .90 = 2,340[4]

FINRA also is increasing the maintenance margin requirements for listed and over-the-counter uncovered options on leveraged ETFs in a similar fashion. Currently, the maintenance margin requirement for a listed, uncovered option overlying an ETF on a broad-based index or benchmark is:

- 100% of the option premium;
- plus 15% of the ETF market value;
- minus any out-of-the-money amount;

subject to a minimum requirement of:

- 100% of the option premium plus 10% of the ETF market value for call options; and
- 100% of the option premium plus 10% of the exercise amount for put options.

For a listed, uncovered option overlying an ETF on a narrow-based index or benchmark, the percentage of the ETF market value is currently 20%.[5]

For a listed, uncovered option on a leveraged ETF, the formula above will continue to apply; however, the percentages of the underlying ETF market value will be determined using the same methodology as the underlying ETF. Thus, instead of using 15% of the ETF market value for a broad-based ETF and 20% for a narrow-based ETF, a leveraged ETF at 200% would use 30% (two times 15%,or 40% for narrow-based) of the market value, and a leveraged ETF at 300% would use 45% (three times 15%, or 60% for narrow-based).

Portfolio Margin Account

In a portfolio margin account, eligible products and related instruments are grouped into specific portfolio types and theoretical gains and losses are computed based on a prescribed stress range relative to the portfolio type. The stress range of 10 equidistant intervals represents assumed market price movement from the current market value of the underlying instrument. The greatest theoretical loss becomes the margin requirement for that product. Currently, the stress range applied to an ETF and related listed options is based on the portfolio type that the ETF falls under.

For leveraged ETFs and related listed options, the Options Clearing Corporation has increased the stress ranges within its TIMS model proportionately to the amount of leverage on the ETF.[6] For example, an ETF with 300% leverage that falls under the equity or narrow-based index portfolio type would have its stress range increased to -45% / +45% (3 x .15).[7]

Day Trading

For day-trading purposes, the calculations to determine day-trading buying power and day-trade calls will also be based on the amount of leverage on the ETF. Thus, the day-trading buying power on a leveraged ETF will need to include the higher margin requirements prescribed above.

The following example should help demonstrate the calculation of day-trading buying power as it relates to a leveraged ETF:

> Customer A has a total, long market value, based on the previous nights' close of business, of $100,000. The market value is composed entirely of long positions in a 300% leveraged ETF. The customer is carrying a margin debit balance of $20,000. The day-trading buying power would be computed as follows:

Total Market Value:	$100,000
Debit Balance:	$20,000
Account Equity:	$80,000
FINRA Maintenance Requirement:	$75,000 (3 times the normal $25,000 maintenance requirement)
FINRA Excess Equity:	$5,000
Day-Trading Buying Power:	$6,665

The day-trading buying power in this example is computed by multiplying the FINRA excess equity by 1.333, which coincides with a 75% maintenance requirement for the leveraged ETF. It also assumes that the client would be day trading the same, or similar, 300% leveraged ETF.

Additional Margin

FINRA is aware that other securities that contain inherent leverage (*e.g.,* leveraged mutual funds) may be held and traded in customer accounts on a margin basis, and as such, firms are reminded to assess the adequacy of current maintenance requirements for these products and the need to increase them where appropriate.

Pursuant to NASD Rule 2520(d) and Incorporated NYSE Rule 431(d), firms must have procedures in place to:

- review limits and types of credit extended to all customers;
- formulate their own margin requirements; and
- review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by FINRA's rules for individual securities or customer accounts.

Endnotes

1 In 2008, the SEC began issuing exemptive orders that allow certain ETFs to be actively managed and, thus, not track an underlying benchmark or index. *See* SEC Rel. No. 338901 (Mar. 11, 2008), 73 FR 14618, 14620 n. 20 (Mar. 18, 2008). *See also Regulatory Notice 09-31*.

2 *See Regulatory Notice 09-31*.

3 NASD Rule 2520(c) and Incorporated NYSE Rule 431(c) prescribe a maintenance margin requirement of $2.50 per share or 100% of the current market value, whichever is greater, for each short stock priced at less than $5.00 per share, and $5.00 per share or 30% of the current market value, whichever is greater, for each short stock priced at $5.00 per share or greater.

4 As the examples indicate, the maintenance margin levels would double for an ETF offering 200% leverage and triple for an ETF offering 300% leverage. If the leveraged ETF is designed to provide 150% of the performance of the underlying index or benchmark, then the requirement would be the current maintenance requirement for a standard ETF, multiplied by 1.5 (*e.g.,* 1.5 x .25 = .375).

5 For an over-the-counter uncovered option overlying an ETF on a broad-based index or benchmark, the percentage of the ETF market value to be used is currently 20%, and for an over-the-counter uncovered option overlying an ETF on a narrow-based index or benchmark, the percentage of the ETF market value is currently 30%. For over-the-counter uncovered options on a leveraged ETF, the percentages of the underlying ETF will increase by a factor commensurate with the ETFs leverage. Firms should refer to NASD Rule 2520(f)(2)(D) and Incorporated NYSE Rule 431(f)(2)(D) when calculating margin requirements on over-the-counter options.

6 The Options Clearing Corporation's TIMS model is currently the only model approved by the SEC. For a partial list of leveraged and inverse ETFs, see *www.optionsclearing.com/products/rbh_documentation.jsp*.

7 Currently, the Options Clearing Corporation's (OCC) TIMS model does not have the ability to determine theoretical pricing for all over-the-counter options, and therefore cannot determine the theoretical gains and losses for all such products. A firm that wishes to utilize a risk-based methodology for over-the-counter options that the OCC's model does not recognize must first have its proprietary model approved by the SEC. *See* NASD Rule 2520(g) and Incorporated NYSE Rule 431(g)).