Regulatory Notice 12-58

Foreign Equity Securities

SEC No-Action Guidance Expanding the Definition of "Ready Market" for Certain Foreign Equity Securities

December 2012

Notice Type

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

Key Topics

- FTSE World Index
- Net Capital
- Foreign Equity Securities
- Foreign Margin Stock
- "Ready Market"

Referenced Rules & Notices

- FINRA Rule 4210
- Regulation T
- SEA Rule 15c3-1
- Securities Exchange Act of 1934

Executive Summary

The staff of the Division of Trading and Markets of the Securities and Exchange Commission (SEC staff) has issued a no-action letter[1] setting forth conditions under which broker-dealers may treat certain foreign equity securities as having a "ready market" under SEA Rule 15c3-1(c)(11)(i) and subject to the haircuts under SEA Rule 15c3-1(c)(2)(vi)(J) (the no-action letter). This expands the number of foreign securities eligible as foreign margin stock under Regulation T of the Board of Governors of the Federal Reserve System.[2]

The text of the SEC staff's no-action letter is located on the *SEC's website*.

Questions concerning this *Notice* should be directed to:

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Background & Discussion

SEA Rule 15c3-1(c)(2)(vii) requires a broker-dealer to deduct 100 percent of the carrying value of securities it holds in its proprietary account for which there is no ready market, as defined in paragraph (c)(11) of the rule, or which cannot be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions. SEA Rule 15c3-1(c)(11)(i) provides that the term "ready market" includes "a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom."

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Currently under SEA Rule 15c3-1, broker-dealers may treat foreign equity securities that are listed on the FTSE World Index as having a "ready market," and subject to the haircut requirements under paragraph (c)(2)(vi)(J) of the rule.[3] The FTSE World Index is currently limited to approximately 2,300 securities. FINRA member firms have expressed interest in expanding the criteria for recognizing foreign equity securities as having a "ready market" under SEA Rule 15c3-1 to include more than those that are listed on the FTSE World Index. Member firms have suggested that there are many more issuers of a substantial size for which there is a ready market within the meaning of SEA Rule 15c3-1. In response to such member firm interest, FINRA requested, and the SEC staff has granted, no-action relief to expand the definition of "ready market" regarding foreign equity securities. The SEC staff's no-action letter states that foreign equity securities will be deemed as having a "ready market" under SEA Rule 15c3-1(c)(11) and subject to haircuts under paragraph (c)(2)(vi)(J) of the rule if the following conditions are met:

1. The security is listed for trading on a foreign securities exchange located within a country that is recognized on the FTSE World Index, where the security has been trading on that exchange for at least the previous 90 days;

2. Daily quotations for both bid and ask or last sale prices for the security provided by the foreign securities exchange on which the security is traded are continuously available to broker-dealers in the United States, through an electronic quotation system;

3. The median daily trading volume (calculated over the preceding 20 business day period) of the foreign equity security on the foreign securities exchange on which the security is traded is either at least 100,000 shares or $500,000[4]; and

4. The aggregate unrestricted market capitalization in shares of such security exceeds $500 million over each of the preceding 10 business days.

The no-action letter states that any foreign equity security that ceases to meet one or more of the conditions set forth above will continue to be considered to have a "ready market" for five business days from the date the security ceases to meet the conditions. After the end of this five business day period, the security will be considered to have a "ready market" only if and when it again meets all of the conditions.

The SEC staff's no-action letter further provides:

- Broker-dealers may utilize the provisions of SEC Rule 15c3-1(c)(2)(vi)(J) to calculate the haircuts for foreign equity securities that meet all of the conditions set forth in the letter. However, a broker-dealer should perform this calculation independent of the haircut calculation for other securities subject to the provisions of SEA Rule 15c3-1(c)(2)(vi)(J).[5]

- Broker-dealers that choose to utilize the no-action relief would need to demonstrate, upon examination or inquiry, that any foreign equity security used as collateral for a margin loan met all of the conditions set forth in the letter, and to make and keep current, and maintain all relevant records in accordance with SEA Rules 17a-3 and 17a-4.

The no-action letter notes that FINRA expects that broker-dealers relying on the no-action relief will maintain appropriate risk management systems to monitor for concentration, volatility, and liquidity when extending credit secured by foreign securities, and should consider imposing higher "house" maintenance margin requirements as warranted. Measurements for computing such exposure should be reviewed at the individual account level as well as across all accounts held at the broker-dealer.

Finally, the no-action letter states that, pursuant to SEA Rule 15c3-1, if markets can absorb only a limited number of shares of an equity security for which a ready market exists, the non-marketable portion in the proprietary or other accounts of a broker-dealer is subject to a 100 percent deduction to net capital and is treated as a non-allowable asset consistent with current interpretations.[6]

The no-action letter addresses foreign equity securities. FINRA notes that member firms should be aware that options on such securities remain subject to the initial and maintenance margin requirements as set forth in FINRA Rule 4210(f)(2)(E)(iii).

Endnotes

1. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Securities and Exchange Commission, to Grace B. Vogel, Executive Vice President, Member Regulation, FINRA (November 28, 2012).

2. Federal Reserve Regulation T (17 CFR 220.2) defines a foreign margin stock as a "foreign security that is an equity security that: (1) [a]ppears on the Board's periodically published List of Foreign Margin Stocks; or (2) [i]s deemed to have a 'ready market' under [SEA] Rule 15c3-1 . . . or a 'no-action' position issued thereunder."

3. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Securities and Exchange Commission, to Dominic A. Carone, Chairman, Capital Committee, Securities Industry Association (August 13, 1993) (the 1993 Letter). The no-action letter states that the terms and conditions of the 1993 Letter with respect to foreign equity securities listed on the FTSE World Index will continue to apply after the issuance of the no-action letter. *See also* /02 of SEA Rule 15c3-1(c)(2)(vii) in the *FINRA Interpretations of Financial and Operational Rules*.

4. The no-action letter states that shares purchased by the computing broker-dealer during the preceding 20 business day period are to be excluded when determining the median trading volume. *See also* footnote 6 below.

5. The no-action letter states that a broker-dealer may combine foreign equity securities listed on the FTSE World Index under the conditions of the 1993 Letter and those foreign equity securities meeting the conditions of the no-action letter for purposes of calculating the haircuts specified under SEA Rule 15c3-1 (c)(2)(vi)(J).

6. *See* Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Edward Kwalwasser, Senior Vice President, New York Stock Exchange, and Thomas R. Casella, Vice President, National Association of Securities Dealers (October 5, 1987) (the 1987 Letter). The no-action letter notes that, in the 1987 Letter, the SEC issued relief to a broker-dealer if, when faced with a blockage in securities, it treats as readily marketable securities that portion of the block which equals the aggregate of the most recent four-week, inter-dealer trading volume. The number of shares exceeding this amount should be considered non-marketable and subject to a 100 percent deduction from net capital and is treated as a non-allowable asset, unless the broker-dealer demonstrates to the satisfaction of its Designated Examining Authority that a ready market exists for these excess shares. The shares purchased by the computing broker-dealer during the most recent four-week period are to be excluded when determining trading volume. *See also* /01 of SEA Rule 15c3-1(c)(2)(vii) in the *FINRA Interpretations of Financial and Operational Rules*.