

letter regarding the proposal,⁴ and the NASD responded to the comment.⁵

The NASD filed Amendment Nos. 1 and 2 to the proposal on June 2, 2000, and July 30, 2003, respectively. This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments and is simultaneously approving, on an accelerated basis, Amendment Nos. 1 and 2.

II. Description of the Proposal

A. Background

Section 7 of the Exchange Act⁶ authorizes the Board of Governors of the Federal Reserve System ("Federal Reserve Board") to establish requirements for the purchase or carrying of securities on margin. Pursuant to this authority, the Federal Reserve Board promulgated Regulation T,⁷ which sets minimum initial margin requirements. Regulation T provides that transactions in non-equity securities are subject to either "good faith" margin requirements⁸ or the level set by the rules of a self-regulatory organization ("SRO"), whichever is higher.⁹ Accordingly, the maintenance margin requirements established by the NASD or another SRO set the minimum margin levels for non-equity securities.¹⁰

As described more fully below, the proposal amends NASD Rule 2520 to: (1) lower the customer maintenance margin requirements for certain non-equity securities; and (2) permit good faith margin treatment for certain non-equity securities held in "exempt accounts," as defined in the proposal.

B. Reduced Customer Maintenance Margin for Non-Equity Securities Not Held in Exempt Accounts

With respect to non-equity securities that are not held in exempt accounts, the proposal: (1) Reduces the customer maintenance margin requirement for highly rated foreign sovereign debt¹¹

from 20% of current market value to 1% to 6% of current market value, depending on the time to maturity; (2) reduces the customer maintenance margin requirement for exempted securities other than U.S. government obligations from 15% of current market value to 7% of current market value; (3) reduces the customer maintenance margin requirement for investment grade non-equity securities¹² from 20% of current market value to 10% of current market value; and (4) establishes a customer maintenance margin requirement of 20% of current market value for all other marginable non-equity securities.¹³

C. Good Faith Margin Treatment for Certain Non-Equity Securities Held in Exempt Accounts

1. Good Faith Margin Treatment

The proposal will permit broker-dealers to effect transactions in "exempt accounts" without being required to collect either margin or marked to the market losses¹⁴ on exempted securities, mortgage-related securities,¹⁵ or major foreign sovereign debt securities.¹⁶ However, a broker-dealer must take a capital charge for any uncollected marked to the market losses on exempt account positions in these securities.¹⁷

For transactions in exempt accounts involving highly rated foreign sovereign debt¹⁸ and investment grade debt,¹⁹ the proposal establishes margin requirements of 0.5% and 3%,

or guaranteed by the government of a foreign country, its provinces, states or cities, or a supranational entity that are assigned a rating in one of the two top rating categories by at least one nationally recognized statistical rating organization. See NASD Rule 2520(a)(9).

¹² The proposal defines "investment grade debt" as any debt securities assigned a rating in one of the top four rating categories by at least one nationally recognized statistical rating organization. See NASD Rule 2520(a)(10).

¹³ The proposal defines "other marginable non-equity securities" to include debt securities not traded on a national securities exchange that meet certain requirements and private pass-through securities not guaranteed by a U.S. government agency that meet certain requirements. See NASD Rule 2520(a)(16).

¹⁴ Marked to the market losses are unrealized losses on a position in securities resulting from a decline in the position's market value.

¹⁵ The proposal defines "mortgage related securities" to mean securities that fall within the definition in Section 3(a)(41) of the Exchange Act. See NASD Rule 2520(a)(12).

¹⁶ The proposal defines "major foreign sovereign debt securities" as debt securities issued or guaranteed by the government of a foreign country or supranational entity that are assigned a rating in the top rating category by at least one nationally recognized statistical rating organization. See NASD Rule 2520(a)(11).

¹⁷ See NASD Rule 2520(e)(2)(F).

¹⁸ See note 11, *supra*.

¹⁹ See note 12, *supra*.

respectively.²⁰ Although a broker-dealer is not required to collect this margin, it must take a capital charge for any uncollected margin and for any uncollected marked to the market losses.²¹

2. Limitation on Capital Charges

The proposal limits the amount of capital charges a broker-dealer may take in lieu of collecting marked to the market losses.²² Specifically, a broker-dealer may not enter into transactions with exempt accounts that would increase the broker-dealer's capital charges if the broker-dealer's capital charges exceed: (1) 5 % of the broker-dealer's tentative net capital²³ on any one account or group of commonly controlled accounts; or (2) 25% of the broker-dealer's tentative net capital on all accounts combined, unless the excess no longer exists on the fifth business day after it was incurred. The broker-dealer also must notify the NASD that it has reached the 5% or 25% threshold.

D. Amendment No. 1

Under the proposal, a broker-dealer must maintain a written risk analysis methodology for managing the credit risk associated with extending good faith margin on securities transactions in "exempt accounts."²⁴ Amendment No. 1 provides a draft Notice to Members ("NTM") that addresses the written risk analysis methodology that members must establish and maintain. Specifically, the NTM states that a member's written risk analysis methodology should include the following:

- Procedures for obtaining and reviewing the appropriate customer account documentation and the customer financial information necessary to determine exempt account status for the extension of credit under the Rule;
- Procedures and guidelines for the determination, review and approval of credit limits to customers and across all customers who qualify as exempt accounts under the Rule;
- Procedures and guidelines for monitoring credit risk exposure to the organization relating to exempt account customers;
- Procedures and guidelines for the use of stress testing of exempt accounts in order to monitor market risk exposure

²⁰ See NASD Rule 2520(e)(2)(G).

²¹ See NASD Rule 2520(e)(2)(G).

²² See NASD Rule 2520(e)(2)(H).

²³ Generally, tentative net capital is a broker-dealer's net worth after deducting most illiquid assets but before making haircut deductions.

²⁴ See NASD Rule 2520(e)(2)(H)(i).

⁴ See letter from Wendy Fried, Vice President and Associate General Counsel, The Bond Market Association ("TBMA"), to Jonathan Katz, Secretary, Commission, dated June 30, 2000 ("TBMA Letter").

⁵ See letter from Patrice M. Gliniecki, Vice President and Deputy General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated July 27, 2000 ("NASD Letter"). The TBMA Letter, and the NASD's response, are discussed below.

⁶ 12 U.S.C. 78(g).

⁷ 12 CFR 220 *et seq.*

⁸ Regulation T defines "good faith" margin as the amount of margin that a broker-dealer would require in exercising sound credit judgment.

⁹ 12 CFR 220.12(b).

¹⁰ See NASD Rule 2520(c).

¹¹ The proposal defines "highly rated foreign sovereign debt securities" as debt securities issued