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FINRA Proposes Amendments to Margin Requirement Rules.

The proposed amendments could significantly alter the landscape for extended settlement of securities offerings by expressly limiting the public offering exception for "whenissued" securities to equity IPOs

Key Points:

The proposed amendments:

- Define an "extended settlement transaction" as any transaction that is agreed to settle beyond T+2 and require all such transactions to be margined as though they were transacted in margin accounts
- Expressly narrow the scope of the current "primary distribution" exception for "when issued" securities to only apply to equity IPOs, and thus exclude public or "Rule 144A" offerings of debt securities, as well as follow-on or exchange offerings of equity securities
- Extend the exception whereby member firms can choose to take capital charges for any net mark to market loss on transactions in when-issued securities in "designated accounts" to the broader category of "exempt accounts" (which includes certain institutional investors), foreign broker-dealers, and DVP/RVP accounts

The Financial Industry Regulatory Authority (FINRA) has proposed amendments to its margin requirement rules, which protect member firms against customer credit risk by generally requiring firms to collect margin when they extend credit to their customers.

The proposed amendments would deem any transaction that is agreed to settle beyond T+2 an "extended settlement transaction" for which margin must be collected as if in a margin account, absent an applicable exception. The proposed amendments would also expressly limit the public offering exception for when-issued securities in cash accounts to equity IPOs. This change could significantly impact existing market practice for registered offerings of debt, as well as private offerings resold under Rule 144A. Furthermore, due to increased negative carry in debt refinancings, as well as delays in the launch of offerings that cause issuers to miss attractive market windows (as T+2 is insufficient to prepare the requisite closing documentation for many debt financings without a strong running start), the amendments could likely increase the cost of capital for issuers in the US capital markets. The authors of this Client Alert also believe the proposed amendments could cause member firms to be forced to take additional capital charges in order to allow transaction professionals (including the member firms themselves, as well as attorneys, auditors, trustees, and issuers) a sufficient amount of time to finalize the requisite closing documentation. The cost will either be borne by firms or passed through to issuers.

Background

T+2 Settlement Cycle

A settlement cycle for a securities transaction begins at the date of the contract to enter into a securities transaction (commonly referred to as the “trade date” or “T”) and ends when both the “payment of funds” and the “delivery of securities” have occurred between the transacting parties. Rule 15c6-1(a) of the Securities Exchange Act of 1934 (the Exchange Act) requires the settlement cycle to take place within two days (commonly referred to as “T+2”) “unless otherwise expressly agreed to by the parties at the time of the transaction.”1 Accordingly, although the default requirement is that settlement take place within two business days, such period can be extended by agreement between the transacting parties.

Regulation T

Regulation T (Reg T), adopted by the Federal Reserve pursuant to Section 7 of the Exchange Act, regulates the securities credit activity of broker-dealers. As part of such regulation, Reg T specifically sets forth the periods of time in which a broker-dealer is required to (i) obtain cash payment from its customer in relation to a securities purchase in a cash account and (ii) have its customer post margin to cure a margin deficiency in a margin account. Reg T seeks to limit the exposure to market risk by broker-dealers in the event of delays beyond the normal settlement cycle by requiring either the cash payment or the posting of margin in lieu thereof to take place within one “payment period” of the date of purchase.2 “Payment period” is defined as “the number of business days in the standard securities settlement cycle in the United States, as defined in paragraph (a) of SEC Rule 15c6–1 [T+2], plus two business days.”3 Reg T thus requires broker-dealers to secure from their customers payment in cash accounts or margin in margin accounts, within four business days of trade date (T+4). Reg T provides certain limited exceptions to this requirement in certain situations, including, with respect to purchases of when-issued securities and “delivery against payment” transactions in cash accounts.

With respect to when-issued securities, in cash accounts, Reg T requires full cash payment within one “payment period” of the date the security “was made available by the issuer for delivery to purchasers.”4 Accordingly, in a cash account, a customer is not required to make payment within four days (T+4) after the purchase transaction is executed, but rather four days after the issuance or distribution of a when- issued security. With respect to “delivery against payment” transactions, the broker-dealer has up to 35 calendar days (T+35) to obtain payment “if the security is delayed due to mechanics of the transaction and is not related to the customer’s willingness to pay.”

FINRA Rule 4210

FINRA Rule 4210 builds on the requirements of Reg T to impose further requirements on FINRA member broker-dealers with respect to their credit activities, including the treatment of when-issued securities transactions. As a general matter, FINRA Rule 4210 requires when-issued transactions to be treated as if the securities were issued on the trade date in both cash and margin accounts. However, FINRA Rule 4210 provides certain limited exceptions to this requirement with respect to cash accounts. Specifically, rather than obtaining cash payment, broker-dealers can choose to take capital charges for any net mark to market loss on transactions or net positions in when issued securities in cash accounts of FINRA members or “designated accounts.”5 Additionally, neither margin nor capital charge requirements apply to when-issued securities in cash accounts when the securities “are the subject of a primary distribution in connection with a bona fide offering by the issuer to the general public for cash.”6 Finally, the current rule states that “the amount of margin … required by any provision of [Rule 4210] shall be obtained as promptly as possible and in any event within 15 business days from the date such deficiency occurred.”7

As a practical matter, the industry has viewed the current rule as permitting extended settlements in certain situations involving when issued securities. The exception for primary distributions to the general public has been widely viewed as applying to all registered offerings, including debt offerings, and has even been extended in some cases to Rule 144A offerings.

Proposed Amendments to FINRA Rule 4210

Definition of "Extended Settlement Transaction"

In the proposed amendments, FINRA brings clarity on a fundamental level to the question of when a broker-dealer is required to obtain margin in this context by introducing a definition of "extended settlement transaction." Under the proposed new FINRA Rule 4210(a)(18), "extended settlement transaction" is defined as:

"any contract for the purchase or sale of a security (including any exempted security) that does not provide for the payment of funds by the customer (in the case of a customer purchase) or delivery of securities by the customer (in the case of a customer sale) by the second business day after the date of the contract."

In turn, the proposed rule would expressly require all extended settlement transactions to be margined as though they were in margin accounts, except for specifically excepted transactions. In explaining the application of the definition, FINRA highlights that a transaction in relation to which a firm accepted in good faith a customer's agreement to pay within T+2 but for which the customer was only able to make payment on T+3 due to an unexpected issue would not be an extended settlement transaction. FINRA states, however, that if settlement within T+3 is agreed to in advance or if the firm does not have a good- faith belief in settlement in T+2 the transaction would be an extended settlement transaction. Accordingly, the proposed rule would make clear that firms are not able to rely on the additional two-day cure period afforded by Reg T for payment in cash accounts or margin in margin accounts unless the firm accepted in good faith the customer's agreement to pay in T+2 and payment was delayed up to an additional two business days due to unforeseen circumstances.

When-Issued Securities Transactions

Restriction of Public Offering Exception to Equity IPOs

As noted above, under the current rule, neither margin nor capital charge requirements apply to when- issued securities in cash accounts when the securities "are the subject of a primary distribution in connection with a bona fide offering by the issuer to the general public for cash."8 The proposed amendments would expressly narrow the scope of this exception to only apply to equity IPOs and thus exclude when-issued transactions in debt securities and secondary follow-on or exchange offerings of equity securities. In the release, FINRA acknowledges that certain firms have interpreted this provision more broadly to additionally capture these types of offerings, but states that its original intention with the exception was to only exclude equity IPOs and that the proposed amendments clarify that original intention.9

Ironically, while FINRA's proposal would exclude equity IPOs from the default requirement, equity IPOs (and other common stock offerings) for US issuers are among the offerings least likely to use an alternative settlement cycle. The existing computer systems used for equity trading are generally unable to accommodate extended settlement of an equity IPO. When extended settlement is used in common stock offerings, it is typically due to timing constraints imposed by foreign law (including requirements for delivery of "wet ink" signatures) and the practicalities of cross-border offerings.

However, FINRA's proposal could cause a substantial change in market practice for primary distributions of debt offerings. Due to the volume of documentation to be completed between the pricing and closing of those offerings,10 market practice for the vast majority of high-yield debt is a settlement cycle of T+4 to T+6. Similarly, a significant volume of investment grade and convertible debt offerings settle between T+3 and T+5. Movement to a T+2 settlement cycle could result in delayed launches (due to a need to get more documentation into place prior to pricing), as well as increased negative carry by issuers when they issue new debt prior to completion of a redemption notice period or completion of a tender offer. Unfortunately, this change could eliminate much of the benefit provided by the Securities and Exchange Commission's (SEC's) recent relief on debt tender offers that permitted "five business day" tender offers to allow issuers and investors to better align settlement and funding dates; that synchronization requires at least a T+5 settlement cycle for an offering that prices on the day of launch. The use of a T+2 settlement cycle may also be problematic for acquisition financings, as practical realities (and regulatory approvals) necessitate additional notice periods prior to selecting a closing date (and a failed offering often results in a funded bridge loan, which cannot be documented in such a short period of time).

New Exceptions for US Treasury and Municipal Securities

FINRA acknowledges in the release that the public offering exception historically has been interpreted by firms to except new issuances of US Treasury securities and municipal securities and, based on its belief that these transactions present low risks relative to other non-equity offerings, proposes new exceptions to avoid disruptions to these markets. The new exceptions would specifically allow for settlement within T+14 for new issuances of US Treasury securities and T+42 for new issuances of municipal securities.

Allowing for Capital Charges in Lieu of Payment in Cash Accounts for Exempt Accounts, Non-Member Broker-Dealers, and Bona Fide DVP Customers

As noted above, under the current rule, firms can choose to take capital charges for any net mark-to-market loss on transactions or net positions in when-issued securities in cash accounts of FINRA members or "designated accounts" rather than obtain cash payment.11 The proposed amendment would extend this exception to "exempt accounts," an existing definition under the current rule that includes designated accounts, non-member broker-dealers (including foreign broker-dealers), and certain institutional investors that (i) have a net worth of at least US$45 million, (ii) have assets of at least US$40 million, and (iii) make available certain information through public filings or otherwise regarding ownership, business operations, and financial condition. The proposed amendment would also present this option to firms for "bona fide DVP customers," a new definition that would capture customers with whom the firm has a delivery versus payment (DVP) /receive versus payment (RVP) arrangement that satisfies the requirements of FINRA Rule 11860.

Other Changes

The proposed amendments would make certain other clarifications and changes, including by introducing certain new specific extended settlement transaction categories in relation to which the margin requirement may be delayed for certain periods of time.

Takeaways

The regulation of extended settlement transactions has long been a murky and arcane area, and clarity is welcome. However, if the proposed amendments are adopted as proposed, they could significantly change the practical settlement landscape. There are a number of situations in which extended settlements are a necessary and important structural mechanism and, while the proposed amendments create some useful bright lines, there remain many commonplace situations that practically require extended settlement. For example, many cross-border offerings are practically impossible to implement without extended settlement. Moreover, while firms do have the option to take a capital charge in lieu of collecting margin in certain situations, this option could lead to an increase in the cost of capital, which will either be borne by member firms or passed on to issuers.

While the proposed amendments seek to clarify FINRA's views on margin requirements, the policy needs for such action are worth considering further. That is: Is the credit risk mitigation that FINRA is seeking to achieve worth the inevitable increase in the cost of capital and the difficulties that shorter settlement of certain offerings will cause?

Comments on the proposed amendments must be submitted to FINRA by May 14, 2021.

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