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U.S. COMMODITY FUTURES TRADING COMMISSION

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PUBLIC MEETING

Tuesday, July 2, 2002

1155 21<sup>st</sup> Street, NW  
Room 1000  
Washington

The meeting convened, pursuant to notice, at  
10:00 a.m.

PARTICIPANTS:

JAMES E. NEWSOME, Chairman  
BARBARA PEDERSEN HOLUM, Commissioner  
THOMAS J. ERICKSON, Commissioner  
JOHN LAWTON, Staff

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P R O C E E D I N G S

CHAIRMAN NEWSOME: Okay, the meeting is called to order. This is a public meeting of the Commodity Futures Trading Commission to discuss two securities futures products rule makings.

And I would like to start off the meeting first by thanking specifically a number of our senior staff, but even more broadly a large number of staff at the Commission who have spent a tremendous number of hours away from home here at the office working on these rules. Specifically, I want to thank John Lawton, Phyllis Dietz, Larry Patent, not only for your work, but for your leadership among these numerous other staffs. So, thank you guys, very much.

I also wanted to thank, start off by thanking my fellow commissioners, one for their patience, as we've worked very diligently to move and to get to this point and also for their willingness to move rather hurriedly over the last few days so that we could, in fact, continue with this meeting that we had scheduled today.

The first item on the agenda is the final rules for treatment of customer funds in security futures products transactions. Mr. Lawton, we'll turn it over to you to brief the Commission.

MR. LAWTON: Thank you, Mr. Chairman and Commissioners.

I'm here to present to the Commission a recommendation of staff that the Commission authorize publication in The Federal Register of a release announcing the adoption rules applicable to accounts holding futures securities products.

The rules address CFTC and SEC customer protection, record keeping, reporting and bankruptcy rules, as well as the Securities Investor Protection Act of 1970. This is the so-called SEG SIPC Release.

As you know, the Commission previously voted to adopt rules in this area on May 30. The SEC held a meeting on these rules on June 12. At that meeting the SEC Chairman and Commissioners determined to modify the rules as presented to them

in one significant way: they eliminated the requirement that customers provide a signed acknowledgement concerning the type of protection to be afforded customer funds deposited in connection with securities futures transactions.

As proposed, the rule would have required a full FCM--would have required that a full FCM, full BD obtain a signed acknowledgement from a customer before the firm could accept an order for an SFP from that customer.

In the acknowledgement, the customer would affirm his or her understanding that the account would not be protected under the alternative regulatory scheme.

This requirement was intended to help demonstrate the customer's understanding that an SFP held in a futures account would not be covered by SEC Rule 15c-33 and the Securities Investor Protection Act or SIPA and an SFP held in a securities account would not be protected by the CFTC's segregation rule.

In recommending that this position be adopted, CFTC staff was deferring to the expertise

of the SEC with regard to requirements under SIPA. Given that the SEC has now determined that the written acknowledgement is not necessary under SIPA to effectuate the proposed SEG SIPC regime, CFTC staff recommends that the Commission delete the signed acknowledgement requirement.

The staff document before you also contains a reference--the same reference that was contained in the document presented on our May 30 meeting concerning amendments to the SEC's reserve formula. The SEC intends to address these issues in a separate release. Staff continues to discuss this matter with SEC staff.

The proposed release also contains a number of technical and conforming changes. Thank you.

CHAIRMAN NEWSOME: Thank you, John. Do other members of the senior staff have any comments that they would like to provide the Commission at this time? Seeing none, Commissioner Holum, do you have any questions or comments?

COMMISSIONER HOLUM: None, thank you.

CHAIRMAN NEWSOME: Commissioner Erickson?

COMMISSIONER ERICKSON: No, questions, thank you.

CHAIRMAN NEWSOME: Nor, do I have any questions. I appreciate the logic of Chairman Pitt, as they looked at that issue. And, certainly, I think his thoughts mirror the thoughts of the CFTC, as well. So we appreciate that gesture. If there are no other questions or comments. I'll entertain a motion that the Commission approve the joint final rules for publication in The Federal Register on the applicability of the CFTC and the SEC customer protection, record keeping, reporting and bankruptcy rules and the Securities Investor Protection Act of 1970 to accounts holding securities futures products as outlined in the memorandum of the Division of Trading and Markets. Do I have a motion?

COMMISSIONER HOLUM: So moved.

COMMISSIONER ERICKSON: Second.

CHAIRMAN NEWSOME: All those in favor say, aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: The vote is unanimous. The last item for Commission consideration is the customer margins rules related to security futures. As, I think every knows, the CFMA directed the Federal Reserve Board to establish rules for margin. Additionally, Section 7(c)(2)(B) provides for the FED to delegate such responsibilities to the CFTC and the SEC. On March 6, 2001, the Federal Reserve Board did just that.

Now, for the last 14 months, the staffs of the CFTC and the SEC have worked diligently to draft rules that accomplish two things: One, obviously, to follow the intent of Congress.

Two, to create a fair, level playing field for all market participants. And so at this time, John, I'll turn it over to you to brief the Commission on this matter.

MR. LAWTON: Thank you Mr. Chairman and Commissioners.

I'm now going to present to the Commission a recommendation of the staff that the Commission authorize publication in The Federal Register of a release announcing the adoption of

rules establishing margin requirements for securities futures products.

These rules would be adopted pursuant to Section 7(c) of the Securities Exchange Act of 1934, which directs the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements imposed by brokers, dealers and members of national securities exchanges for securities futures products.

In addition, 7(c) provides that the FED may delegate this rule-making authority jointly to the SEC and the CFTC. On March 6, 2001, the FED did so.

The statute provides that the customer margin requirements for securities futures 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 be consistent with margin requirements for comparable option contracts traded on an exchange registered pursuant to Section 6A of the Exchange Act and also provide for initial and maintenance margin levels

that are not lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded options. Fourth, they must be and remain consistent with the margin requirements established by the Federal Reserve Board under Regulation T.

The CFTC and the SEC approved proposed rules for public comment on September 26, 2001. The Commissions received 19 comment letters, many of which were very detailed. In developing the final rules, the CFTC and SEC staff have considered these comments and made a number of responsive changes.

Given the statutory constraints described above, these are very complicated rules. I won't go into great detail in this presentation, but I'll highlight several of the more salient items.

In summary, the final rules, among other things, establish standalone requirements that are consistent with Regulation T, but do not apply Regulation T in its entirety to futures accounts. They establish minimum initial and maintenance

margin levels for outright positions in security futures at 20 percent of current market value.

They permit self-regulatory authorities to set margin levels lower than 20 percent of current market value for certain strategy-based offset positions involving security futures and one or more related securities or futures.

They clarify the use of long-option value and open-trade equity.

They establish several categories of exclusion from coverage under this rule.

And they set forth procedures applicable to under-margined accounts.

I'll briefly discuss each of these topics.

First, Regulation T: Under the proposed rules, Regulation T would have applied both to securities accounts, which are already subject to Reg T and to futures accounts which are not otherwise subject to Reg T if they were to carry security futures.

Of the 12 commenters who addressed this issue, 11 opposed direct application of Reg T to

security futures held in futures accounts. They believed it was not required under the statute and would impose unnecessary programming and other administrative costs.

The staff believes it is not necessary to apply Reg T in its entirety to security futures transactions to satisfy the requirements under Section 7 of the Exchange Act. Accordingly, the staff is recommending that the Commission adopt standalone margin rules that include certain requirements of Reg T. This would entail using an account-specific approach for those aspects of account administration that need not be conformed in order to satisfy the requirements that the margin rules for security futures be consistent with Reg T.

Moving on now to the margin level for outright positions. Under the proposal, the minimum initial and maintenance margin levels required of customers for each security futures carried in a long or short position would be 20 percent of the current market value of such security future.

This proposed level was based on the requirement under the statute that the initial and maintenance margin levels must not be lower than the lowest level of margin exclusive of premium required for any comparable option contracts.

Eleven commenters addressed this aspect of the proposed rules; six commenters found 20 percent to be an acceptable level; two commenters advocated a 25 percent margin level; and two commenters, which were associations, stated their members could not reach a consensus as between 20 percent and 25 percent; 1 commenter expressed the view that 20 percent would be either too high or too low.

After considering the commenters' views, the staff is recommending that the Commission adopt the margin rules as proposed. The staff has considered the comments and believes that the minimum margin level of 20 percent satisfies the comparability standard of the Act.

In addition, the staff notes that final rules--that the final rules permit self-regulatory authorities and intermediaries to establish higher

margin levels or take any other appropriate action necessary to preserve their own financial integrity.

Moving now to the third item--offsets. The proposed rules included a provision to allow exchanges to adopt rules that reduce the margin levels below 20 percent of current market value for customers with certain positions in securities or in futures that offset the risk of their positions in security futures.

The proposed rule provided, further, that the resulting margin levels could not be lower than the lowest customer margin levels required for comparable offset positions involving exchange-traded options.

In addition, the Commissions published a table that included offsets for security futures that the Commissions had preliminarily identified as consistent with those permitted for comparable offset positions involving options and they would, therefore, qualify for reduced margin levels.

After considering the commenters' views on these issues, the staff is recommending that the

Commission adopt, substantially as proposed, rules that permit self-regulatory authorities to reduce the required margin for offset positions involving security futures.

Staff is also recommending that the Commission retain, with certain revisions, the table of offsets that the staff has deemed to be consistent with offsets recognized for comparable exchange-traded options.

In particular, the revised table of offset reflects an adjustment in the level of margin required for certain calendar and basket spreads involving security futures that more accurately reflect the risk of such positions.

In addition, an offset position for spreads involving non-fungible security futures has also been added to the table.

Specifically, the table of offsets provides for a reduced minimum initial and maintenance requirement for calendar spreads and basket spreads. Minimum requirement recognized for those spreads has been reduced to 5 percent of the

current market value of the underlying long or short position.

In addition, based on a commenter's suggestion, staff believes that an additional offset should be recognized for spreads involving identical, non-fungible security futures.

Because there is a possibility that certain security futures may not be fungible across markets, a customer may simultaneously hold a long security future and a short security future on the same underlying security which has identical contract terms. As a result the customer will be economically neutral but will be required to margin both positions to expiration and to meet daily variation settlement requirements with respect to each contract.

Based on discussion with SEC staff, the level currently set in the table for this type of position is 3 percent.

Moving to the fourth item: long option value and open-trade equity. The proposed rules did not address the question whether the net value of options in a securities or futures account could

be applied to satisfy the required margin for security futures.

The rules of the futures exchanges generally permit FCMS to include the value of listed options on contracts for future delivery in computing the equity in the futures account. The rules of national securities exchanges and the NASD, however, generally, deny value to options carried for a customer for purposes of computing the equity in the customer's account.

A commenter expressed great concern that the exclusion of net option value from the calculation of equity in futures accounts would create significant operational difficulties for intermediaries that carry security futures in futures accounts.

Two other commenters expressed the view that recognition of option value for purposes of determining whether the required margin for security futures is satisfied in a futures account could create a significant regulatory disparity with exchange-traded options carried in securities accounts.

Staff has considered the commenters' concerns and are recommending approval of final rules that would provide that a net long or short option in a listed--I'm sorry a net long or short position in a listed put or call option carried in a futures account shall be valued in accordance with the margin rules applicable to the account for purposes of determining whether the required margin is satisfied.

For these purposes, listed options are defined as being any put or call that is issued by a clearing agency registered under Section 17a of the Exchange Act or cleared and guaranteed by a derivatives clearing organization registered under Section 5b of the CEA and traded on or subject to the rules of an exchange.

SEC staff has indicated that it is willing to entertain changes by securities exchanges to grant value to listed options in securities accounts under appropriate circumstances.

In addition, the Commissions intend to review their determination--any determination to

grant value to long options carried in futures accounts, after six months of trading in security futures products, to determine whether it has created a material disparity between the margin requirements for security futures and the margin requirements for comparable exchange-traded options.

The proposed rules also did not specifically address in detail whether open-trade equity, that is, the daily marked-to-market gain or loss in the value of futures or other exchange-traded contracts would be included in the equity in an account for purposes of determining whether the required margin for security futures is satisfied.

Eight commenters raised the issue and requested clarification from the Commissions. Those commenters generally requested that the Commissions clarify that broker-dealers and FCMS would treat open-trade equity on security futures positions as cash for purposes of margin and collateral.

In particular, the commenters suggested that FCMS would have to make costly systems changes

if they were not allowed to recognize open-trade equity for security futures as they are currently permitted to do for other futures.

In light of the commenters' views on this issue, the staff recommends that the final rules clarify that open-trade equity may be applied to satisfy the required margin for security futures and related positions.

Moving now to the fifth topic, which is exclusions, the rules before the Commission include several specific exclusions from these rules for certain categories of financial relations. Most of these are substantially as proposed. I will mention two of them here: portfolio margining and foreign customers.

Proposed rules provided an exclusion for margin calculated by a portfolio margining system that has been approved by the SEC and as applicable to the CFTC. Fourteen comment letters addressed the issue of portfolio margining. All of them supported that concept for security futures.

Ten of the commenters strongly supported the implementation of full portfolio margining for security futures as soon as possible.

Section 7 of the Exchange Act provides that 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.

After considerable discussion as to the application of this standard to security futures, CFTC and SEC staff believe that the risk-based portfolio margin for security futures may not be permitted until a similar methodology is approved for exchange-traded options.

Moving now to the second exclusion: foreign persons. I'm sorry, one additional point. Staff does--is committed, however, to working with the industry to develop a portfolio margining system for security futures as soon as possible.

Now, moving to foreign persons. The proposed rules provided an exclusion from the margin requirements for financial relations between a foreign branch of a creditor and a foreign person involving foreign security futures. This exclusion was intended to be consistent with the way Reg T treats financial relations between a foreign branch of a creditor and a foreign person involving foreign securities. One commenter addressed this exclusion.

Staff recommends that the Commission adopt this exclusion with two modifications: First the scope of the exclusion could be expanded so that it applies to the U.S. offices, as well as the foreign branch offices of a security futures intermediary.

The commenter expressed the view that the exclusion, as proposed, would create a competitive disadvantage for U.S. firms whose foreign customers would likely migrate to foreign offices or competing foreign firms in order to obtain the margin levels available on a foreign exchange. After considering the commenter's view, staff

believes that expanding the exclusion is appropriate and is consistent with the corresponding exclusion under Reg T.

The second modification clarifies the scope of this exclusion. Because the proposed rules did not define the term foreign security futures, the final rules would provide that the exclusion applies to financial relations between a security futures intermediary and a foreign person involving security futures traded on or subject to the rules of a foreign board of trade.

Thus, the exclusion would apply, regardless of whether the underlying security is issued in the United States or a foreign country.

In conclusion, I would like to thank, Michael Piracci, and especially Phyllis Dietz who worked many, many hours on this project and did an outstanding job. Thank you. And I'll take any questions--try to take any questions that you have, thanks.

CHAIRMAN NEWSOME: Thank you, John.  
Before we get into questions, Phyllis, Larry, any

comments or thoughts, anything additionally from you?

MS. DIETZ: No.

CHAIRMAN NEWSOME: Okay, thank you.

Commissioner Holum, questions or comments?

COMMISSIONER HOLUM: I have no questions, thank you.

CHAIRMAN NEWSOME: Commissioner Erickson?

COMMISSIONER ERICKSON: Yes, I've got a few questions if you're ready for them.

MR. LAWTON: I'll try.

COMMISSIONER ERICKSON: --I also want to extend my thanks and appreciation to you all for really keeping close watch on this project for over a year now and advancing these rules to the point we've got them. And I'm very thankful and grateful to you for keeping our interests at heart.

Whoever wants to take these questions, John, I'll direct them to you, but if it's more appropriate for Larry or Phyllis terrific. One of the things you talked about a little bit here is this table of offsets. And it's included in the preamble to the rules package that we have, but not

included in the rules. So my first question is, do we have plans to make this more broadly available so that people have access to this table and if, so, where?

MR. LAWTON: We don't have any current plans, but I think that's a good idea and we will probably try to do something along those lines.

COMMISSIONER ERICKSON: Okay. Thanks. I have a second question related to the table of offsets. It applies to specific kinds of trading strategies and I'm presuming that, as people have more comfort and develop a greater comfort level in trading these, the Commissions will be receiving petitions for additional strategies to be included in these exceptions. I'm curious about the process that we might be using to entertain those additional exceptions.

MR. LAWTON: I think the way that the rule is drafted, they could be submitted pursuant to exchange rules. So long as they were consistent with the statutory requirements and the requirements in the actual regulations, exchanges could submit rules both to the CFTC and the SEC and

would have to be reviewed through the applicable processes at both exchanges. But the universe of potential offsets is not necessarily bound by this chart.

COMMISSIONER ERICKSON: Okay. The second line of questions is related to the language, I guess it comes from Reg T, talking about the exemption from margin rules for firms whose primary business does not come from other broker-dealers, FCMs, floor traders, floor brokers, and there are a number of other criteria that are built into that and that minimum number or 1,000 customers. Where does this concept come from if you could first focus on that?

MR. LAWTON: Yeah, there is a provision in Reg T and so what we were attempting to do was to draw a parallel provision on the futures side which, essentially, provides that the customer margin requirements wouldn't provide--wouldn't apply to these entities, I mean, most commonly an FCM--an FCM trading for its own account would not be subject to the requirements, customer margin

requirements, they could be subject to the exchange member requirements.

COMMISSIONER ERICKSON: So this goes to an FCM trading primarily proprietary accounts--

MR. LAWTON: That's right.

COMMISSIONER ERICKSON: --as opposed to retail accounts?

MR. LAWTON: Right. And so the--I think the various provisions that come from Reg T I think are intended to identify legitimate broker-dealers in that case, you have to have a certain customer business so that one wouldn't register, perhaps, to get reduced margin treatment.

COMMISSIONER ERICKSON: Are there any default margin obligations that attach for those that are exempted?

MR. LAWTON: I think it would be the exchange rules so I think the existing exchange member requirements would probably apply.

COMMISSIONER ERICKSON: Okay. Is this exemption substantially different than the way FCMs are currently treated in our own regime?

MR. LAWTON: I don't think so, I think that they would, in fact, be margined under the existing system to the extent that an FCM qualified for this exemption would be margined for its proprietary trades, for its security futures, as it is margined for proprietary trades for other kinds of futures.

COMMISSIONER ERICKSON: A couple of questions about portfolio margining. I realize the law requires consistent margining of options, and today we're adopting a static 20 percent margin requirement for all transactions.

Personally, I believe, that by not recognizing SPAN, we lose the dynamic of market evaluation of risk, and I understand that nothing prohibits exchanges, or intermediaries for that matter, from increasing margins where it's appropriate. I just am kind of curious about portfolio margining and SPAN, and I know we've given a six-month time period to review and assess. Is there any idea at the staff level about how to proceed?

MR. LAWTON: Well, again, I think the statute requires that there be progress on the exchange-traded option side. There is a proposal before the SEC right now that would allow portfolio margining on a fairly limited pilot basis for certain types of traders. One complicating factor is that proposal is not simply limited to exchange-traded options, but is actually a cross-margining proposal which makes it a little bit more difficult to--for both the SEC and for us to process. I think that would be the first step that you would have to have some sort of portfolio margining on the exchange-traded options side, then you could proceed to have comparable margining on the future side.

COMMISSIONER ERICKSON: And that really raises another point, and a question that I have. Until any progress is made with portfolio margining on the securities side, we really won't see any of the benefits of cross-margining. Cross-margining is--is effectively off the table for security futures products, is that fair to say?

MR. LAWTON: I think that's right.

COMMISSIONER ERICKSON: I have no further questions, thank you. And thanks again.

MR. LAWTON: Thank you.

CHAIRMAN NEWSOME: Okay, thank you Commissioner Erickson. Along that same line of thinking that Commissioner Erickson just finished, in my discussions with Chairman Pitt, we talked about the six-month review of long option value of margin for offsets. Is there any process in place so that at the end of the six months we can come to the table to talk about these? Or as we go forward do we need to develop a process in order to sit down in six months and talk about these?

MR. LAWTON: Yeah, we--we have not developed a process yet, I think we'll need to work with the exchanges and clearing houses once these are launched to try to gather data on these items as quickly as possible.

CHAIRMAN NEWSOME: Okay. So you feel comfortable that we can put a process in place--

MR. LAWTON: Yes, sir.

CHAIRMAN NEWSOME: --in order to do such? Okay. Phyllis, any thoughts on that or--

Secondly, I think, certainly when we look at what we're doing today, it has to be considered an unprecedented achievement. Two agencies sharing jurisdiction, being tasked with writing very highly technical rules was a challenge. But I think, as demonstrated by today's action, one that was achievable. Certainly, I think if the SEC or the CFTC had been tasked, alone, with writing these rules they would probably be a little bit different. However, our directions were to work together and we have done that and so I would just like to ask the general question of John or others. Are you confident that we have fulfilled the requirements under the Act in what we have in front of us today?

MR. LAWTON: Yes, sir, I think we have.

CHAIRMAN NEWSOME: All right, thank you very much. Does anyone else have any questions or comments for the staff? If there are no further questions, then I'll entertain a motion that the Commission approve for publication in The Federal Register, the joint final rule-making establishing customer margin requirements for security futures

as outlined in the Memorandum of the Division of Trading and Markets, dated June 28, 2002. We'll entertain a motion.

COMMISSIONER HOLUM: So moved.

COMMISSIONER ERICKSON: Second.

CHAIRMAN NEWSOME: All those in favor, say aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: The vote is unanimous. The motion passes. Are there any closing comments by either of my colleagues?

COMMISSIONER ERICKSON: No, thank you.

CHAIRMAN NEWSOME: Okay. If not, I'll entertain a motion that we adjourn.

COMMISSIONER HOLUM: So moved.

COMMISSIONER ERICKSON: Second.

CHAIRMAN NEWSOME: All those in favor, say aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: The vote is unanimous, the meeting is adjourned. Thank you.

[Whereupon, at 10:31 a.m., the meeting  
was adjourned.]

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