COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 41

RIN 3038–AE88

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–86304; File No. S7–09–19]

RIN 3235–AM55

Customer Margin Rules Relating to Security Futures

AGENCY: Commodity Futures Trading Commission and Securities and Exchange Commission.

ACTION: Joint proposed rules.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'') and the Securities and Exchange Commission (''SEC'') (collectively, the ''Commissions'') are proposing amendments to regulations that establish minimum customer margin requirements for security futures. More specifically, the proposed amendments would lower the margin requirement for an unhedged security futures position from 20% to 15%, as well as propose certain revisions to the margin offset table consistent with the proposed reduction in margin.

DATES: Comments should be received on or before August 26, 2019.

ADDRESSES: Comments should be sent to both agencies at the addresses listed below.

CFTC: You may submit comments, identified by RIN 3038–AE88, by any of the following methods:

- *CFTC Website: https://comments.cftc.gov.* Follow the instructions for submitting comments through the website.
- *Mail:* Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.
- *Hand Delivery/Courier:* Same as Mail above.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *https://www.cftc.gov.* You should submit only information that you wish to make available publicly. If you wish for the CFTC to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in CFTC Rule 145.9, 17 CFR 145.9.

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from *https://www.cftc.gov* that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

SEC: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the SEC's internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number S7–09–19 on the subject line.

Paper Comments

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–09–19. This file number should be included on the subject line if email is used. To help the SEC process and review your comments more efficiently, please use only one method. The SEC will post all comments on the SEC's website (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for website viewing and printing in the SEC's Public Reference Room, 100 F Street NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that the SEC does not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda, or other substantive items may be added by the SEC or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the SEC's website. To ensure direct electronic receipt of such notifications, sign up through the ''Stay Connected'' option at *www.sec.gov* to receive notifications by email.

FOR FURTHER INFORMATION CONTACT:

CFTC: Melissa A. D'Arcy, Special Counsel and Sarah E. Josephson, Deputy Director, Division of Clearing and Risk, at (202) 418–5430; and Michael A. Penick, Economist at (202) 418–5279, and Ayla Kayhan, Economist at (202) 418–5947, Office of the Chief Economist, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.

SEC: Michael A. Macchiaroli, Associate Director, at (202) 551–5525; Thomas K. McGowan, Associate Director, at (202) 551–5521; Randall W. Roy, Deputy Associate Director, at (202) 551–5522; Sheila Dombal Swartz, Senior Special Counsel, at (202) 551–5545; or Abraham Jacob, Special Counsel, at (202) 551–5583; Division of Trading and Markets, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–7010.

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The CFTC is proposing to amend CFTC Rule 41.45(b)(1), 17 CFR 41.45(b)(1), and the SEC is proposing to amend SEC Rule 403(b)(1), 17 CFR 242.403(b)(1),[1] under authority delegated by the Board of Governors of the Federal Reserve System (''Federal Reserve Board'') pursuant to Section 7(c)(2) of the Securities Exchange Act of 1934 (''Exchange Act'').[2] The Commissions also are proposing to revise the margin offset table, consistent with the proposed reduction in margin.

I. Background

The Commodity Futures Modernization Act of 2000 (''CFMA''),[3] which became law on December 21, 2000, lifted the ban on trading security futures [4] and established a framework for the joint regulation of security futures by the CFTC and the SEC. A security future is a futures contract on a single security or on a narrow-based security index.[5]

A. Applicable Statutory Framework

As part of the statutory scheme for the regulation of security futures, the CFMA provided for the issuance of regulations governing customer margin for security futures. Customer margin for security futures includes two types of margin, (i) initial margin, and (ii) maintenance margin. Together, the initial and maintenance margin must satisfy the required margin established by the Commissions.[6]

The CFMA added a new subsection (2) to Section 7(c) of the Exchange Act,[7] which directs the Federal Reserve Board to prescribe regulations establishing initial and maintenance customer margin requirements imposed by brokers, dealers, and members [8] of national securities exchanges [9] for security futures. In addition, Section 7(c)(2) provides that the Federal Reserve Board may delegate this rulemaking authority jointly to the Commissions.

Section 7(c)(2)(B) of the Exchange Act provides that the customer margin requirements, ''including the establishment of levels of margin [10] (initial and maintenance) for security futures products,'' must satisfy four requirements. First, they must preserve the financial integrity of markets trading security futures products. Second, they must prevent systemic risk. Third, they must (1) be consistent with the margin requirements for comparable options traded on any exchange registered pursuant to Section 6(a) of the Exchange Act; [11] and (2) provide for initial and maintenance margin levels that are not lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded options. Fourth, they must be, and remain consistent with, the margin requirements established by the Federal Reserve Board under Regulation T (''Regulation T'').[12]

With regard to the third requirement, there is limited legislative history [13] regarding how or why the comparison should be to exchange-traded options. As discussed further below, under certain circumstances the products behave similarly in terms of their overall risk profiles. However, from the perspective of market participants, exchange-traded options and security futures often serve two distinct economic functions.

Exchange-traded options are tools for hedging and speculating on the underlying equity markets. On the other hand, security futures are ''delta one derivatives'' [14] that are more similar to total return equity swaps insofar as they provide exposure to equities without requiring ownership of the underlying instrument. Specifically, security futures are used to (1) establish synthetic long or short exposure to the underlying equity security or equity securities, and/or (2) temporarily transfer securities, similar to securities

[1] CFTC regulations referred to herein are found at 17 CFR Ch. 1; SEC regulations referred to herein are found at 17 CFR Ch. 2.

[2] 15 U.S.C. 78g(c)(2).

[3] Appendix E of Public Law No. 106–554, 114 Stat. 2763 (2000).

[4] *See* Section 1a(31) of the Commodity Exchange Act (''CEA''), 7 U.S.C. 1a(44); and Section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55) (defining the term ''security future'').

[5] *Id.* A ''security future'' is distinguished from a ''security futures product,'' which is defined to include security futures as well as any put, call, straddle, option, or privilege on any security future. *See* Section 1a(45) of the CEA, 7 U.S.C. 1a(45); and Section 3(a)(56) of the Exchange Act, 15 U.S.C. 78c(a)(56) (defining the term ''security futures product''). Futures on indexes that are not narrow-based security indexes are subject to the exclusive jurisdiction of the CFTC. This rule proposal applies only to margin on security futures and not to margin on options on security futures. For the purposes of this proposal, most discussion will relate to security futures only. For the sake of clarity and consistency, the term ''security futures products'' will be used when discussing security futures and the options on security futures together throughout this proposal. Under CEA Section 2(a)(1)(D)(iii)(II) and Exchange Act Section 6(h)(6), the CFTC and SEC may, by order, jointly determine to permit the listing of options on security futures; that authority has not been exercised.

[6] Initial margin must be deposited as collateral when a customer makes an initial investment in security futures. Maintenance margin is the minimum amount a customer must maintain in its margin account while owning security futures. If a customer's margin level falls below the maintenance margin amount, a customer may be required to make an additional deposit. Maintenance margin for security futures is different from variation settlement. Variation settlement is a daily or intraday mark to market payment for a security future. *See* CFTC Rule 41.43(a)(32), 17 CFR 41.43(a)(32); SEC Rule 401(a)(32), 17 CFR 242.401(a)(32).

[7] 15 U.S.C. 78g(c)(2).

[8] Futures commission merchants (as defined in Section 1(a)(28) of the CEA), which may be members of national securities exchanges, clearing members at clearinghouses, or customers of clearing members at clearinghouses, are discussed in detail below.

[9] OneChicago, LLC (''OCX''), the only U.S. national securities exchange currently listing security futures, filed a rulemaking petition, dated August 1, 2008, requesting that the minimum required margin for unhedged security futures be reduced from 20% to 15%. Letter from Donald L. Horwitz, Managing Director and General Counsel, OCX, to David Stawick, Secretary, CFTC, and Nancy M. Morris, Secretary, SEC, dated Aug. 1, 2008, at 2 (''OCX Petition''). OCX also is a designated contract market registered with the CFTC.

[10] The terms ''margin level'' and ''level of margin'', when used with respect to a security futures product, mean the amount of margin required to secure any extension or maintenance of credit, or the amount of margin required as a performance bond related to the purchase, sale, or carrying of a security futures product. 15 U.S.C. 78c(a)(57)(B).

[11] Given the statutory language, for the sake of clarity and consistency, the term ''comparable exchange-traded options'' will be used to describe single stock options throughout this proposal.

[12] 12 CFR 220 *et seq.*

[13] For example, earlier versions of the statutory language stated that margin should be set at levels appropriate to ''prevent competitive distortions between markets offering similar products'', and the reasons given for instituting the margin requirements was that ''[u]nder the bill, margin levels on these products would be required to be harmonized with the options markets.'' *See* S. Report 106–390 (Aug. 25, 2000) at pp.5 and 39.

[14] Delta one derivatives are financial instruments with a delta that is close or equal to one. Delta measures the rate of change in a derivative relative to a unit of change in the underlying instrument. Delta one derivatives have no optionality, and therefore, as the price of the underlying instrument moves, the price of the derivative is expected to move at, or close to, the same rate.

lending or equity repurchase agreements.[15] However, while exchange-traded options and security futures can serve distinct economic functions, they generally share similar risk profiles for purposes of assessing margin. For example, both short security futures positions and certain exchange-traded options strategies produce unlimited downside risk. Investors in security futures and writers of options may lose their margin deposits and premium payments and be required to pay additional funds. As a result, the margin requirements for security futures can be compared to margin practices for exchange-traded options in order to determine appropriate margin levels.

In comparison, security futures traded in Europe are subject to risk-based margin calculations that differ from the margin requirements that apply to security futures in the U.S. LCH Ltd. applies a Standard Portfolio Analysis of Risk (''SPAN'') margin methodology for the security futures it clears,[16] and Eurex applies portfolio-based margining through its new margin methodology, Eurex Clearing Prisma, to its cleared security futures.[17] As described below, in the U.S., security futures may be portfolio margined under current rules only if they are held in a securities account.[18]

B. Prior Regulatory Action by the Commissions

On March 6, 2001, the Federal Reserve Board delegated its authority under Section 7(c)(2) to the Commissions.[19] Pursuant to that authority, the SEC and the CFTC adopted customer margin requirements for security futures.[20]

The 2002 Final Rules establish margin requirements for security futures to be collected by security futures intermediaries from their customers.[21] A security futures intermediary is a creditor, as defined under Regulation T, with respect to its financial relations with any person involving security futures, and includes registered entities such as brokers, dealers, and futures commission merchants (''FCMs'').[22] The amendments proposed today to CFTC regulation 41.45(b)(1) and SEC rule 242.403(b)(1) concern the minimum required margin such entities would be required to collect from customers in this context.

In the 2002 Final Rules, the Commissions established minimum initial and maintenance margin levels for unhedged security futures at 20% of their ''current market value.'' [23] In addition, the Commissions' rules permit self-regulatory organizations and self-regulatory authorities (together ''SROs''),[24] to set margin levels lower than 20% of current market value for customers with certain strategy-based offset positions involving security futures and one or more related securities or futures.[25]

Neither the current regulations nor the proposed amendments prohibit SROs or security futures intermediaries from establishing higher initial or maintenance margin levels than the required margin or from taking appropriate action to preserve their own financial integrity.[26] SROs and security futures intermediaries may determine that higher margin levels are required for security futures under certain market conditions. Similar to current regulations, the Commissions are proposing to preserve this flexibility because it is important for SROs and security futures intermediaries to be able to manage their customers' risks appropriately.

The Commissions enumerated specific exclusions from the margin rule for security futures, and those exclusions would continue under the proposed amendments.[27] For example, margin requirements that derivatives clearing organizations (''DCOs'') or clearing agencies impose on their members are not subject to the 20% security futures margin requirement, as this provides clearinghouses flexibility and discretion in managing their members' exposures. In addition, Section 7(c)(2) of the Exchange Act does not confer authority over margin requirements for clearing agencies and DCOs.[28] The margin rules of clearing agencies registered with the SEC are approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[29] The CFTC has authority to ensure compliance with core principles for DCOs registered with the CFTC under Sections 5b and 5c of the CEA.[30]

Another exclusion is for margin calculated by a portfolio margining system under rules that meet the four criteria set forth in Section 7(c)(2)(B) of the Exchange Act [31] and that have been approved by the SEC and, as applicable, the CFTC.[32] Subsequent to the adoption of 2002 Final Rules, and consistent with the exclusion, three SROs [33] initiated

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[15] *See e.g.,* OCX (describing trading strategies for security futures), *available at https://www.onechicago.com/?page_id=25157.*

[16] *See* LCH's discussion of ''London SPAN'', *available at https://www.lch.com/risk-collateral-management/group-risk-management/risk-management-ltd/ltd-margin-methodology/london.*

[17] *See* Eurex Exchange's discussion of ''Risk parameters and initial margins'', *available at http://www.eurexchange.com/exchange-en/market-data/clearing-data/risk-parameters.*

[18] *See* the Financial Industry Regulatory Authority, Inc. (''FINRA'') Rule 4210(g) and the Cboe Exchange, Inc. (''CBOE'') Rule 12.4. *See also* Section 713 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''). Public Law 111–203,124 Stat. 1376 (2010). The Dodd-Frank Act provided the SEC and CFTC with authority to facilitate portfolio margining by allowing cash and securities to be held in a futures account, and futures and options on futures and related collateral to be held in a securities account, subject to certain conditions. *See* Exchange Act Section 15(c)(3)(C) and CEA Section 4d(h), 15 U.S.C. 78o(c)(3)(C), and 7 U.S.C. 6d(h).

[19] Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC (Mar. 6, 2001) (''FRB Letter''), reprinted as Appendix B to Customer Margin Rules Relating to Security Futures, 66 FR 50720, 50741 (Oct. 4, 2001) (joint proposed rulemaking by the Commissions) (''2001 Proposed Rules'').

[20] *See Customer Margin Rules Relating to Security Futures,* 67 FR 53146 (Aug. 14, 2002) (joint rulemaking by the Commissions, hereinafter the ''2002 Final Rules''); 17 CFR 41.42–41.49 (CFTC regulations); 17 CFR 242.400–242.406 (SEC regulations).

[21] *See* CFTC Rule 41.45(a), 17 CFR 41.45(a); SEC Rule 403, 17 CFR 242.403.

[22] *See* CFTC Rule 41.43(a)(29), 17 CFR 41.43(a)(29); SEC Rule 401(a)(29), 17 CFR 242.401(a)(29). A security future is both a security and a future, so customers who wish to buy or sell security futures must conduct the transaction through a person registered both with the CFTC as either an FCM or an introducing broker and the SEC as a broker-dealer. The term ''security futures intermediary'' includes FCMs that are clearing members or customers of clearing members of the Options Clearing Corporation (''OCC''), which is the clearinghouse that clears security futures listed on OCX.

[23] *See* CFTC Rule 41.45(b)(1), 17 CFR 41.45(b)(1); SEC Rule 403(b)(1), 17 CFR 242.403(b)(1). *See also* CFTC Rule 41.43(a)(4), 17 CFR 41.43(a)(4); SEC Rule 401(a)(4), 17 CFR 242.401(a)(4) (defining the term ''current market value'').

[24] For the sake of clarity and consistency, the defined term ''SRO'' will be used to describe self-regulatory organizations and self-regulatory authorities throughout this proposal. ''Self-regulatory authority'' is defined at CFTC Rule 41.43(a)(30), 17 CFR 41.43(a)(30) and SEC Rule 401(a)(30), 17 CFR 242.401(a)(30).

[25] *See* CFTC Rule 41.45(b)(2), 17 CFR 41.45(b)(2); SEC Rule 403(b)(2), 17 CFR 242.403(b)(2).

[26] *See* CFTC Rule 41.42(c)(1), 17 CFR 41.42(c)(1); SEC Rule 400(c)(1), 17 CFR 242.400(c)(1).

[27] *See* CFTC Rule 41.42(c)(2)(i)–(v), 17 CFR 41.42(c)(2)(i)–(v); SEC Rule 400(c)(2)(i)–(v), 17 CFR 242.400(c)(2)(i)–(v).

[28] *See* CFTC Rule 41.42(c)(2)(iii), 17 CFR 41.42(c)(2)(iii); SEC Rule 400(c)(2)(iii), 17 CFR 242.400(c)(2)(iii). *See also* 15 U.S.C. 78g(c)(2) and FRB Letter (''The authority delegated by the [Federal Reserve Board] is limited to customer margin requirements imposed by brokers, dealers, and members of national securities exchanges. It does not cover requirements imposed by clearing agencies on their members.'').

[29] 15 U.S.C. 78s(b)(2).

[30] 7 U.S.C. 7a–1 and 7 U.S.C. 7a–2.

[31] 15 U.S.C. 78g(c)(2)(B).

[32] *See* CFTC Rule 41.42(c)(2)(i), 17 CFR 41.42(c)(2)(i); SEC Rule 400(c)(2)(i), 17 CFR 242.400(c)(2)(i).

[33] The three SROs that proposed pilot programs are FINRA, the New York Stock Exchange LLC (''NYSE'') and CBOE (formerly known as Chicago

pilot programs for risk-based portfolio margining rules that permit a security futures intermediary to combine certain of a customer's securities and futures positions in a securities portfolio margin account to compute the customer's margin requirements based on the net market risk of all the customer's positions in the account.[34] As discussed in more detail below, these SRO risk-based portfolio margin rules established a margin requirement for unhedged exchange-traded options and security futures of 15% (*i.e.,* a valuation point range of +/− 15%).[35] In proposed rule filings seeking to make the pilots permanent, the SROs noted that they did not encounter any problems or difficulties relating to such pilot programs.[36] These SRO risk-based portfolio margining rules—originally adopted as a pilot program—became permanent in 2008. These SRO rules require 15% margin (*i.e.,* a valuation point range of +/− 15%) for an unhedged exchange-traded option on an equity security or narrow-based index.[37]

Subsequent to the adoption of 2002 Final Rules, each Commission adopted rules to enhance core principles and standards for the operation and governance of DCOs and covered clearing agencies that, as discussed below, also are generally applicable to the clearance and settlement of security futures. In 2011, the CFTC issued regulations applicable to DCOs, including CFTC Rule 39.13, which concerns margin—both initial and variation margin—that is required to be collected by a DCO from its clearing members.[38] Any DCO clearing security futures is subject to CFTC Rule 39.13,[39] and most of the requirements under CFTC Rule 39.13 apply broadly to all transactions cleared by the DCO, but in some cases security futures transactions are excluded.[40] Any of a DCO's clearing members that are FCMs and that are clearing security futures on behalf of customers would be subject to CFTC Rule 41.45(b)(1).[41]

In 2016, the SEC adopted final rules applicable to clearing agencies registered with the SEC, including SEC Rule 17Ad–22(e)(6), to establish enhanced standards for the operation and governance of registered clearing agencies that meet the definition of ''covered clearing agency.[42] This rule requires a covered clearing agency that provides central clearing services to establish, implement, maintain, and enforce written policies and procedures reasonably designed to, as applicable, cover its credit exposures to its participants by establishing a risk-based margin system that meets certain minimum standards prescribed in the rule.[43] OCC, as a covered clearing agency, is subject to these rules, and its broker-dealer clearing members that clear security futures are subject to SEC Rule 403(b)(1).[44]

C. Consideration of SROs' Risk-Based Portfolio Margining Approaches

As discussed below, the Commissions are proposing to amend the customer margin requirements for security futures that are held outside of risk-based portfolio margining accounts. This amended margin requirement would equal the level of margin required to be collected for security futures under risk-based portfolio margining methodologies. The amended margin requirement also would equal the margin requirement for an unhedged exchange-traded option held in a securities portfolio margin account. Security futures and exchange-traded options held in securities accounts are permitted to take advantage of SRO risk-based portfolio margining, and the Commissions are seeking to align the margin requirement for security futures not held in portfolio margin accounts (by lowering their overall margin rate) with security futures and exchanged-traded options held in these securities accounts.

Under the SRO risk-based portfolio margining rules, the minimum initial and maintenance margin on a customer's entire portfolio, including an unhedged position in a security future or exchange-traded option, shall be the greater of: (i) The amount of any of the ten equidistant valuation points representing the largest theoretical loss in the portfolio as calculated under the rule,[45] or (ii) the total calculated by multiplying $0.375 for each position by the instrument's multiplier, not to

Board Options Exchange, Inc.). The SEC has regulatory authority over all three SROs. In 2010, the CBOE conducted a restructuring transaction in which CBOE became a wholly-owned subsidiary of CBOE Holdings, Inc. The CFTC regulates the Cboe Futures Exchange, LLC (a wholly-owned subsidiary of CBOE Holdings, Inc.) as a designated contract market under Section 5 of the CEA.

[34] *See* Exchange Act Release No. 55471 (Mar. 14, 2007), 72 FR 13149 (Mar. 20, 2007) (SR–NASD–2007–013, relating to the National Association of Securities Dealers' (now known as FINRA) rule change to permit members to adopt a portfolio margin methodology on a pilot basis); Exchange Act Release No. 54918 (Dec. 12, 2006), 71 FR 75790 (Dec. 18, 2006) (SR–NYSE–2006–13, relating to further amendments to the NYSE's portfolio margin pilot program); Exchange Act Release No. 54919 (Dec. 12, 2006), 71 FR 75781 (Dec. 18, 2006) (SR–CBOE 2006–14, relating to amendments to CBOE's portfolio margin pilot program to include security futures); Exchange Act Release No. 54125 (Jul. 11, 2006), 71 FR 40766 (Jul. 18, 2006) (SR–NYSE–2005–93, relating to amendments to the NYSE's portfolio margin pilot program to include security futures); Exchange Act Release No. 52031 (Jul. 14, 2005), 70 FR 42130 (Jul. 21, 2005) (SR–NYSE–2002–19, relating to the NYSE's original portfolio margin pilot proposal); Exchange Act Release No. 52032 (Jul. 14, 2005), 70 FR 42118 (Jul. 21, 2005) (SR–CBOE–2002–03, relating to the CBOE's original portfolio margin pilot proposal).

[35] *See* discussion in section I.C. below.

[36] *See* Exchange Act Release No. 58251 (Jul. 30, 2008), 73 FR 45506 (Aug. 5, 2008) (SR–FINRA–2008–041, relating to the FINRA's proposal to make the portfolio margin pilot program permanent under NASD Rule 2520(g) and Incorporated NYSE Rule 431(g)); Exchange Act Release No. 58243 (Jul. 29, 2008), 73 FR 45505 (Aug. 5, 2008) (SR–CBOE–2008–73, relating to the CBOE's proposal to make the portfolio margin pilot program permanent); and Exchange Act Release No. 58261 (Jul. 30, 2008), 73 FR 46116 (Aug. 7, 2008) (SR–NYSE–2008–66, relating to the NYSE's proposal to make the portfolio margin pilot program permanent). FINRA Rule 4210 (Margin Requirements) became effective December 2, 2010. *See* Exchange Act Release No. 62482 (July 12, 2010) 75 FR 41562 (July 16, 2010) (SR–FINRA–2010–024, relating to FINRA's proposal to adopt FINRA Rule 4210 (Margin Requirements) as part of the process of developing a consolidated FINRA rulebook) and FINRA Regulatory Notice 10–45. As of February 14, 2019, of the 3,777 broker-dealers registered with the SEC, FINRA is the designated examining authority for 3,654 firms (96.7%).

[37] *Id.*

[38] *See DCO General Provisions and Core Principles,* 76 FR 69334, 69364–69379 (Nov. 8, 2011).

[39] The CFTC adopted enhanced risk management requirements for all registered DCOs in 2011. *See id.*

[40] For example, CFTC Rule 39.13(g)(8)(ii) (requiring DCOs to collect customer initial margin, for non-hedge positions, at a level that is greater than 100% of the DCO's initial margin requirements) does not apply to initial margin collected for security futures positions. In September 2012, the CFTC's Division of Clearing and Risk issued an interpretive letter regarding CFTC Rule 39.13(g)(8)(ii) to provide clarifications to DCOs complying with the rule. CFTC Letter No. 12–08 (Sept. 14, 2012). CFTC Letter No. 12–08 states that the customer margin rule under CFTC Rule 39.13(g)(8)(ii) ''does not apply to customer initial margin collected as performance bond for customer security futures positions.'' CFTC Letter No. 12–08 is limited in its discussion to CFTC Rule 39.13(g)(8)(ii) only and, accordingly, the remaining provisions of CFTC Rule 39.13 continue to apply to DCOs clearing security futures.

[41] Currently, the OCC is the only clearinghouse in the United States that clears security futures. OCC is registered with the SEC as a clearing agency pursuant to Section 17A of the Exchange Act and registered with the CFTC as a DCO pursuant to Section 5b of the CEA.

[42] *See Standards for Covered Clearing Agencies,* Exchange Act Release No. 78961 (Sept. 28, 2016), 81 FR 70786 (Oct. 13, 2016).

[43] 17 CFR 240.17Ad–22(e)(6).

[44] 17 CFR 242.403(b)(1).

[45] The actual percentage used to stress a financial instrument will depend on the financial instrument. For example, the up/down market move (high and low valuation points) is +6%/−8% for high capitalization, broad-based market indexes; +/−10% for non-high capitalization, broad-based market indexes; and +/−15% for any other eligible product that is, or is based on, an equity security or a narrow-based index. *See* FINRA Rule 4210(g)(2)(F) and CBOE Rule 12.4(a)(11). Portfolio types containing volatility indexes are subject to market moves of +/−20% for 30-day implied volatility, and +/−40% for 9-day implied volatility. *See* CBOE Rule 12.4(a)(11).

exceed the market value in the case of long positions.[46]

The SRO risk-based portfolio margining system approved by the SEC is a methodology for determining a customer's margin requirement by calculating the greatest theoretical loss on a portfolio of financial instruments at ten equidistant points along a range representing a potential percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative. Theoretical gains and losses for each instrument in the portfolio are netted at each valuation point along the range to derive a potential portfolio-wide gain or loss for the point. Under current SRO risk-based portfolio margining rules, the range of theoretical gains and losses for portfolios of security futures and exchange-traded options that are based on a single equity security or narrow-based index is a market increase of 15% and a decrease of 15% (*i.e.,* the valuation points would be +/− 3%, 6%, 9%, 12%, and 15%).[47]

In addition to requiring a 15% margin for unhedged security futures and exchange-traded options, as a pre-condition to offering portfolio margining to customers under the SRO risk-based portfolio margining system, security futures intermediaries are required to establish a comprehensive, written risk analysis methodology to assess the potential risk to the security futures intermediary's capital over a specified range of possible market movements for positions held in a securities portfolio margin account.[48]

D. Consideration of Statutory Requirements

As noted above, in Section 7(c)(2)(B)(iii) of the Exchange Act[49] Congress provided that the margin requirements for security futures must be consistent with the margin requirements for comparable exchange-traded options, and that the initial and maintenance margin levels for security futures may not be lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded option.

As noted above, despite some distinct economic uses for exchange-traded options and security futures, both products share similar risk profiles. Accordingly, the Commissions are proposing to apply margin requirements to security futures that are consistent with the margin requirements for comparable exchange-traded options.

In summary, as discussed in detail below, because unhedged exchange-traded options and security futures in SRO risk-based portfolio margining programs were permitted to be margined at a lower 15% rate as early as 2008, when the SRO risk-based portfolio margining programs became permanent,[50] the Commissions are proposing to amend their joint margin rules relating to security futures to reduce the minimum required margin for unhedged security futures from 20% to 15%, reflecting the current margin requirements available for comparable exchange-traded options.[51]

With regard to the other three statutory requirements, the Commissions preliminarily believe this proposed action is consistent with preserving the financial integrity of the security futures market, is unlikely to lead to systemic risk, and is consistent with the margin requirements established by the Federal Reserve Board under Regulation T.[52]

II. DISCUSSION

A. Minimum Margin for Unhedged Positions

1. Current Security Futures Margin Rules

Under existing CFTC and SEC regulations, the current minimum initial and maintenance margin levels required of customers for each unhedged long or short position in security futures is 20% of the current market value of such a security future.[53] This margin level was based on the margin requirements for an unhedged short, at-the-money exchange-traded option in 2002.[54] Currently, the margin requirement for an unhedged short, at-the-money exchange-traded option held in a customer account that is not subject to SRO risk-based portfolio margining, where the underlying instrument is either an equity security or a narrow-based index of equity securities, is 100% of the exchange-traded option proceeds, plus 20% of the value of the underlying security or narrow-based index.[55]

2. SRO Risk-Based Portfolio Margin Accounts May Hold Comparable Exchange-Traded Options

When the Commissions adopted the 2002 Final Rules, market participants had no opportunity to margin short exchange-traded options on an equity security or a narrow-based index, at a rate lower than 20%. Therefore, according to Section 7(c)(2)(B)(iii)(II) of the Exchange Act, the Commissions could not establish a margin level for security futures that was lower than the 20% margin level applicable to exchange-traded options. Now, after the adoption of the SRO risk-based portfolio margining for securities customer accounts, market participants may choose to hold their exchange-traded options in accounts that are margined at levels of 15% or lower.[56]

At the time of the 2002 Final Rules, the SROs had not yet proposed portfolio margining rules for exchange-traded options. As of the publication of the 2002 Final Rules, all short exchange-traded options on an equity security or a narrow-based index were required to satisfy a 20% margin rate and it was the Commissions' view that security futures should be subject to the same margin rate for those comparable exchange-traded options.

Today, there is an alternative margin methodology for exchange-traded options that are held in a securities

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[46] *See* FINRA Rule 4210(g)(7) and CBOE Rule 12.4(e).

[47] A theoretical options pricing model is used to derive position values at each valuation point for the purpose of determining the gain or loss. *See* FINRA Rule 4210(g)(2)(F) (defining the term ''theoretical gains and losses''). For example, assuming that the 15% market move creates the largest theoretical loss in the portfolio and that security futures have a linear function (*i.e.,* a price movement in the underlying instrument will translate into a specific dollar value change in the security future), the initial and maintenance margin for a security future will equal close to 15% of the overall unhedged security futures portfolio.

[48] *See* FINRA Rule 4210(g)(1) and CBOE Rule 15.8A. *See also* CFTC Rule 1.11 (requiring FCMs to establish risk management programs that address market, credit, liquidity, capital and other applicable risks, regardless of the type of margining offered).

[49] 15 U.S.C. 78g(c)(2)(B)(iii).

[50] *See supra* note 36.

[51] *See* 2001 Proposed Rules, 66 FR at 50726 (''Pending adoption of such [portfolio margin] systems by regulatory authorities, however, the 20 percent level is consistent with the current requirements for comparable equity options.'').

[52] As discussed in the CFTC's Consideration of Costs and Benefits and the SEC's Economic Analysis, in sections IV.A and B, respectively, the Commissions believe that margin coverage is sufficient and tailored to preserve financial integrity and prevent systemic risk in the security futures market.

[53] *See* CFTC Rule 41.45(b), 17 CFR 41.45(b); SEC Rule 403(b), 17 CFR 242.403(b).

[54] *See* 2002 Final Rules, 67 FR at 53157.

[55] *See generally* FINRA Rule 4210 and CBOE Rule 12.3. For long, exchange-traded options, the purchaser is generally required to pay the full amount of the contract.

[56] As stated above, SRO risk-based portfolio margin rules permit a security futures intermediary to combine certain of a customer's securities positions to compute margin requirements. In cases where a customer holds hedged positions (such as options) on the same underlying security, the portfolio margin requirement may be less than 15%. For purposes of the analysis of the proposed rule amendments, however, the Commissions are determining whether the proposed 15% margin requirement for an unhedged security future held outside a securities portfolio margin account is comparable to a 15% margin requirement for unhedged exchanged-traded options held in a securities portfolio margin account.

margin account and subject to permanent portfolio margin requirements implemented successfully by market participants. The Commissions preliminarily believe that they have satisfied the third prong of the Exchange Act's margin requirements to determine that the margin rate for security futures should be consistent with the margin rate for those exchange-traded options. The Commissions preliminarily believe there is sufficient basis to make that determination at this time, and are proposing that the margin rate for unhedged security futures be consistent with, and the same as, the margin rate for unhedged exchange-traded options held in a risk-based portfolio margining account.

3. Minimum Levels of Margin Required for Security Futures

Congress stated explicitly that the margin level for a security future should not be lower than the lowest level of margin for any comparable exchange-traded option,[57] but it did not state a specific amount that the Commissions would be required to set as a minimum margin requirement. Today, there are exchange-traded options based on an equity security or narrow-based index that are margined at 15%, or lower, as a result of portfolio margining that is now being offered by a number of SROs. Congress intended for the Commissions to set a margin level for a security future that was not lower than the margin rate required for comparable exchange-traded options, which is to say that the Commissions cannot set a margin rate for security futures lower than 15%. The margin required for an unhedged exchange-traded option in a risk-based portfolio margin account, calculated using the SROs' current rules, will equal 15% or less of the underlying equity security's value, because the largest theoretical loss produced by shocking the portfolio will not be more than 15%.

Because the current SRO required margin levels for unhedged exchange-traded options held in a portfolio margin account are set at a level based on shocking the portfolio at 15% price movements, the Commissions preliminarily believe that the unhedged security futures margin rate should not be lower than 15%. Therefore, the Commissions' proposal to lower the margin requirement for security futures complies with the statutory requirement that the margin level for a security future be consistent with the margin for any comparable exchange-traded option.

[57] 15 U.S.C. 78g(c)(2)(B)(iii)(II).

4. The Commissions Have Authority to Determine Which Exchange-Traded Options Are Comparable to Security Futures

In this proposal, the Commissions seek to align the margin rate for security futures with the lower portfolio-based margin rate for exchange-traded options because the Commissions view exchange-traded options held in portfolio margin accounts as comparable to security futures that may be held alongside the exchange-traded options.

Congress did not instruct the Commissions to set the margin requirement for security futures at the same exact level as the margin requirements for exchange-traded options. The Commissions are required to establish a margin requirement that is ''consistent'' with the margin requirements for ''comparable'' exchange-traded options. Because the Commissions have some flexibility in establishing the margin rate for security futures, the Commissions are making the determination that establishing the margin rate for unhedged security futures at the same rate as the margin rate for exchange-traded options that are held alongside security futures inside a portfolio margin account subject to an SRO's portfolio margining rules will provide the most consistent result for security futures.

The Commissions are proposing to decrease the margin requirement for unhedged security futures from 20% to 15% in order to reflect the comparability between unhedged security futures and exchange-traded options that are held in risk-based portfolio margin accounts. The SRO portfolio margining rules, upon which this change is based, are discussed in more detail below.

The Commissions explained in the 2001 proposing release for customer margin for security futures that ''the Federal Reserve Board has expressed the view that 'more risk-sensitive, portfolio-based approaches to margining security futures products' should be adopted [citing the FRB Letter]. Pending adoption of such systems by regulatory authorities, however, the 20% level is consistent with the current requirements for comparable equity options.'' [58]

With the adoption of the SRO securities risk-based portfolio margining rules—including portfolio margining for security futures—the Commissions have preliminarily determined that a proposed minimum margin level of 15% meets the comparability standard of Section 7(c)(2) of the Exchange Act.[59] Under the SROs' securities risk-based portfolio margining rules, a security futures intermediary may combine a customer's related products and calculate margin for a group of similar products on a portfolio margin basis. Each group of products may be subject to a different margin calculation, depending on its risk profile.[60] Portfolios containing exchange-traded options and security futures based on the same underlying security, such as an individual equity or narrow-based index are grouped together.[61] SRO rules calculate the margin requirement for these exchange-traded options and security futures by exposing the instruments to market moves that are +/−15%. The Commissions are proposing to allow security futures intermediaries to margin security futures held outside of these portfolios the same as security futures held inside of the portfolios with other instruments. As a result of this change, security futures held in futures accounts and strategy-based securities margin accounts would be subject to the same margin requirements as unhedged security futures held in securities portfolio margin accounts. The Commissions are proposing to require 15% margin for unhedged security futures because it would bring security futures held outside of a securities portfolio margin account into alignment with the margin requirements for unhedged security futures held within a securities account using risk-based portfolio margining.

[58] *See* 2001 Proposed Rules, 66 FR at 50726.

5. The Margin Requirements Are Consistent for Comparable Exchange-Traded Options

Under the statutory requirement, customer margin requirements,

[59] *See* 15 U.S.C. 78g(c)(2).

[60] Each of the SROs has different portfolio types that will be margined according to the portfolio's risk profile. These portfolio types include: (i) High capitalization, broad-based market index (margin required is calculated using +6/−8% market moves), (ii) non-high capitalization, broad-based market index (margin required is calculated using +/−10% market moves), (iii) narrow-based index (margin required is calculated using +/−15% market moves), (iv) individual equity (margin required is calculated using +/−15% market moves), (v) volatility index (30-day implied) (margin required is calculated using +/−20% market moves), and (vi) volatility index (9-day implied) (margin required is calculated using +/−40% market moves). *See, e.g.,* FINRA Rule 4210(g)(2)(F) and CBOE Rule 12.4(a)(11).

[61] Certain portfolios are allowed offsets such that, at the same valuation point, for example, 90% of a gain in one portfolio may reduce or offset a loss in another portfolio. These offsets would be allowed between portfolios within the narrow-based index group, but not for class groups containing different individual equity securities or eligible products (such as options and security futures) as the underlying security.

including the establishment of levels of margin (initial and maintenance) for security futures must be consistent with the margin requirements for comparable options traded on any exchange registered pursuant to Section 6(a) of the Exchange Act. As noted above, the Commissions believe that certain types of exchange-traded options, no matter what type of an account they are in, are comparable to security futures. The margin requirements for comparable exchange-traded options and security futures must be consistent.

Under this proposal, the Commissions are using a stress level percentage set out for unhedged exchange-traded options based on an equity security or narrow-based index in a portfolio margin account (*e.g.,* +/−15%) to establish a consistent margin level for security futures held outside of a securities portfolio margin account, which use a fixed-rate percentage of market value to set margin.[62] While these two regimes reflect certain differences (in that portfolio margin calculates margin on a portfolio or net basis for securities with the same underlying position, and outside a securities portfolio margin account, margin is calculated on a position-by-position basis), the Commissions believe that these two regimes are consistent when comparing unhedged security futures with comparable exchange-traded options.

As stated above, the Commissions noted in the 2001 Proposed Rules that ''[p]ending adoption of such [portfolio margining] systems by regulatory authorities, however, the 20% level is consistent with the current requirements for comparable equity options.'' [63] Since the adoption of the SRO risk-based portfolio margin rules, subsequent to the adoption of the 2002 Final Rules, unhedged exchanged-traded options based on an equity security or a narrow-based index and unhedged security futures held in a securities portfolio margin account may be margined at 15%. As a result of these developments, the Commissions are proposing to reduce the margin requirement for an unhedged security future held outside of a securities portfolio margin account from 20% to 15%. Consequently, the Commissions preliminarily believe that the proposed level of margin is consistent with the margin requirements for comparable options traded on any exchange registered pursuant to Section 6(a) of the Exchange Act.

6. The Proposed Margin Rule Is Consistent With the Federal Reserve's Regulation T

Section 7(c)(2)(B)(iv) of the Exchange Act requires that margin requirements for security futures (other than levels of margin), including the type, form, and use of collateral, must be consistent with the requirements of Regulation T.[64] In the 2002 Final Rules, while the Commissions determined not to apply Regulation T in its entirety to margin requirements for security futures, the Commissions adopted final rules which included certain provisions that govern account administration, type, form, and use of collateral, calculation of equity, withdrawals from accounts, and the treatment of undermargined accounts. In the 2002 Final Rules, the Commissions stated that ''the inclusion of these provisions in the Final Rules satisfies the statutory requirement that the margin rules for security futures be consistent with Regulation T.'' [65] Because the proposed amendments today solely relate to a reduction in the ''levels of margin'' for security futures, which are not required under the Exchange Act to be consistent with Regulation T, the Commissions preliminarily believe that the margin requirements for security futures as proposed to be amended would continue to be consistent with Regulation T.

7. The Proposed Margin Rule Permits Higher Margin Requirements

Again, under this proposal, the joint margin regulations will continue to permit SROs and security futures intermediaries to establish higher margin levels and to take appropriate action to preserve their own financial integrity.[66] The proposed minimum margin requirement of 15% would apply to an unhedged position in a security future, whether the position is held in a securities account or a futures account.[67] The 15% margin requirement for unhedged security futures would not preclude the use of an existing portfolio margining system, such as SPAN, by an FCM for security futures held in a futures account, so long as the portfolio margining system is modified to produce results that comply with the margin requirements for security futures.[68]

8. Request for Comments

In summary, the Commissions propose that the required minimum margin for each long or short position in a security future shall be 15% of the current market value of such security future. The Commissions request comment on all aspects of the proposed amendment to reduce the margin requirement to 15%. In addition, the Commissions request comment, including empirical data in support of the comments, on the following questions related to the proposal:

- As discussed above, the Commissions believe that because the margin requirement for a comparable option held in a portfolio margin account is calculated by exposing the option to market moves that are +/−15%, the margin methodologies for security futures and comparable exchange-traded options are consistent. Is the Commissions' belief correct? If not, why not?
- Is the proposed reduction in margin for security futures to 15% consistent with the margin requirements for comparable exchange-traded option contracts based on an equity security or narrow-based index held in a securities portfolio margin account? Is it appropriate to compare the proposed margin requirement for an unhedged security futures position held outside a portfolio margin account to an unhedged exchange-traded option held in a securities portfolio margin account for purposes of the comparability standard in Section 7(c)(2)(B)(iii)(I) of the Exchange Act?

[62] While the Commissions are using a single unhedged option for comparison, the Commissions note that a long (short) security future position can be replicated by a portfolio containing one long (short) at-the-money call and one short (long) at-the-money put. This options portfolio creates a synthetic security futures position. The margin requirement applicable to the options portfolio, under approved SRO portfolio margin system rules, is also 15%. In addition, a very deep-in-the-money call or put on the same security (with a delta of one) is an option contract comparable to a security futures contract that will also result in a consistent 15% margin level.

[63] 2001 Proposed Rules, 66 FR at 50726.

[64] 15 U.S.C. 78g(c)(2)(B)(iv).

[65] 2002 Final Rules, 67 FR at 53155.

[66] *See* CFTC Rule 41.42(c)(1), 17 CFR 41.42(c)(1); SEC Rule 400(c)(1), 17 CFR 242.400(c)(1).

[67] In its petition, OCX stated that ''because of operational issues at the securities firms, almost all security futures positions are carried in a futures account regulated by the CFTC and not in a securities account. The proposed joint rulemaking would permit customers carrying security futures in futures accounts to receive margin treatment consistent with that permitted under the [portfolio] margining provisions of CBOE.'' *See* OCX Petition at 2.

[68] For example, a SPAN risk-based portfolio margining methodology can be used to compute required initial or maintenance margin that results in margin levels that are equal to or higher than the margin levels required by the proposed rules. In this regard, for example, the minimum margin requirement for unhedged security futures under the proposed rules would be 15%, and SPAN could not recognize any offset for combination positions that is not permitted under SRO rules, as provided in CFTC Rule 41.45(b)(2), 17 CFR 41.45(b)(2); SEC Rule 403(b)(2), 17 CFR 242.403(b)(2). *See also* note 27 in the 2002 Final Rules, 67 FR at 53148.

• Are there any other comparisons or methodologies for comparison that the Commissions should consider in determining whether the proposed reduction in margin to 15% for security futures meets the standards in Section 7(c)(2)(B)(iii) of the Exchange Act with respect to comparing the margin requirements for security futures with the margin requirements for comparable exchange-traded options? For example, should the comparison or methodologies for comparable options be based on a specific option position (or positions) held in a securities portfolio margin account, such as a deep in-the-money options position or matched pairs of long-short options positions? If so, please identify the position or positions and explain how they would meet the comparability standards under the Exchange Act.

• Are there any other risk-based margin methodologies that could be used to prescribe margin requirements for security futures? If so, please identify the margin methodologies and explain how they would meet the comparability standards under the Exchange Act.

B. Margin Offsets

The Commissions' joint margin rules permit SROs [69] to establish margin levels for offsetting positions involving security futures, which are lower than the required margin levels for unhedged positions.[70] Thus, an SRO may adopt rules that set the required initial or maintenance margin level for an offsetting position involving security futures and related positions at a level lower than the level that would be required if the positions were margined separately. Such rules must meet the criteria set forth in Section 7(c)(2)(B) of the Exchange Act [71] and must be effective in accordance with Section 19(b)(2) of the Exchange Act [72] and, as applicable, Section 5c(c) of the CEA.[73]

In issuing the 2002 Final Rules, the Commissions published a table of offsets for security futures that the Commissions had identified as consistent with those permitted for similar offsetting positions involving exchange-traded options and that would qualify for reduced margin levels.[74] The Commissions are proposing to re-publish the table of offsets to reflect the proposed 15% minimum margin requirement.

As compared to the offsets identified at the time of the adoption of the joint margin rules, certain offsets would reflect a 15% minimum margin requirement for certain offsetting positions (as opposed to the current 20% requirement) and would retain the same percentages for all other offsets.[75] There are no additional adjustments to the offsets table, other than minor footnote edits.

The Commissions preliminarily believe that the offsets identified in the following re-stated table are consistent with the strategy-based offsets permitted for comparable offset positions involving exchange-traded options. SROs seeking to permit trading in security futures generally should modify their rules that impose levels of required margin for offsetting positions involving security futures in accordance with the margin percentages identified in the following table of offsets.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
1. Long security future or short security future.	Individual stock or narrow-based security index.	15% of the current market value of the security future.	15% of the current market value of the security future.
2. Long security future (or basket of security futures representing each component of a narrow-based securities index [1]) and long put option [2] on the same underlying security (or index).	Individual stock or narrow-based security index.	15% of the current market value of the long security future, plus pay for the long put in full.	The lower of: (1) 10% of the aggregate exercise price [3] of the put plus the aggregate put out-of-the-money [4] amount, if any; or (2) 15% of the current market value of the long security future.
3. Short security future (or basket of security futures representing each component of a narrow-based securities index [1]) and short put option on the same underlying security (or index).	Individual stock or narrow-based security index.	15% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	15% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any. [5]
4. Long security future and short position in the same security (or securities basket [1]) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the short stock or stocks.	5% of the current market value as defined in Regulation T of the stock or stocks underlying the security future.
5. Long security future (or basket of security futures representing each component of a narrow-based securities index [1]) and short call option on the same underlying security (or index).	Individual stock or narrow-based security index.	15% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	15% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any.
6. Long a basket of narrow-based security futures that together tracks a broad based index [1] and short a broad-based security index call option contract on the same index.	Narrow-based security index	15% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	15% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any.

[69] As noted above, for the sake of clarity and consistency, the defined term "SRO" is used to describe both self-regulatory organizations and self-regulatory authorities throughout this proposal.

[70] *See* CFTC Rule 41.45(b)(2), 17 CFR 41.45(b)(2); SEC Rule 403(b)(2), 17 CFR 242.403(b)(2).

[71] 15 U.S.C. 78g(c)(2)(B).

[72] 15 U.S.C. 78s(b)(2).

[73] 7 U.S.C. 7a–2(c).

[74] *See* 2002 Final Rules, 67 FR at 53159. The offset table was published in the 2002 Final Rules. It is not part of the Code of Federal Regulations. *See also* FINRA Rule 4210(f)(10)(B)(iii), CBOE Rule 12.3(k)(6), OCX Rule 515(m), and Schedule A to Chapter 5 of the OneChicago Exchange Rulebook.

[75] The offset table lists the margin percentages for a long security future and a short security future. These percentages are the baseline, not offsets, but they are included in the table to preserve consistency with the earlier offset table.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
7. Short a basket of narrow-based security futures that together tracks a broad-based security index[1] and short a broad-based security index put option contract on the same index.	Narrow-based security index	15% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	15% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any.
8. Long a basket of narrow-based security futures that together tracks a broad-based security index[1] and long a broad-based security index put option contract on the same index.	Narrow-based security index	15% of the current market value of the long basket of narrow-based security futures, plus pay for the long put in full.	The lower of: (1) 10% of the aggregate exercise price of the put, plus the aggregate put out-of-the-money amount, if any; or (2) 15% of the current market value of the long basket of security futures.
9. Short a basket of narrow-based security futures that together tracks a broad-based security index[1] and long a broad-based security index call option contract on the same index.	Narrow-based security index	15% of the current market value of the short basket of narrow-based security futures, plus pay for the long call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 15% of the current market value of the short basket of security futures.
10. Long security future and short security future on the same underlying security (or index).	Individual stock or narrow-based security index.	The greater of: 5% of the current market value of the long security future; or (2) 5% of the current market value of the short security future.	The greater of: (1) 5% of the current market value of the long security future; or (2) 5% of the current market value of the short security future.
11. Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put and call must have the same exercise price. (Conversion)	Individual stock or narrow-based security index.	15% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from the call sale may be applied.	10% of the aggregate exercise price, plus the aggregate call in the money amount, if any.
12. Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put exercise price must be below the call exercise price. (Collar).	Individual stock or narrow-based security index.	15% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from call sale may be applied.	The lower of: (1) 10% of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any; or (2) 15% of the aggregate exercise price of the call, plus the aggregate call in-the-money amount, if any.
13. Short security future and long position in the same security (or securities basket[1]) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long stock or stocks.	5% of the current market value, as defined in Regulation T, of the long stock or stocks.
14. Short security future and long position in a security immediately convertible into the same security underlying the security future, without restriction, including the payment of money.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long security.	10% of the current market value, as defined in Regulation T, of the long security.
15. Short security future (or basket of security futures representing each component of a narrow-based securities index[1]) and long call option or warrant on the same underlying security (or index).	Individual stock or narrow-based security index.	15% of the current market value of the short security future, plus pay for the call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 15% of the current market value of the short security future.
16. Short security future, Short put option and long call option. The short security future, short put and long call must be on the same underlying security and the put and call must have the same exercise price. (Reverse Conversion)	Individual stock or narrow-based security index.	15% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any, plus pay for the call in full. Proceeds from put sale may be applied.	10% of the aggregate exercise price, plus the aggregate put in-the-money amount, if any.
17. Long (short) a basket of security futures, each based on a narrow-based security index that together tracks the broad-based index[1] and short (long) a broad based-index future.	Narrow-based security index	5% of the current market value of the long (short) basket of security futures.	5% of the current market value of the long (short) basket of security futures.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
18. Long (short) a basket of security futures that together tracks a narrow-based index[1] and short (long) a narrow based-index future.	Individual stock and narrow-based security index.	The greater of: (1) 5% of the current market value of the long security future(s); or (2) 5% of the current market value of the short security future(s).	The greater of: (1) 5% of the current market value of the long security future(s); or (2) 5% of the current market value of the short security future(s).
19. Long (short) a security future and short (long) an identical security future traded on a different market[6].	Individual stock and narrow-based security index.	The greater of: (1) 3% of the current market value of the long security future(s); or (2) 3% of the current market value of the short security future(s).	The greater of: (1) 3% of the current market value of the long security future(s); or (2) 3% of the current market value of the short security future(s).

[1] Baskets of securities or security futures contracts replicate the securities that compose the index, and in the same proportion.

[2] Generally, unless otherwise specified, stock index warrants are treated as if they were index options.

[3] "Aggregate exercise price," with respect to an option or warrant based on an underlying security, means the exercise price of an option or warrant contract multiplied by the numbers of units of the underlying security covered by the option contract or warrant. "Aggregate exercise price" with respect to an index option means the exercise price multiplied by the index multiplier.

[4] "Out-of-the-money" amounts are determined as follows:

(1) for stock call options and warrants, any excess of the aggregate exercise price of the option or warrant over the current market value of the equivalent number of shares of the underlying security;

(2) for stock put options or warrants, any excess of the current market value of the equivalent number of shares of the underlying security over the aggregate exercise price of the option or warrant;

(3) for stock index call options and warrants, any excess of the aggregate exercise price of the option or warrant over the product of the current index value and the applicable index multiplier; and

(4) for stock index put options and warrants, any excess of the product of the current index value and the applicable index multiplier over the aggregate exercise price of the option or warrant.

[5] "In the-money" amounts are determined as follows:

(1) for stock call options and warrants, any excess of the current market value of the equivalent number of shares of the underlying security over the aggregate exercise price of the option or warrant;

(2) for stock put options or warrants, any excess of the aggregate exercise price of the option or warrant over the current market value of the equivalent number of shares of the underlying security;

(3) for stock index call options and warrants, any excess of the product of the current index value and the applicable index multiplier over the aggregate exercise price of the option or warrant; and

(4) for stock index put options and warrants, any excess of the aggregate exercise price of the option or warrant over the product of the current index value and the applicable index multiplier.

[6] Two security futures are considered "identical" for this purpose if they are issued by the same clearing agency or cleared and guaranteed by the same derivatives clearing organization, have identical contract specifications, and would offset each other at the clearing level.

The Commissions request comment on the re-stated table of offsets to reflect the proposed 15% minimum margin requirement. In addition, the Commissions request comment, including empirical data in support of the comments, on the following questions related to the re-stated table of offsets:

• In light of the proposed reduction in margin requirements for unhedged security futures from 20% to 15%, should any of the other percentages in the offsets table also be reduced? If so, would those percentages still be consistent with the margin requirements for comparable exchange-traded options?

• Are there offset positions in addition to those enumerated in the above chart that are consistent with the margin requirements for comparable exchange-traded options, and which the Commissions should consider adding to the list of offsets?

• Are there offset positions included in the above chart which the Commissions should delete from the list of offsets?

III. Paperwork Reduction Act

A. CFTC

The Paperwork Reduction Act of 1995 ("PRA")[76] imposes certain requirements on federal agencies (including the CFTC and the SEC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The proposed rules do not require a new collection of information on the part of any entities subject to these rules. Accordingly, the requirements imposed by the PRA are not applicable to these rules.

B. SEC

The PRA[77] imposes certain requirements on federal agencies (including the CFTC and the SEC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The proposed amendments do not contain a "collection of information" requirement within the meaning of the PRA. Accordingly, the PRA is not applicable.

[76] 44 U.S.C. 3501 *et seq.*

[77] *Id.*

IV. Consideration of Costs and Benefits (CFTC) and Economic Analysis (SEC) of the Proposed Amendments

A. CFTC

1. Introduction

Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.[78] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors below. Where reasonably feasible, the CFTC has endeavored to estimate quantifiable costs and benefits. Where quantification is not feasible, the CFTC identifies and describes costs and benefits qualitatively.

[78] 7 U.S.C. 19(a).

2. Economic Baseline

The CFTC's economic baseline for purposes of considering the proposed amendment is the security futures margin rule that exists today. In the 2002 Final Rules, the Commissions adopted security futures margin rules that complied with the statutory requirements under Section 7(c)(2)(B) of the Exchange Act. The rules state that, ''the required margin for each long or short position in a security future shall be twenty (20) percent of the current market value of such security future.'' [79] The 2002 Final Rules also allow SROs to set margin levels lower than the 20% minimum requirement for customers with ''an offsetting position involving security futures and related positions.'' [80] In addition, the 2002 Final Rules permit certain customers to take advantage of exclusions to the minimum margin requirement for security futures.

The CFTC will consider the costs and benefits of this rule proposal as compared with the baseline of the current minimum initial and maintenance margin levels for unhedged security futures, which is set at 20% of the current market value of such security future.

3. Summary of Proposed Amendment

The proposed amendment would lower the minimum margin level for an unhedged position in a security future from 20% of its current market value to 15% of its current market value. In connection with this change, the security futures margin offsets table would be restated so that it is consistent with the proposed reduction in margin.

4. Description of Possible Costs

The CFTC has preliminarily determined that, to the extent that there are operational or technology costs associated with modifying operational and administrative systems for calculating security futures customer margin, such costs are not likely to be significant given that the infrastructure for calculating such margin already exists and is not likely to require major reprogramming.

i. Risk-Related Costs for Security Futures Intermediaries and Customers

There are three types of risk-related costs that could result from the adoption of the proposed amendment. The first risk-related cost is reducing margin requirements for security futures that could expose security futures intermediaries and their customers to losses in the event that margin collected is insufficient to protect against market moves and there is a default of a security futures intermediary or its customer. Pursuant to OCC's bylaws, any security futures intermediary that is a clearing member of OCC grants a security interest in any account it establishes and maintains to OCC, and therefore a customer's assets may be obligated to OCC upon default.[81] As a result, FCMs could be exposed to a loss if the 15% margin rate for security futures is insufficient. However, this risk is mitigated by the fact that if a 15% margin level is determined to be insufficient, the security futures intermediary has the authority to collect margin in an amount that exceeds the minimum requirement in order to protect its financial integrity.[82]

A second type of risk-related cost might arise where an FCM collects the minimum margin required from customers in order to maintain or expand its customer business. Lower margin requirements might facilitate an FCM permitting its customers to take on additional risk in their positions in order to increase business for the FCM. Such additional risks could put the FCM at risk if the customer were to default, and other customers at the FCM could risk losses if the FCM or one of its customers defaulted. A related third type of risk-related cost stems from the possibility of increased leverage among security futures customers. Customers posting less margin to cover security futures positions might be able to increase their overall market exposure and thereby increase their leverage.

The second and third risk-related costs are mitigated, to some degree, by regulations that apply to security futures intermediaries that are registered as FCMs. For example, FCMs are subject to capital requirements under CFTC regulations,[83] and in instances where the security futures intermediary is jointly registered as a broker-dealer FCM, the SEC's capital rules also apply.[84] In addition, FCMs are required to establish a system of risk management policies and procedures pursuant to CFTC Rule 1.11. This risk management program is designed to protect the FCM and its customers against a variety of risks, including the potential future exposure of a security futures position that initial and maintenance margin is designed to address.

Lastly, risk-related costs to the security futures intermediary are further mitigated by the fact that OCX represents that the vast majority of its open interest is held by eligible contract participants (''ECPs'') as defined in Section 1a(18) of the CEA.[85] Generally speaking, ECPs are financial entities or individuals with significant financial resources or other qualifications, that make them appropriate persons for certain investments.[86] According to data provided by OCX, over 99% of the notional value of OCX's products was held by ECPs as of March 1, 2016 and March 1, 2017.

ii. Appropriateness of Margin Requirements

A possible risk-related cost of lowering margin requirements for security futures is that a DCO may not have sufficient margin on deposit to cover the potential future exposure of cleared security futures positions. However, as explained above, a review of margin coverage data for related options on futures supports the view that decreasing margin requirements from 20% to 15% margin will not have a significant effect on the safety and soundness of the security futures intermediaries and DCOs. Moreover, the risk management expertise at security futures intermediaries and DCOs, as well as the general applicability of CFTC Rule 39.13 to security futures, supports a view that DCOs and security futures intermediaries will continue to manage the risks of these products effectively even with lower margin requirements.[87]

The CFTC has reviewed the security futures markets under normal market

[79] CFTC Rule 41.45(b)(1), 17 CFR 41.45(b)(1). *See* CFTC Rule 41.43(a)(4), 17 CFR 41.43(a)(4) (defining the term ''current market value.'').

[80] CFTC Rule 41.45(b)(2), 17 CFR 41.45(b)(2).

[81] *See* OCC Bylaws, Maintenance of Accounts, Section 3, Interpretations and Policies .07, adopted September 22, 2003, last accessed on January 3, 2018, *available at https://www.theocc.com/components/docs/legal/rules_and_bylaws/occ_bylaws.pdf.*

[82] *See* CFTC Rule 41.42(c)(1), 17 CFR 41.42(c)(1); SEC Rule 400(c)(1), 17 CFR 242.400(c)(1).

[83] *See* CFTC Rule 1.17, 17 CFR 1.17.

[84] *See* SEC Rule 240.15c3–1, 17 CFR 240.15c3–1.

[85] *See also* CFTC Rule 1.3, 17 CFR 1.3.

[86] For example, an individual can qualify as an ECP if the individual has amounts invested on a discretionary basis, the aggregate of which is in excess of: (i) $10,000,000; or (ii) $5,000,000 if the individual also enters into an agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual.

[87] As discussed above, security futures intermediaries are authorized to collect margin above the amounts required by the Commissions. However, as for-profit entities, security futures intermediaries may be incentivized to lower their margin rates in order to compete for customer business. If security futures intermediaries engage in competition for business based on margin pricing, it is possible that security futures intermediaries will collect only the required level of margin (*i.e.,* 15% under the proposed rule change), regardless of the market conditions, which could impair their ability to protect against market risk and losses.

conditions and observed that a 15% level of margin would be sufficient to cover daily price moves in most instances (*i.e.,* more than 99.5%).[88] Therefore, the CFTC preliminarily believes that the proposed amendment will not have a substantial negative impact on (1) the protection of market participants or the public, (2) the financial integrity of security futures markets, or (3) sound risk management practices of DCOs or security futures intermediaries.

The risk customers and/or intermediaries face from reducing margin for security futures is addressed at the clearinghouse level because there are additional protections under CFTC regulations. For example, CFTC Rule 39.13 requires a DCO to establish initial margin requirements that are commensurate with the risks of each product and portfolio. In addition, CFTC Rule 39.13 requires that initial margin models meet set liquidation time horizons and have established confidence levels of at least 99%. These DCO initial margin requirements are distinct from the margin requirements that are the subject of this proposal and serve to mitigate the possibility that a DCO may default (resulting in a systemic event). In the event that a DCO determined that a 15% margin level for security futures is insufficient to satisfy a DCO's obligation under CFTC Rule 39.13, the DCO would be required to collect additional margin from its clearing members.[89]

The CFTC observes that the current and proposed margin requirements for security futures are materially distinct from initial margin requirements for DCOs. The initial margin requirements for DCOs are risk-based and designed to permit DCOs to use risk-based margin models to determine the appropriate level of margin to be collected, subject to the CFTC's minimum requirements under CFTC regulations in Part 39. The current and proposed margin requirements for security futures do not incorporate risk-based strategies or calculations. Despite proposing a non-risk-based margin requirement for security futures, the CFTC continues to support the use of risk-based margin models for all derivatives because use of such models are a sound way for DCOs to manage their clearing risks appropriately.

iii. Costs Associated With Margin Offsets Table

The Commissions are proposing to restate the table of offsets for security futures to reflect the proposed 15% minimum margin requirement. The CFTC does not believe that lowering the margin requirements for certain offsets will increase costs to customers, security futures intermediaries, or DCOs. The categories of permissible offsets will remain the same and there will be no change to the inputs used to calculate the offset, other than to decrease the initial and maintenance margin on all security futures from 20 to 15%. Moreover, the same risk to the customers and security futures intermediaries will exist if the Commissions decrease the margin required for security futures trading combinations eligible for offsets as it will with security futures without an offset.

Finally, the CFTC notes that security futures intermediaries and customers will continue to be required to comply with daily mark-to-market and variation settlement procedures applied to security futures, as well as the large trader reporting regime that applies to futures accounts.

5. Description of Possible Benefits

The CFTC has preliminarily determined that there are significant benefits associated with the proposed amendment. The proposed amendments would align customer margin requirements for security futures held in a futures or securities account with those that are held in a securities risk-based portfolio margin account. The CFTC believes that it would increase competition by establishing a level playing field between security futures carried in the SRO securities risk-based portfolio margining account and security futures carried in a futures account or a securities account.

Additionally, the reduced minimum margin level could facilitate more trading in security futures, which would increase market liquidity to the benefit of market participants and the public. Increased liquidity could contribute to the financial integrity of security futures markets, particularly in the event an FCM finds that it must manage the default of a customer's security futures positions.

The lower minimum margin requirement also might decrease the direct cost of trading in security futures and increase capital efficiency because more funds would be available for other uses. Lowering the minimum margin requirement also could enable the one U.S. security futures exchange to better compete in the global marketplace, where security futures traded on foreign exchanges are subject to risk-based margin requirements that are generally lower than those applied to security futures traded in the U.S.

The proposal restates the table of offsets for security futures to reflect the proposed 15% minimum margin requirement. These offsets would continue to provide the benefits of capital efficiency to customers because offsets recognize the unique features of certain specified combined strategies and would permit margin requirements that better reflect the risk of these strategies. Moreover, the same benefits of lowering margin costs for customers and increasing business in security futures could result from lowering margin requirements for offsetting security futures positions.

[88] Conducting a value-at-risk analysis of 74 of the most liquid security futures contracts during a limited time-frame (November 2002–June 2010), CFTC staff found that there were 195 instances where a 15% margin was insufficient and 99 instances where a 20% margin was insufficient. For all observations, a 15% margin was sufficient for 99.81% of all observations while a 20% margin was sufficient for 99.91% of all observations. CFTC staff notes that this period covers the fall of 2008, one of the most volatile quarters in history. The CFTC staff also notes that since 2010, volatility in the equity markets has typically been lower (*e.g.,* as measured by the Chicago Board Options Exchange Volatility Index (''VIX'')) than in the 2002 to 2010 period. In particular, the VIX, which measures market expectations of near term volatility as conveyed by stock index option prices, has, at its highest levels since June 2010, never reached levels higher than 48 (as compared to almost 90 at the peak during the financial crisis). It is therefore reasonable to conclude that a 15% margin would be sufficient for almost all days since 2010. *See, e.g.,* VIX data available from the Federal Reserve Bank of Saint Louis at *https://fred.stlouisfed.org/series/VIXCLS.*

[89] The CFTC expects that any difference between the margin charged at the DCO and the margin charged by the security futures intermediary will be addressed by additional margin calls, if necessary. The DCO can require additional margin from its clearing members (which in some cases will be the security futures intermediary), to cover changes in market positions. DCOs and clearing members are familiar with margin call procedures and have established rules and policies to efficiently transfer funds when needed. If a customer's account has insufficient funds to meet the margin call, its clearing member may provide the amount to the DCO and collect it from the customer at a later time. In this scenario, the clearing member may take on a liability or additional risk on the customer's behalf for a short period of time. The CFTC notes that this practice is the same for security futures as it is for other products subject to clearing and it does not view this temporary shifting of risk between the clearing member and the customer as a unique source of risk to security futures. Furthermore, this proposed change in required margin from 20% to 15% would not alter the relationship between DCOs and their clearing members, or between clearing members and their customers. The CFTC acknowledges that it is possible that DCOs and security futures intermediaries will collect different levels of margin, but it is not necessarily a result of this proposed rule change. Moreover, the difference in margin collected is not an unmitigated source of risk for the security futures intermediaries because they have the authority to collect additional funds from their customers in the event of a margin call and can choose to set margin levels higher than the minimum level required by the Commissions.

6. Consideration of Section 15(a) Factors

This section will discuss the expected results of the proposal to amend CFTC Rule 41.45(b)(1) to reduce the minimum initial and maintenance margin levels for each security future to 15% of the current market value of such contract from the current requirement of 20% in light of the five factors under Section 15(a) of the CEA, as itemized above.

i. Protection of Market Participants and the Public

The proposed amendment continues to protect market participants and the public from the risks of a default in the security futures market. As discussed above, the CFTC believes that a 15% minimum initial and maintenance margin requirement in combination with other protections, such as the general applicability of CFTC Rule 39.13 to DCOs that offer to clear security futures products, will protect U.S. market participants, including security futures customers and security futures intermediaries, from the risk of a default in security futures. In addition, security futures intermediaries, such as FCMs, are authorized to collect additional margin from their customer if the FCM believes a customer's positions may pose excessive risk.

The existence of separate margin requirements at the DCO level provides assurance to the CFTC that lowering the minimum margin level for security futures will not present a risk to the financial system.[90] In cases where the 15% margin level as determined by the security futures intermediary is insufficient to satisfy a DCO's obligation under CFTC Rule 39.13, the DCO would be required to collect additional margin from its clearing members. As a result, DCOs will always have adequate margin to manage risks presented by security futures.

Finally, the CFTC staff has reviewed market activity in security futures and found that a 15% level of margin would be sufficient to cover daily price moves in a significant number of instances (*i.e.,* more than 99.5%).[91]

ii. The Efficiency, Competitiveness and Financial Integrity of the Markets

This proposal is intended to enhance the efficiency and competitiveness of the security futures market in the U.S. by bringing the initial and maintenance margin requirements for security futures in line with requirements for security futures subject to an SRO risk-based portfolio margining program.[92] Market participants trading in security futures will benefit from lower margin requirements, that more accurately reflect their risk exposures, and they will be able to use their capital more efficiently in other investment opportunities. Furthermore, a decrease in initial and maintenance margin requirements from 20% to 15% of the current market value of each security futures contract may increase the attractiveness of the U.S. security futures market and may increase the competitiveness of the U.S. security futures market with international markets. The proposal also improves the competitiveness of security futures as compared to exchange-traded options. For example, it would help to re-establish a level playing field between options exchanges and the security futures exchange, and between broker-dealers/securities accounts and FCMs/futures accounts. Overall, the CFTC preliminarily believes that this proposal will have a positive effect on competition in the U.S. security futures market.[93]

Furthermore, this proposal could enhance the financial integrity of the security futures market in the U.S. Lowering the amount of initial and maintenance margin required for customers trading in security futures may increase the number of customers trading in security futures and/or increase the amount of trading. Either an increase in the number of customers or trades in security futures market would strengthen the financial integrity of the security futures market by enhancing its liquidity.

The CFTC preliminarily believes that a 15% margin requirement will be sufficient to protect against the risk of default in greater than 99% of cases. After examining the economic data, the CFTC believes that a 15% margin requirement for security futures will protect other customers and DCOs against most risks of default.

Again, the CFTC notes that the DCOs clearing security futures are subject to CFTC regulations requiring the DCO to maintain adequate risk management policies, including initial margin requirements. DCOs may require additional margin, in an amount that is greater than 15%, on certain security futures positions or portfolios if the DCO notes particular risks associated with the products or portfolios. Accordingly, the proposed rule amendment would maintain or possibly improve the financial integrity of the security futures markets in the U.S.

iii. Price Discovery

As discussed above, the CFTC preliminarily believes that the proposed amendment is expected to have a positive effect on competition, which may result in some new customers entering the security futures market and increased trading by existing customers. In addition, trading from foreign markets may shift to the U.S. security futures market. This increased activity in the U.S. security futures market may have a positive effect on price discovery in the security futures market. While changes in price discovery may be difficult to measure, this proposal is unlikely to harm price discovery and indeed may improve price discovery in the security futures market in the U.S.

iv. Risk Management

As discussed further above, margin requirements are a critical component of any risk management program for cleared financial products. Security futures have been risk-managed through central clearing and initial and maintenance margin requirements for over fifteen years. The CFTC recognizes the necessity of sound initial and maintenance margin requirements for DCO and FCM risk management programs. Initial and maintenance margin collected addresses potential future exposure, and in the event of a default, such margin protects non-defaulting parties from losses.

v. Other Public Interest Considerations

The CFTC has not identified any additional public interest considerations related to the costs and benefits of this proposal.

7. Request for Comment

The CFTC requests comment on all aspects of the costs and benefits associated with the proposed rule amendments, specifically, with regard to all Section 15(a) risk factors. In particular, the CFTC requests that commenters provide data and any other information or data upon which the commenters relied to reach any conclusions regarding the proposal. Finally, the CFTC seeks estimates and

[90] *See* CFTC Rule 39.13, 17 CFR 39.13.

[91] *See supra* note 88.

[92] The CFTC preliminarily believes that this proposal effectively balances the need for greater efficiency with the statutory requirements under Section 7(c)(2)(B)(iii) of the Exchange Act, which prevents the CFTC from considering any alternatives to this proposal that would reduce the minimum initial margin and maintenance margin levels for unhedged security futures below 15%. The CFTC worked to identify alternatives, but it does not believe that there are any reasonable alternatives to this proposal.

[93] *See also* the CFTC's analysis of anti-trust considerations in section VII. below. The CFTC has preliminarily identified no anticompetitive effects of this proposal.

views regarding the specific costs and benefits for a security futures clearing organization, exchange, intermediary, or trader that may result from the adoption of the proposed rule amendment.

The CFTC seeks estimates of the costs and benefits that may result from the adoption of the proposed rule amendments to reduce the minimum margin requirement to 15% of current market value or the application of permitted margin offsets.

B. SEC

1. Introduction

In the following economic analysis, the SEC considers the benefits and costs, as well as the effects on efficiency, competition, and capital formation that would result from the SEC's proposed amendments. [94] The SEC evaluates these benefits, costs, and other economic effects relative to a baseline, which the SEC takes to be the state of the markets for security futures products and the regulations applicable to those markets at the time of this proposal.

The amendments that the SEC is proposing would reduce minimum margin requirements for security futures positions held in customer accounts of broker-dealers [95] not subject to an approved portfolio margining system. As a result of the SEC's proposed amendments, the minimum margin requirements on customers' unhedged security futures positions would be lowered to 15%.[96] Similarly, the SEC's guidance on minimum margin requirements for certain hedged security futures positions would also be lowered in a conforming manner.[97] The SEC's proposed amendments would make minimum margin requirements on security futures positions held in securities accounts not eligible for portfolio margining consistent with the minimum margin requirements that would currently apply to those positions were they to be held in separate [98] accounts eligible for portfolio margining.[99]

As discussed below, the SEC believes that the proposed rule amendments will primarily benefit broker-dealers offering security futures trading accounts that are not eligible for portfolio margining, their customers who trade (or wish to trade) security futures at higher levels of leverage than currently permitted, and exchanges that offer trading in security futures products.[100] The SEC does not believe that the proposed rule amendments will impose any direct costs on market participants.

Although the SEC believes that the proposed rule amendments will not impose any direct costs, they could nonetheless impose various indirect costs. Most importantly, lower minimum margin requirements are likely to facilitate greater leverage, which can harm financial stability, imposing costs on the broader financial system. However, because of the very small size of the U.S. security futures markets and their insignificance to the broader U.S. financial markets, the SEC does not believe the proposed amendments will have material impact on financial stability.[101] In addition, the greater leverage permitted under the proposed rule amendments may result in customers taking on additional risk. Customers who are not aware of these risks may suffer unexpected losses as a result.[102]

The SEC believes that the proposed rule amendments will improve competition among providers of customer security futures accounts (*i.e.,* FCMs and broker-dealers), and increase the potential for competition across security futures, options, and other related markets. The SEC also believes that their impact on economic efficiency and capital formation will be minimal.[103]

Many of the costs, benefits, and other effects the SEC discusses are difficult to quantify. Therefore, much of the discussion is qualitative in nature. The SEC's inability to quantify certain costs, benefits, and effects does not imply that such costs, benefits, or effects are less significant. The lack of a quantitative analysis is largely due to the SEC's lack of data on the markets for security futures.[104] The SEC requests that commenters provide relevant data and information to assist the SEC in analyzing the economic consequences of the proposed amendments. More generally, the SEC requests comment on all aspects of this initial economic analysis, including on whether the analysis has: (1) Identified all benefits and costs, including all effects on efficiency, competition, and capital formation; and (2) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation. The SEC also requests comment on any reasonable alternatives to the proposed rule amendments.

2. Baseline

The SEC evaluates the impact of rules relative to specific baselines. Here, the SEC takes the baseline to be the regulatory regime applicable to the markets for security futures as well as the state of these markets as of the end of 2017. As discussed above, the term ''security futures'' refers to futures on a single security and futures on narrow-based security indexes.[105] More generally, ''security futures product'' refers to security futures and options on security futures. Unlike futures markets on commodities or ''broad-based'' equity indexes, the U.S. market for security futures is currently small and does not play a significant role in the U.S. financial system.[106] The limited role of security futures markets is likely due to their short history,[107] uncertainty relating to tax treatment,[108] and competition from the more developed equity and options markets.[109] Incentives to participate in the security futures markets (rather than the markets

[94] The Exchange Act states that when the SEC is engaging in rulemaking under the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the SEC shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. 15 U.S.C. 78c(f). In addition, Exchange Act Section 23(a)(2) requires the SEC, when making rules or regulations under the Exchange Act, to consider, among other matters, the impact that any such rule or regulation would have on competition and states that the SEC shall not adopt any such rule or regulation which would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act. *See* 15 U.S.C. 78w(a)(2).

[95] The 2002 Final Rules established margin requirements for customers' security futures accounts held through ''security futures intermediaries'', including registered entities such as brokers, dealers, and FCMs. The SEC's proposed amendments affect broker-dealers. *See supra* note 22 and accompanying text.

[96] *See* proposed SEC Rule 403(b)(1).

[97] Conforming reductions to minimum margin percentages on hedged security futures positions would be reflected in a restatement of the table of offsets published in the 2002 Final Rules. This table of offsets is not part of the Code of Federal Regulations. *See* 2002 Final Rules, 67 FR at 53159.

[98] The presence of other (related) securities in the portfolio margin account (*e.g.,* positions in the underlying) could affect the required margin for the security futures position.

[99] *See supra* note 47 and accompanying text.

[100] *See infra* sections IV.B.3.i. and ii.

[101] *See infra* section IV.B.2.

[102] *See infra* sections IV.B.3.i. and ii.

[103] *See infra* section IV.B.3.iii.

[104] *See infra* sections IV.B.2. and IV.B.3.i.

[105] *See supra* section I.

[106] *See infra* section IV.B.2.i.

[107] Trading in security futures became possible only after the passage of CFMA in 2000. *See supra* notes 4 and 5, and accompanying text.

[108] Specifically, the proposition that exchange-for-physical single stock security futures qualify for the same tax treatment as stock loan transactions under Section 1058 of the Internal Revenue Code has not been tested. *See e.g.,* Exchange Act Release No. 71505 (Feb. 7, 2014).

[109] Security futures markets face competition from equity and options markets because in principle, the payoff from a security futures position is readily replicated using either the underlying security, or through options on the underlying security.

for the underlying or the options markets) arise either from reduced market frictions (*e.g.,* short sale constraints, pin risk) or from a regulatory advantage (*e.g.,* lower margin requirements).

As with other types of futures, both the buyer and seller in a security futures transaction can potentially default on his or her respective obligation. Because of this, an intermediary to a security futures transaction will typically require a performance bond (''margin'') from both parties to the transaction. Higher margin levels imply lower leverage, which reduces risk. Private incentives encourage a counterparty that intermediates security futures transactions to require a level of margin that adequately protects its interests. However, in the presence of market failures, private incentives alone may lead to margin levels that are inefficient. For example, margin levels set by intermediaries may allow investors who do not fully understand the risk of security futures products to take highly leveraged positions that may result in unexpected losses. Moreover, even when all parties are fully aware of the risks of leverage, privately-negotiated margin arrangements may be too low. For example, the risk resulting from higher leverage levels can impose negative externalities on financial system stability, the costs of which would not be reflected in privately-negotiated margin arrangements. Such market failures provide an economic rationale for regulatory minimum margin requirements.[110]

i. The Security Futures Market

The security futures markets provide a convenient means of obtaining delta exposure to an underlying security.[111] To effectively compete with other venues for obtaining similar exposures (*i.e.,* equity and options markets), security futures markets must reduce market frictions or provide more favorable regulatory treatment.[112] Security futures markets may reduce market frictions by providing lower cost means of financing equity exposures. They can simplify taking short positions by eliminating the need to ''locate'' borrowable securities.[113] They can also provide an opportunity for customers to gain greater leverage through lower margin requirements (relative to margin in security or options transactions). The SEC does not currently have data on participants in the security futures markets or their trading motives.

Currently only one U.S. exchange, OCX, provides trading in security futures. OCX is a designated contract market regulated by the CFTC and a notice-registered national securities exchange.[114] As of the end of 2017, 13,652 security futures contracts on 1,759 names were traded on the exchange.[115] Of these 13,652 contracts, 730 had open interest at the end of the year. Total open interest at the end of the year was 476,430 contracts, with a gross notional value of $3 billion. Annual trading volume in 2017 was 15 million contracts, an increase of 39% from the prior year. Although growing, the security futures market is currently very small. For comparison, as of the end of 2017, open interest in equity options was 290 million contracts with annual trading volume of 3.7 billion contracts.[116]

According to OCX, almost all security futures positions were carried in futures accounts of CFTC-regulated FCMs and introducing brokers (''IBs'').[117] Consequently, the SEC believes only a small fraction of security futures accounts fall under the SEC's margin rules. The SEC believes that none of the accounts that are subject to the SEC's margin rules are currently using risk-based portfolio margining.[118] Therefore, the SEC believes that all of the accounts falling under the SEC's margin rules are currently subject to the general margin requirement and the associated strategy-based offsets.[119]

The SEC is seeking comment on the characterization of the market for security futures:

• What are the principal motives for participants transacting in security futures? What are the advantages of these markets (vis-à-vis options or equity markets)? What are the disadvantages?

• Do customers transact in security futures through securities accounts ? Why or why not?

• To the extent that customers transact security futures transactions through securities accounts, are these accounts subject to portfolio margining? If not, why not?

ii. Regulation

Under existing SEC rules the minimum margin requirement for a customer's unhedged security futures position not subject to an exemption is 20%.[120] SROs may allow margin levels lower than 20%for accounts with ''strategy-based offsets'' (*i.e.,* hedged positions).[121] Strategy-based offsets can involve security futures as well as one or more related securities or futures positions. Accounts subject to an SRO's approved portfolio margining system are also exempt from the minimum margin requirement.[122] Under currently approved SRO portfolio margining systems, the effective margin requirement for an unhedged exposure to a security futures position on a narrow-based index or an individual equity would be 15%.[123] Under current rules, only customer securities accounts held through SEC-regulated broker-dealers could potentially be subject to portfolio margining; however, the SEC is not aware of any broker-dealers offering such accounts. Margin requirements for security futures positions of clearing members (*i.e.,* their accounts at a clearing agency or DCO) are not subject to the aforementioned margin requirements.[124]

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[110] Monetary authorities may also rely on regulatory margin requirements as a policy tool. The SEC does not consider such motives here.

[111] The derivative of the theoretical price of a futures contract with respect to the price of the underlying (*i.e.,* the ''delta'') is 1: For a $1 increase (decrease) in the price of an underlying security, the theoretical price of its security future increases (decreases) by $1.

[112] *See supra* note 109.

[113] In these respects, a security future functions like a cleared total return swap.

[114] Section 6(g) of the Exchange Act permits a notice of registration to be filed by an exchange registering as a national securities exchange for the sole purpose of trading security futures products. 15 U.S.C. 78f(g). *See also* Rule 6a–4 (Notice of registration under Section 6(g) of the Act, amendment to such notice, and supplemental materials to be filed by exchanges registered under Section 6(g) of the Act). 17 CFR 240.6a–4.

[115] Security futures data from OCX, *available at https://ftp.onechicago.com/market_data/.*

[116] Options data from OCC, *available at https://www.theocc.com/webapps/historical-volume-query.*

[117] *See* OCX Petition.

[118] If security futures positions were held in accounts eligible for portfolio margining, they would be included in the risk-based portfolio margin calculation and thus effectively subject to a lower (*i.e.,* 15%) margin requirement under the baseline. There are approximately 18 broker-dealers that have been approved by SROs to offer portfolio margining and are members of OCC to clear security futures. However, based on an analysis of FOCUS filings from year-end 2017, no broker-dealers had collected margin for security futures accounts subject to portfolio margining. *See infra* note 138. *See also* Exchange Act Release No. 54919 (Dec. 12, 2006), 71 FR 75781 (Dec. 18, 2006) (SR–CBOE 2006–14, relating to amendments to CBOE's portfolio margin pilot program to include security futures); Exchange Act Release No. 54125 (Jul. 11, 2006), 71 FR 40766 (Jul. 18, 2006) (SR–NYSE–2005–93, relating to amendments to the NYSE's portfolio margin pilot program to include security futures).

[119] *See supra* note 25 and accompanying text.

[120] *See supra* notes 20–23 and accompanying text.

[121] *See supra* note 25 and accompanying text.

[122] *See* CFTC Rule 41.42(c)(2)(i), 17 CFR 41.42(c)(2)(i); SEC Rule 400(c)(2)(i), 17 CFR 242.400(c)(2)(i).

[123] This follows from the methodology of current SRO risk-based portfolio margining rules as applied to delta one securities. *See supra* notes 47 and 111.

[124] *See* SEC Rule 400(c)(2)(i)–(v). 17 CFR 242.400(c)(2)(i)–(v). Clearing members are instead subject to margin rules of the clearing organization as approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act, 15 U.S.C. 78s(b)(2). *See* notes 42–44 and accompanying text.

3. Analysis of the Proposals

The SEC is proposing to amend SEC Rule 403(b)(1) to reduce the minimum initial and maintenance margin levels for unhedged security futures to 15% from the current requirement of 20%.[125] To the extent that the SROs file proposed rule changes and the SEC approves them, this would have the effect of reducing minimum margin on security futures positions held in customer securities accounts at broker-dealers that are not currently authorized to use a portfolio margining system.[126] As described in the previous section, the vast majority of security futures positions are held in futures accounts at CFTC-regulated entities. Consequently, the proposed changes to the margin requirements are expected to have very limited effects.[127]

i. Benefits

The SEC believes that the proposed amendment to SEC Rule 403(b)(1) [128] would benefit customers currently trading security futures through securities accounts not subject to portfolio margining and whose house margin requirement is set (by the broker-dealer) to the current regulatory minimum. To the extent that customers with security futures accounts held at broker-dealers are currently subject to margin levels reflecting the regulatory minimums,[129] the proposed reductions to margin requirements could reduce these customers' costs of engaging in security futures transactions, increase their liquidity, and provide an opportunity for greater leverage. The SEC believes that these benefits are likely to result in increased position-taking by customers, with attendant benefits to broker-dealers providing security futures trading accounts, and to security futures trading exchanges.[130]

Based on data provided by OCX, at the end of 2017, open interest in the U.S. security futures markets was 476,430 contracts, with a gross notional value of $3 billion.[131] SEC staff understands that approximately 2% of these contracts are believed to involve securities accounts subject to SEC margin requirements. None of these accounts are believed to be subject to portfolio margining.[132] The SEC constructed an estimate of the upper bound of margin collected under SEC margin rules as the sum (across all contracts listed on OCX) of twice [133] the product of: The contract settlement price, 20% (current margin requirement), the contract's open interest, and 2% (the fraction of accounts believed to be subject to SEC customer margin rules). Because some of the contracts held in securities accounts may be subject to strategy offsets (that would result in lower margin requirements), this represents an upper bound. The SEC estimates that the margin requirements on customers' security futures positions held in securities accounts was no more than $24 million. To the extent that the proposed reduction in regulatory minimums is passed on to customers, the SEC estimates that the amount of margin required to secure security futures transactions in securities accounts could be reduced by as much as $6 million. This reduction would benefit affected customers by improving their liquidity.[134]

As part of this rulemaking, the Commissions are proposing to publish a restated table of offsets for hedged security futures positions.[135] This restatement would make the table of offsets conform to the proposed 15% minimum margin requirement on unhedged positions.[136] These revisions to the offset table would provide guidance consistent with the lower general margin levels on unhedged positions that the SEC is proposing. Because the SEC does not have data on specific hedged positions held in broker-dealers' customer accounts subject to SEC margin rules, the SEC is unable to further quantify the reductions in margin that would be attributable specifically to any potential SRO rules that follow the restatement of the offset table.

The reductions to margin requirements the SEC is proposing will have the immediate effect of improving the liquidity of customers trading security futures through broker-dealer accounts. These improvements to liquidity could lead to increased participation in security futures markets with attendant benefits to broker-dealers providing security futures accounts, security futures exchanges, and clearing agencies.[137]

In addition, the SEC believes that the proposed rule amendments may reduce costs for participants in the security futures markets through improved operational efficiency. In particular, the customers of broker-dealers that do not offer portfolio margining may be able to avail themselves of lower margin requirements on security futures transactions without having to maintain separate accounts with broker-dealers that do provide portfolio margining.

It is not possible for the SEC to estimate broker-dealers' customers' sensitivity to margin requirements on security futures due to an absence of historical data. The SEC also does not possess data on current customer margin requirements (broker-dealers may set requirements above regulatory minimums),[138] nor does the SEC possess data on broker-dealers',[139] security futures exchanges',[140] or clearing agencies' [141] profits related to security futures transactions, as this information is not reported to the SEC. Because the SEC lacks these data, the SEC is currently unable to quantify the benefits to broker-dealers, security futures exchanges, and clearing agencies resulting from any reduction to minimum margin requirements.

ii. Costs

Because broker-dealers may set customer margin levels higher than the proposed regulatory minimums, the proposed rule amendments do not

[125] 17 CFR 242.403(b)(1). In addition, the Commissions are proposing to publish a re-stated table of offsets to reflect the proposed reduction in margin. *See* section II.B. above. This table of offsets is not part of the Code of Federal Regulations. *See* 2002 Final Rules, 67 FR at 53159. SROs seeking to permit trading in security futures may modify their rules to parallel the levels identified in the re-stated table of offsets.

[126] Specifically, the SEC expects broker-dealers that become subject to lower regulatory minimum customer margin requirements on security futures to reduce customer margin requirements on security futures positions that are currently set at the regulatory lower bound (*i.e.,* 20%). *See supra* text accompanying note 100.

[127] Concurrently, the CFTC is proposing to similarly amend CFTC Rule 41.45(b), affecting security futures positions held in futures accounts at CFTC-regulated entities. *See supra* section II.A.

[128] Throughout, the analysis of costs and benefits is limited to the effects of the SEC's rule change, and does not reflect costs and benefits resulting from corresponding changes to CFTC rules.

[129] Security futures accounts may be subject to "house" margin requirements that exceed the regulatory minimums.

[130] Increased position-taking by customers is expected to increase fees collected related to security futures transactions effected by broker-dealers and security futures exchanges.

[131] *See supra* note 115.

[132] *See supra* note 118.

[133] Both sides of a security futures contract may potentially be subject to SEC customer margin requirements.

[134] *See* Telser, Lester G., "Why There Are Organized Futures Markets," The Journal of Law and Economics 24, no. 1 (Apr. 1, 1981): 1–22.

[135] *See* 2002 Final Rules, 67 FR at 53159.

[136] *See* 17 CFR 242.403(b)(2).

[137] *See supra* note 130.

[138] With respect to security futures, the SEC currently requires broker-dealers to provide only one item on quarterly regulatory filings: The amount of margin collected from accounts subject to portfolio margining rules (FOCUS item 4467). In the fourth quarter of 2017, no broker-dealer reported collecting any such margin; *see also supra* note 118.

[139] *See id.*

[140] OCX does not release financial statements.

[141] OCC's annual financial reports do not provide a breakdown of profits based on the type of product cleared.

impose direct conduct costs on broker-dealers. The SEC believes that broker-dealers will weigh any additional private costs associated with lower margin requirements against the private benefits of lower margin requirements.[142] In so doing they may opt to leave margins at a higher level than the regulatory minimum.[143]

If the reduction to the minimum margin requirement on security futures is—as the SEC expects—passed on to customers, it will lower the costs of customer position taking and provide opportunities for greater leverage. As described above, the SEC believes this will generally benefit investors trading in security futures.[144] However, to the extent that unsophisticated retail investors who trade security futures are not fully aware of the risks,[145] reducing margin requirements would increase the potential for them to suffer unexpected losses.[146] Thus, the proposed reduction in margin requirements could impose indirect costs on unsophisticated retail investors. Under the baseline, retail investors are believed to represent a very small fraction (less than 1%) of open interest in security futures. Thus, the SEC believes that the potential costs borne by unsophisticated retail investors will be low. Moreover, the ability of margin requirements to serve as an efficient instrument of customer protection is questionable.[147]

In addition, to the extent that the proposed reductions in regulatory margin requirements lead broker-dealers to decrease customer margin requirements, they could increase the risk of the broker-dealer defaulting. Such a default may impose costs on the defaulting broker-dealer's customers as well as its counterparties. However, broker-dealers participating in security futures markets are subject to clearing organizations' prudential margin requirements and the SEC believes that such requirements are reasonably designed to mitigate the risk of a broker-dealers' default.[148] In addition, the SEC believes that in the event of such a default, the SEC's customer protection rule would protect customers' assets held in a securities account.[149]

Because broker-dealers affected by the proposed amendments are already subject to a regulatory minimum level for customer margin requirements, and because they would be under no obligation to alter their existing customer margin requirements, the SEC believes that the compliance costs resulting from the proposed reduction to said minimum would be *de minimis.*[150] In addition, the SEC does not believe that the affected entities would bear any additional compliance costs as a result of the proposed rule amendments.

The SEC requests comments, data, and estimates on all aspects of the costs and benefits associated with the proposed calculations for margin on security futures. The SEC requests data to quantify the potential costs and benefits described above. The SEC seeks estimates of these costs and benefits, as well as any costs and benefits that the SEC has not identified that may result from the adoption of these proposed rule amendments. The SEC also requests qualitative feedback on the nature of the potential benefits and costs described above and any benefits and costs the SEC may have overlooked.

iii. Effects on Efficiency, Competition, and Capital Formation

In addition to the specific costs and benefits discussed above, the reductions to margin requirements on security futures that the SEC is proposing may have broader effects on efficiency, competition, and capital formation. The SEC believes that these effects will generally be positive, but unlikely to be significant. The SEC discusses these effects in more detail in the remainder of this section. The SEC requests comment on all aspects of this analysis of the burden on competition and promotion of efficiency, competition, and capital formation.

a. Efficiency

As discussed in the previous section, the SEC believes that broker-dealers will weigh the costs associated with customer defaults against the benefits of lower margin requirements when setting margin requirements for their customers. Although private considerations would render market-determined margin levels optimal from a broker-dealer's perspective, market imperfections could lead broker-dealers to impose margin requirements that are not economically efficient.[151] The relevant market imperfections in the context of margin requirements relate to externalities on financial stability arising from excessive leverage.[152]

Historically, a key aspect of the rationale for regulatory margin requirements on securities transactions was the belief that such requirements could improve economic efficiency by limiting stock market volatility resulting from ''pyramiding credit.'' [153] Leveraged

[142] That is, in weighing the costs and benefits the SEC does not expect broker-dealers to consider externalities resulting from their choices.

[143] Under broker-dealer margin rules, broker-dealers also can establish ''house'' margin requirements as long as they are at least as restrictive as the Federal Reserve and SRO margin rules. *See, e.g.,* FINRA Rule 4210(d).

[144] To the extent that regulatory margin requirements serve a micro-prudential function, these benefits may be reduced or eliminated. However the SEC does not believe that micro-prudential effects are a major consideration here. *See infra* note 152.

[145] *See* FINRA, *Security Futures—Know Your Risks, or Risk Your Future, available at http://www.finra.org/Investors/InvestmentChoices/P005912* and National Futures Association, *Security Futures, An Introduction to Their Uses and Risks* (2002), *available at https://www.nfa.futures.org/members/member-resources/files/security-futures.pdf.*

[146] The judgement of retail investors receives significant criticism in the academic literature. *See e.g.,* Odean, Terrance. ''Do Investors Trade Too Much?'' *The American Economic Review* 89, no. 5 (1999): 1279–98. *See also* Barber, Brad M, and Terrance Odean. ''Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors.'' *The Journal of Finance* 55, no. 2 (April 1, 2000): 773–806. *See also* Heimer, Rawley Z, and Alp Simsek. ''Should Retail Investors' Leverage Be Limited?'' Working Paper. National Bureau of Economic Research, December 2017.

[147] Fixed margin requirements cannot differentiate between different types of customers (*e.g.,* sophisticated vs. unsophisticated, financially constrained vs. unconstrained) or the risk of the position. *See* Figlewski Stephen, ''Margins and Market Integrity: Margin Setting for Stock Index Futures and Options,'' Journal of Futures Markets 4, no. 3 (1984): 385–416. *See also* FRB, A Review and Evaluation of Federal Margin Regulation: A Study (1984).

[148] *See supra* notes 42–44 and accompanying text.

[149] *See* Rule 15c3–3, 17 CFR 240.15c3–3. *See also Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products, Final Rule,* Exchange Act Release No. 46473 (Sept. 9, 2002), 67 FR 58284 (Sept. 13, 2002).

[150] Under the proposed rule, broker-dealers could maintain existing customer margin requirements and avoid incurring any implementation costs.

[151] *See supra* note 142.

[152] The SEC acknowledges that other market imperfections (*e.g.,* asymmetric information, adverse selection) may also play a role, although the SEC believes these to be less relevant to this context. Asymmetric information about market participants' quality can lead privately-negotiated margin levels to be inefficient. For example, competition among broker-dealers may lead to a ''race to the bottom'' in margin requirements when customers' ''quality'' is not perfectly observable. *See e.g.,* Santos, Tano, and Jose A. Scheinkman, ''Competition among Exchanges,'' *The Quarterly Journal of Economics* 116, no. 3 (Aug. 1, 2001): 1027–61. Alternatively, problems of adverse selection (*e.g.,* potential to re-invest customer margin in risky investments) or moral hazard (*e.g.,* expectations of government rescue) may also create incentives for broker-dealers to offer margin requirements that are too low. Asymmetric information about broker-dealer quality may make it impossible for customers to provide sufficient market discipline, leading to a problem similar to that faced by bank depositors. *See* Dewatripont, Mathias, and Jean Tirole, ''Efficient Governance Structure: Implications for Banking Regulation,'' *Capital Markets and Financial Intermediation,* 1993, 12–35.

[153] *See* Moore, Thomas Gale, ''Stock Market Margin Requirements,'' *Journal of Political Economy* 74, no. 2 (April 1, 1966): 158–67.

exposures built up during price run ups could lead to the collapse of prices when a small shock triggers margin calls and a cascade of de-leveraging. The utility of margin requirements in limiting such ''excess'' volatility and the contribution of derivative markets to such volatility have been a perennial topic of debate in the academic literature, rekindled periodically by crisis episodes.[154] Most recently, the 2007–2008 financial crisis saw similar concerns (*i.e.,* procyclical leverage, margin call-induced selling spirals) raised in the securitized debt markets.[155] While the SEC believes that lower margin requirements can increase the risk and severity of market dislocations, the SEC does not believe—given the current limited scale of the security futures markets and the limited role played by SEC registrants in these markets—that the proposed reductions to minimum margin requirements present a material financial stability concern.[156]

b. Competition

Under the baseline, risk-based portfolio margining is not available to customers holding security futures positions in futures accounts, and these positions are thus subject to the 20% margin requirement. The proposed reduction in margin would permit customers holding security futures in futures accounts to receive margin treatment consistent with margin treatment for customers holding security futures positions in a securities account permitted under the current SRO securities portfolio margining rules.[157] This could establish a more level playing field between options exchanges and security futures exchanges, and between broker-dealers/securities accounts and FCMs/futures accounts.

In principle, a more level playing field should enhance competition among broker-dealers and FCMs for security futures business. In practice however, the majority of security futures transactions are already conducted through futures accounts, and of those that are not, none are subject to portfolio margining.[158] It is therefore unlikely that the proposed changes will have an immediate impact on competition among existing intermediaries of security futures transactions (*i.e.,* broker-dealers and FCMs). However, it is likely that the reduction in margin levels will increase participation in the security futures markets. If sufficiently large, such increased participation may spur additional broker-dealers and FCMs to offer security futures trading.

More broadly, by aligning margin requirements applicable to a security futures position (which generally are not portfolio margined) with those applicable to equivalent options positions[159] (which generally are subject to portfolio margining), the proposed amendment could be expected to encourage growth of the security futures market. The security futures market can provide a low-friction means of obtaining delta exposures, and relatively high margin requirements (vis-à-vis comparable options positions) which may have played a role in restraining its development. To the extent that reducing margin requirements leads to significant growth of this market, it may have additional—less direct—competitive implications. For example, increased liquidity in security futures may lead to increased use of this market to obtain short exposures, which could, in turn, adversely affect intermediaries' securities lending business.

c. Capital Formation

The proposed rule changes are not expected to have an immediate material impact on capital formation. To the extent that the proposed reductions in margin requirements encourage significant growth in the security futures markets, it may, in time, improve price discovery for underlying securities. In particular, a more active security futures market can reduce the frictions associated with shorting equity exposures, making it easier for negative information about a firm's fundamentals to be incorporated into security prices. This could promote more efficient capital allocations by facilitating the flow of financial resources to their most productive uses.

The SEC generally requests comment on all aspects of this analysis of the burden on competition and promotion of efficiency, competition, and capital formation.

iv. Alternatives Considered

The SEC believes that reducing minimum customer margin requirements for security futures to a level between 15% and 20% would maintain inconsistencies in margin requirements across security futures and options, without providing significant benefits as compared to the proposed amendments. Accordingly, in light of the objectives of this particular rulemaking, and in the context of the statutory framework discussed above, the SEC does not believe that there are reasonable alternatives to the proposal to reduce the minimum initial and maintenance margin levels for unhedged security futures to 15%.

V. Regulatory Flexibility Act

A. CFTC

The Regulatory Flexibility Act (''RFA'') requires that federal agencies, in promulgating rules, consider the impact of those rules on small entities.[160] The proposed amendments will affect designated contract markets, FCMs, and customers who trade in security futures. The CFTC has previously established certain definitions of ''small entities'' to be used by the CFTC in evaluating the impact of its rules on small entities in accordance with the RFA.[161]

In its previous determinations, the CFTC has concluded that contract markets are not small entities for purposes of the RFA, based on the vital role contract markets play in the national economy and the significant amount of resources required to operate as SROs.[162] The CFTC also has determined that notice-designated contract markets are not small entities for purposes of the RFA.[163]

The CFTC has previously determined that FCMs are not small entities for purposes of the RFA, based on the fiduciary nature of FCM-customer

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[154] *See id. See also* Figlewski, Stephen, ''Futures Trading and Volatility in the GNMA Market,'' *The Journal of Finance* 36, no. 2 (1981): 445–56. *See also* Edwards, Franklin R, ''Does Futures Trading Increase Stock Market Volatility?,'' *Financial Analysts Journal* 44, no. 1 (1988): 63–69. *See also* Kupiec, Paul H, ''Margin Requirements, Volatility, and Market Integrity: What Have We Learned Since the Crash?,'' *Journal of Financial Services Research* 13, no. 3 (June 1, 1998): 231–55.

[155] *See e.g.,* Adrian, Tobias, and Hyun Song Shin, ''Liquidity and Leverage,'' *Journal of Financial Intermediation* 19, no. 3 (2010): 418–437.

[156] If the security futures market were to significantly increase in size as a result of these proposed changes or other factors, the impact of lower margin requirements on overall market stability would be greater than the minimal impact the SEC expects under current market conditions. However, for reasons described in notes 106–108 and accompanying text, above, the SEC does not believe this type of significant growth is likely in the foreseeable future.

[157] *See* OCX Petition.

[158] *See supra* note 118.

[159] A long (short) security future position can be replicated by a portfolio containing one long (short) at-the-money call and one short (long) at-the-money put. The margin requirement applicable to the latter under approved portfolio margin systems is 15%.

[160] 5 U.S.C. 601 *et seq.*

[161] *Policy Statement and Establishment of Definitions of ''Small Entities'' for Purposes of the Regulatory Flexibility Act,* 47 FR 18618, 18618–21 (Apr. 30, 1982).

[162] *Id.* at 18619.

[163] *Designated Contract Markets in Security Futures Products: Notice-Designation Requirements, Continuing Obligations, Applications for Exemptive Orders, and Exempt Provisions,* 66 FR 44960, 44964 (Aug. 27, 2001).

relationships as well as the requirements that FCMs meet certain minimum financial requirements.[164] In addition, the CFTC has determined that notice-registered FCMs,[165] for the reasons applicable to FCMs registered in accordance with Section 4f(a)(1) of the CEA,[166] are not small entities for purposes of the RFA.[167]

Finally, the CFTC notes that according to data from OCX, 99% of all customers transacting in security futures as of March 1, 2016 and March 1, 2017 qualified as ECPs. The CFTC has found that ECPs should not be considered small entities for the purposes of the RFA.[168] An overwhelming majority of the customers transacting in security futures currently are ECPs and are not small entities. Therefore, a change in the margin level for security futures is not anticipated to affect small entities.

Accordingly, the CFTC Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The CFTC invites public comments on this determination.

B. SEC

The RFA requires that federal agencies, in promulgating rules, consider the impact of those rules on small entities.[169] Section 3(a) [170] of the RFA generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules to determine the impact of such rulemaking on small entities unless the SEC certifies that the rule amendments, if adopted, would not have a significant economic impact on a substantial number of small entities.[171]

For purposes of SEC rulemaking in connection with the RFA,[172] a small entity includes a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to SEC Rule 17a–5(d) (under the Exchange Act),[173] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[174] The proposed rule amendments would reduce the required margin for security futures from 20% to 15%. The proposed rule amendments would affect brokers, dealers, and members of national securities exchanges, including FCMs required to register as broker-dealers under Section 15(b)(11) of the Exchange Act, relating to security futures.[175]

IBs and FCMs may register as broker-dealers by filing Form BD-N.[176] However, because such IBs may not collect customer margin they are not subject to these rules. In addition, the CFTC has concluded that FCMs are not considered small entities for purposes of the RFA.[177] Accordingly, there are no IBs or FCMs that are small entities for purposes of the RFA that would be subject to the proposed rule amendments.

In addition, all members of national securities exchanges registered under Section 6(a) of the Exchange Act are registered broker-dealers.[178] The SEC estimates that as of December 31, 2017, there were approximately 1,060 broker-dealers that were ‘‘small’’ for the purposes of SEC Rule 0–10. Of these, the SEC estimates that there are less than ten broker-dealers that are carrying broker-dealers (*i.e.,* can carry customer margin accounts and extend credit). However, based on December 31, 2017 FOCUS Report data, none of these small carrying broker-dealers carried debit balances. This means these ‘‘small’’ carrying firms are not extending margin credit to their customers, and therefore, the proposed rules likely would not apply to them. Therefore, while SEC believes that some small broker-dealers could be affected by the proposed amendments, the amendments will not have a significant impact on a substantial number of small broker-dealers.

Accordingly, the SEC certifies that the proposed rule amendments would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The SEC encourages written comments regarding this certification. The SEC solicits comment as to whether the proposed rule amendments could have an effect on small entities that has not been considered. The SEC requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ‘‘SBREFA,’’ [179] a rule is considered ‘‘major’’ where, if adopted, it results or is likely to result in:

• An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);

• A major increase in costs or prices for consumers or individual industries; or

• Significant adverse effect on competition, investment or innovation.

If a rule is ‘‘major,’’ its effectiveness will generally be delayed for 60 days pending Congressional review. The Commissions request comment on the potential impact of the proposed amendments for margin requirements for security futures on:

• The U.S. economy on an annual basis;

• Any potential increase in costs or prices for consumers or individual industries; and

• Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

[164] *Supra* note 159 at 18619.

[165] A broker or dealer that is registered with the SEC and that limits its futures activities to those involving security futures products may notice register with the CFTC as an FCM in accordance with Section 4f(a)(2) of the CEA (7 U.S.C. 6f(a)(2)).

[166] 7 U.S.C. 6f(a)(1).

[167] 2002 Final Rules, 67 FR at 53171.

[168] *Opting Out of Segregation,* 66 FR 20740, 20743 (Apr. 25, 2001).

[169] 5 U.S.C. 601 *et seq.*

[170] 5 U.S.C. 603.

[171] 5 U.S.C. 605(b). The proposed amendments are discussed in detail in section II. above. The SEC discusses the potential economic consequences of the amendments in section IV. (Economic Analysis) above. As discussed in section III (Paperwork Reduction Act) above, the proposed amendments do not contain a ‘‘collection of information’’ requirement within the meaning of the Paperwork Reduction Act.

[172] Although Section 601 of the RFA defines the term ‘‘small entity,’’ the statute permits agencies to formulate their own definitions. The SEC has adopted definitions for the term ‘‘small entity’’ for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in SEC Rule 0-10 (under the Exchange Act), 17 CFR 240.0–10. *See Statement of Management on Internal Accounting Control,* Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

[173] 17 CFR 240.17a–5(d).

[174] *See* 17 CFR 240.0–10(c).

[175] *See* SEC Rule 400(a), 17 CFR 242.400(a).

[176] These notice-registered broker-dealers are not included in the 1,060 small broker-dealers discussed below, as they are not required to file FOCUS Reports with the SEC. *See* SEC Rule 17a–5(m)(4), 17 CFR 240.17a–5(m)(4).

[177] *See* 47 FR 18618, 18618–21 (Apr. 30, 1982). *See also* 66 FR 14262, 14268 (Mar. 9, 2001).

[178] National securities exchanges registered under Section 6(g) of the Exchange Act—notice registration of security futures product exchanges—may have members who are floor brokers or floor traders who are not registered broker-dealers; however, these entities cannot clear securities transactions or collect customer margin, and, therefore, the proposed rules would not apply to them.

[179] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various Sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

VII. Anti-Trust Considerations

Section 15(b) of the CEA requires the CFTC to ''take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the purposes of [the CEA], in issuing any order or adopting any [CFTC] rule or regulation (including any exemption under Section 4(c) or 4c(b)), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to Section 17 of [the CEA].'' [180] The CFTC believes that the public interest to be protected by the antitrust laws is generally to protect competition. The CFTC requests comment on whether this proposal implicates any other specific public interest to be protected by the antitrust laws.

The CFTC has considered the proposal to determine whether it is anticompetitive and has preliminarily identified no anticompetitive effects. The CFTC requests comment on whether the proposal is anticompetitive and, if it is, what the anticompetitive effects are.

Because the CFTC has preliminarily determined that the proposal is not anticompetitive and has no anticompetitive effects, the CFTC has not identified any less anticompetitive means of achieving the purposes of the CEA. The CFTC requests comment on whether there are less anticompetitive means of achieving the relevant purposes of the CEA that would otherwise be served by adopting the proposal.

VIII. Statutory Basis

The SEC is proposing the amendment to SEC Rule 403(b)(1) pursuant to the Exchange Act, particularly Sections 3(b), 6, 7(c), 15A and 23(a). Further, these amendments are proposed pursuant to the authority delegated jointly to the SEC, together with the CFTC, by the Federal Reserve Board in accordance with Exchange Act Section 7(c)(2)(A).

Text of Rules

List of Subjects

17 CFR Part 41

Brokers, Margin, Reporting and recordkeeping requirements, Security futures products.

17 CFR Part 242

Brokers, Confidential business information, Reporting and recordkeeping requirements, Securities.

[180] 7 U.S.C. 19(b).

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 41

For the reasons discussed in the preamble, the Commodity Futures Trading Commission proposes to amend 17 CFR part 41 as set forth below:

PART 41—SECURITY FUTURES PRODUCTS

■ 1. The authority citation for part 41 continues to read as follows:

Authority: Sections 206, 251 and 252, Pub. L. 106–554, 114 Stat. 2763; 7 U.S.C. 1a, 2, 6f, 6j, 7aa–2, 12a; 15 U.S.C. 78g(c)(2).

■ 2. Amend § 41.45 by revising paragraph (b)(1) to read as follows:

§ 41.45 Required margin.

* * * * *

(b) *Required margin.* (1) *General rule.* The required margin for each long or short position in a security future shall be fifteen (15) percent of the current market value of such security future.

* * * * *

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

In accordance with the foregoing Title 17, chapter II, part 242 of the Code of Federal Regulations is proposed to be amended as follows:

PART 242—REGULATIONS M, SHO, ATS, AC, NMS, AND SBSR AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

■ 3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78ka–1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dda–1, 78mm, 80aa–23, 80aa–29, and 80aa–37.

■ 4. Section 242.403 is amended by revising paragraph (b)(1) to read as follows:

§ 242.403 Required margin.

* * * * *

(b) *Required margin.* (1) *General rule.* The required margin for each long or short position in a security future shall be fifteen (15) percent of the current market value of such security future.

* * * * *

By the Securities and Exchange Commission.

Dated: July 3, 2019.

Vanessa A. Countryman,

Secretary.

Issued in Washington, DC, on July 9, 2019, by the Commodity Futures Trading Commission.

Christopher Kirkpatrick,

Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

Commodity Futures Trading Commission (CFTC) Appendices to Customer Margin Rules Relating to Security Futures—CFTC Voting Summary and CFTC Commissioner's Statement

Appendix 1—CFTC Voting Summary

On this matter, Chairman Giancarlo and Commissioners Quintenz, Behnam, Stump, and Berkovitz voted in the affirmative. No Commissioner voted in the negative.

Appendix 2—Statement of CFTC Commissioner Dan M. Berkovitz

I support issuing the joint notice of proposed rulemaking (''Proposal'') with the Securities Exchange Commission (''SEC'') (collectively with the CFTC, ''Commissions'') to amend the security futures margin requirements.

In 2000, Congress passed the Commodity Futures Modernization Act (''CFMA'') which permitted security futures trading.[1] The CFMA provides that customer margin requirements for security futures shall be set at levels that:

(1) Require (a) consistency with the margin requirements for comparable exchange-traded options and (b) margin levels not lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded options,

(2) preserve the financial integrity of markets trading security futures products,

(3) prevent systemic risk, and

(4) are and remain consistent with certain margin requirements established by the Federal Reserve Board under its Regulation T.[2]

The Proposal would decrease the required minimum margin from 20 percent to 15 percent of the current market value. The Proposal reasons that amending the minimum required margin reflects the current stress level percentage of 15 percent set for unhedged exchange-traded options in self-regulated organization risk-based portfolio margining programs.[3] This action would increase consistency in the markets by bringing the margin requirement for security futures held outside of a securities portfolio margin account into alignment with the margining for security futures under risk-based portfolio margining methodologies.[4]

The 20 percent level was originally set by the Commissions in 2002. Markets have

[1] *See* App. E of Public Law 106–554, 114 Stat. 2,763 (2000).

[2] *See* 15 U.S.C. 78g(c)(2)(B) (2018).

[3] Proposal, section II.A.5.

[4] See 15 U.S.C. 78g(c)(2)(B) (2018).

evolved since that time and it is appropriate to reconsider the margin level in light of the subsequent adoption of the risk-based portfolio margining programs. In doing so, the Proposal has followed the statutory mandate to set the security futures margin requirement at levels consistent with, and not lower than, levels for similar options.

In conclusion, I commend the joint work by the Commissions' respective staffs in preparing the Proposal. The Proposal represents an opportunity for the Commissions to gain more knowledge about the security futures markets, reevaluate the status quo, and establish a more effective regulatory standard. I look forward to public comments in response to the Proposal, particularly comments that provide additional data and analysis regarding the appropriateness of the 15 percent level under each of the statutory factors the Commissions must consider.

[FR Doc. 2019–15400 Filed 7–25–19; 8:45 am]

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