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National Futures Association
200 West Madison Street
Suite 1600
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December 5, 2001

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By E-Mail (secretary@cftc.gov)

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Customer Margin for Security Futures

Dear Ms. Webb:

National Futures Association (NFA) is a registered futures association under the Commodity Exchange Act (CEA) and a limited purpose national securities association under the Securities Exchange Act of 1934 (Exchange Act), as amended by the Commodity Futures Modernization Act of 2000 (CFMA). NFA appreciates this opportunity to comment on the Commodity Futures Trading Commission's (CFTC) proposed rules regarding security futures margins that were proposed jointly with the Securities and Exchange Commission (SEC).[1] NFA is filing a comment letter with the SEC that contains identical comments.

Given the constraints imposed by the CFMA, the Commissions' margin proposal is well-thought-out and endeavors to be forward-looking and evenhanded. NFA commends the staff of both Commissions for their admirable work in developing this proposal.

NFA understands that industry groups anticipate filing comments suggesting that the treatment of margin follow the account – with futures rules governing transactions in futures accounts and securities rules governing transactions in securities accounts, subject to the same minimum level. NFA believes that this approach makes sense from both an operational and a regulatory perspective. From

[1] 66 Fed. Reg. 50720 (Oct. 4, 2001).

an operational perspective, it would minimize the programming expense, the amount of training that must be provided to back office personnel, and the potential for error that arises when transactions in the same account are subject to different margin rules. From a regulatory perspective, both the securities and the futures margining practices have proven effective over the years, and we see no reason why they would be less effective for security futures products – especially in the futures area, where margin requirements will be significantly higher than margin requirements for traditional futures contracts.

NFA recognizes, however, that the CFMA imposes certain restrictions on the Commissions in adopting margin rules, and it is the Commissions who will have to determine whether they can, or should, adopt margin requirements that follow the account. Therefore, NFA is also providing comments on specific aspects of the Commissions' proposal.

Application of Regulation T

The CFMA amended Section 7(c) of the Exchange Act by adding a new subsection (2)(B)(iv), which requires that "the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with [Regulation T]."[2] NFA recognizes that consistency requires reasonable comparability in either content or result. If Congress had meant "consistent" to mean "identical," however, it would have used that word or would simply have applied "the requirements established by the Board, pursuant to subparagraphs (A) and (B) of this paragraph (1)" to security futures products. For the reasons given below, we believe that the Commissions should not incorporate Regulation T wholesale but should adopt separate rules for security futures transactions.

Since Regulation T has never been applied to futures accounts, neither NFA nor futures commission merchants (FCMs) notice-registered as broker-dealers are knowledgeable about Regulation T. Even those firms that are fully-registered as both FCMs and broker-dealers often have separate operational and legal staff for their futures and securities activities. NFA will, of course, do whatever is necessary to ensure that its staff and the staff at the FCMs it audits understand the relevant requirements of Regulation T. Nonetheless, since a number of Regulation T's requirements are irrelevant to security futures, NFA believes the learning curve will be

[2] 15 U.S.C. 78g(c)(2)(B)(iv). Former subsection (2) was redesignated as subsection (3).

lower and the entire margin process will be more efficient if the applicable requirements are separately spelled out.

More importantly, NFA is concerned that simply applying the requirements of Regulation T to security futures products will have unintended results. Regulation T is designed to govern credit extended by broker-dealers to their customers. However, futures margin is not credit but a performance bond. Applying regulations designed to govern credit to non-credit transactions is neither an efficient nor an effective means of regulation.

The joint release states that security futures transactions would be recorded in a Margin Account.[3] However, Section 220.4(a) of Regulation T appears to prohibit multiple Margin Accounts for the same customer, with limited exceptions spelled out in that rule. This conflicts with the Commissions' companion proposal that would allow firms to carry security futures positions in either a futures or a securities account – a proposal that we fully support – since Section 220.4(a) would presumably prohibit a joint broker-dealer from carrying security futures positions in a futures account deemed a Margin Account if it also has a Margin Account for that customer's more traditional securities activities.[4] Although this may not initially be a problem for notice-registered broker-dealers, it may become a problem when customers begin trading foreign security futures products, since CFTC Regulation 30.7 requires firms to separate the funds to margin foreign futures contracts from the funds to margin domestic futures contracts.

Applying Regulation T wholesale could also have a number of other unintended results, some of which may be identified in other comment letters. Further, some of these results may not be discovered until firms gain actual experience with applying Regulation T to security futures products. Therefore, we recommend that the Commissions adopt separate margin rules for security futures products, although those rules could, where appropriate, incorporate definitions or specific provisions of Regulation T by reference.

The Commissions asked for comments on how a stand-alone rule would remain consistent with Regulation T over time. Obviously, the Commissions would have to keep abreast of changes to and new interpretations of Regulation T and amend the security futures rules when necessary. Nonetheless, this is a better solution in the

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[3] 66 Fed. Reg. 50720, 50722 (Oct. 4, 2001).

[4] See 66 Fed. Reg. 50786 (Oct. 4, 2001).

long run because the changes and interpretations could themselves have unintended results when applied to security futures products.

Margin Levels

The CFMA also amended Section 7(c) of the Exchange Act by adding a new subsection (2)(B)(iii), which requires that margin requirements be consistent with margin requirements for comparable exchange-traded securities options and that initial and maintenance margin levels be no lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded securities options.[5] The Commissions propose minimum initial and maintenance margin levels of 20% of the current market value of the security futures contract.[6] NFA believes that this proposal complies with Section 7(c)(2)(B)(iii) and should be adopted as a general requirement, with exemptions for portfolio margining and offsetting positions.

Initial and maintenance requirements for short equity options are set at 20% plus the premium and minus the amount by which the option is out-of-the-money, subject to certain minimums related to the exercise price. Since security futures contracts do not have either a premium (which is excluded from the Section 7(c)(2)(B)(iii) calculation in any event) or an exercise price, NFA believes that a simple 20% requirement is consistent with the margin requirements for exchange-traded equity options.

Section 7(c)(2)(B)(i) and (ii) state that margins for security futures products should be set at levels that will preserve the financial integrity of the security futures markets and prevent systemic risk.[7] A 20% margin level is more than adequate to meet these objectives. Futures margins have traditionally been significantly less than 20%, yet in the long history of the futures markets FCM melt-downs have been few and far between and no U.S. exchange or clearing house has ever become insolvent or unable to meet its obligations.

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[5] 15 U.S.C. 78g(c)(2)(B)(iii).

[6] The Commissions propose using that day's settlement price of the security futures contract to establish current value for purposes of calculating the 20% margin requirement. Although we believe this is a logical approach, we are not familiar with all of the operational issues that may be involved. Therefore, we defer to other commenters on this issue.

[7] The Federal Reserve Board has also stated that "the most important function of customer margin requirements should be prudential. . . ." See the Federal Reserve Board's March 6, 2001 letter delegating its margin authority to the Commissions.

NFA is a strong proponent of portfolio margining, which looks at a customer's overall position when assessing risk. Portfolio margining -- like other margin-setting practices for futures -- also adjusts for volatility. The risk profile of a high volatility stock or futures contract is very different from the risk profile of a low volatility stock or futures contract, and portfolio margining is much better at recognizing these differences than a straight percentage margin requirement. Therefore, portfolio margining is an efficient method of ensuring that margin requirements are set high enough to preserve the financial integrity of the markets and prevent systemic risk without tying up unnecessary funds that the customer could use more efficiently elsewhere. We applaud the Commissions' proposal to allow portfolio margining systems subject to appropriate regulatory approvals, and we encourage the exchanges and the Commissions to work together to achieve this objective.

NFA also supports the Commissions' proposal to allow margin offsets for certain positions subject to exchange rules that receive the necessary regulatory approvals. We believe that the exchanges, working with the industry, are the best judges of what those offsets should be.

Margin Collection

NFA agrees that margin -- both initial and maintenance -- should be collected as promptly as possible. However, we are concerned about the efficiency of the collection mechanics proposed by the Commissions.

Under current CFTC rules, FCMs must take a capital charge for maintenance margin calls outstanding for more than three business days.[8] Since margin calls are not issued until the following day, this essentially gives customers five business days (T+4) to meet those calls before the FCM must take a capital charge, and it gives the firm an incentive to collect the margin within that time. The Commissions' proposal requires collection within "three business days after the position is established" and, therefore, appears to reduce this time to four business days (T+3). As we understand it, initial margin on short stock option positions must be collected within five business days, and maintenance margin can be outstanding as long as 15 business days before the positions must be liquidated. Security futures products should be no more risky than other futures products or than short stock option positions. Therefore, NFA recommends that the period for collecting initial and

[8] See CFTC Regulation 1.17(c)(5)(viii).

maintenance margin be extended to T+4 to be consistent with existing requirements in both the futures and securities industries.

NFA's larger concern, however, is with the procedures that must be followed if margin is not received within the required time period. Section 220.4(d) of Regulation T requires broker-dealers to liquidate positions if an initial margin call is not met in full within the required time. The time can be extended in appropriate circumstances, but only with the approval of the firm's examining authority. The Commissions' proposal applies this requirement to maintenance margin as well, although it does not actually say what firms are required to do if a maintenance margin call is not met.[9] While we recognize that an ever increasing number of margin calls are sent by electronic means and satisfied by wire transfer, some customers -- particularly small, retail customers -- still rely on the mail. Requiring a firm to liquidate positions unless the margin call is met or the time period is extended by the firm's examining authority could create significant burdens for both the firm and the examining authority. These burdens are much greater than those imposed for other security transactions, where customers have an extra day to meet initial margin requirements and eleven extra days to meet maintenance margin requirements, and they will primarily disadvantage retail customers.

FCMs, including notice-registered FCMs, will have an incentive to collect security futures margins promptly (or to liquidate positions when margin calls are not met) in order to avoid putting up their own funds with their clearing organizations or firms. Failure to collect margin (or liquidate positions) also exposes the firm to market risk in those positions. Further, as noted above, the capital charge applicable to fully-registered FCMs, including FCMs that are also fully-registered as broker-dealers, provides an additional incentive for FCMs to collect margins in a timely manner.

NFA will, of course, adopt rules for granting extensions to pay margin calls if the Commissions adopt final rules utilizing that procedure. NFA recommends, however, that the Commissions rely on the current incentives and not require firms to obtain permission every time it has good reason to give a customer a little more time to meet a margin call.[10]

Other Issues

[9] We recognize that this is the procedure applied to maintenance margin for securities under self-regulatory organization rules.

[10] NFA will, of course, adopt rules for granting extensions if necessary.

It appears from the release that the Commissions anticipate allowing open trade equity to be withdrawn or used to margin new positions, as is the case in the futures industry, and NFA fully supports this approach. Since futures mark-to-market daily and profits and losses are recognized at that time, open trade equity in futures positions is considered a cash equivalent. In order to avoid any potential confusion, however, we believe that the final rules should specifically define security futures open trade equity as a cash equivalent.

Compared with current futures requirements, using Regulation T to specify the type of collateral appears to broaden the permissible collateral in some instances and narrow it in other instances. The collateral requirements in both industries have proven effective, and we believe they are comparable in result. Therefore, we believe that the type of collateral should follow the account.

If you have any questions concerning this letter, please contact me (312-781-1413, tsexton@nfa.futures.org) or Kathryn Camp (312-781-1393, kcamp@nfa.futures.org).

Respectfully submitted,

Thomas W. Sexton
Vice President and General Counsel

cc: Elizabeth L.R. Fox, Esq. (Office of the General Counsel)
Lawrence B. Patent, Esq. (Division of Trading and Markets)

(kpc/CommentLetters/SPF Margins-CFTC)