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COMMENT

December 5, 2001

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

Mr. Jonathan G. Katz
Secretary to the Commission
Securities and Exchange Commission
450 Fifth Street
Washington DC 20549-0609

Re: Proposed Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50720 (October 4, 2001); Release No. 34-44853
SEC File No. S7-16-01

Dear Ms. Webb and Mr. Katz:

The Futures Industry Association ("FIA")[1] and the Securities Industry Association ("SIA")[2] are pleased to submit this joint comment letter in response to the captioned proposed rulemaking (the "Proposed Rules") by the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") (together, the "Commissions"). We commend the Commissions for their efforts to address the complex issues presented by the application of statutorily mandated margin regulations to security futures contracts. The Associations support many aspects of the Commissions' proposed rulemaking. The Associations believe, however, that certain fundamental changes in the structure of the Commissions' approach are necessary. The principal comments of the Associations are summarized immediately below:

First, the Associations believe that it is essential that the Commissions enable firms to use their existing systems and processes to comply with customer margin requirements to

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[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 50 of the largest futures commission merchants (" FCMs") in the United States, the majority of which are registered broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international.

[2] SIA brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans, and generates $358 billion of revenue. Securities firms employ approximately 760,000 individuals in the United States. More information about SIA is available on its home page: http://www.sia.com.

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the maximum extent consistent with statutory mandates under the Commodity Futures Modernization Act of 2000 ("CFMA"). Such an approach would be consistent with the Commissions' Joint Release on Customer Protection and Recordkeeping, 66 Fed. Reg. 50786 (October 4, 2000) (the "SIPC/Seg Rule Proposal"). In this regard, the Associations note that the application of Regulation T ("Reg. T") to futures accounts will create significant operational and cost obstacles to the use of futures accounts for carrying security futures contracts. The Associations do not believe that the application of Reg. T to futures accounts is necessary in order to accomplish the Commissions' statutory mandate, and recommend an alternative approach to accomplishing the Commissions' policy objectives.

Second, the Associations believe it is important that the Commissions' proposed margin framework accommodate the implementation of portfolio margining at an early stage. The Associations view the principal function of margin as affording protection from the credit risk implicit in securities futures, options or the financing of securities. As a result, margin requirements for a particular product should be related to the specific market risk associated with that product. Since the specific market risk associated with individual securities varies with the underlying security, margin requirements should also vary in relation to the level of market risk associated with the underlying security. The most effective way to accomplish this result is through the implementation of a risk-based system of portfolio margining, consistent with the recommendations of the Board of Governors of the Federal Reserve System (the "FRB") in connection with the FRB's delegation to the Commissions of margin rulemaking authority for security futures.[3] Recognizing the complexities involved in implementing portfolio margining, the Associations recommend that such implementation occur on a phased-in basis.

To the extent that there is a need to establish a single minimum margin requirement for security futures contracts, members of the Associations are divided as to the minimum level of initial and maintenance margin that should be required for these contracts. Some members support the Commissions' proposed 20% minimum margin requirement for outright security futures positions. These members believe that 20% is appropriate in

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[3] In its March 6, 2001 letter delegating margin setting authority to the Commissions, the FRB stated:

> The Board requests that the Commissions provide an assessment of progress toward adopting more risk-sensitive, portfolio-based approaches to margining securities futures products. The Board has encouraged the development of such approaches by, for example, amending its Regulation T so that portfolio margining systems approved by the Securities Exchange Commission can be used in lieu of the strategy-based system embodied in the Board's regulation. The Board anticipates that the creation of security future products will provide another opportunity to develop more risk-sensitive, portfolio-based approaches for all securities, including security options and security futures products.

See Letter dated March 16, 2001 from the FRB to James E. Newsome and Laura S. Unger ("FRB Delegation Letter").

light of the CFMA and the margin requirements applicable to listed security options. These members further believe that 20% provides adequate protection in the context of the customary T+1 settlement of margin calls, and that brokerage firms may obtain additional protection by implementing higher customer margin requirements on an individual firm basis.

Other Association members share a concern that a 20% minimum margin requirement is too low, even in the context of a T+1 margin settlement cycle. These concerns relate to prudential considerations, as well as to concerns that the margin requirements across similar products lack comparability and the resulting potential for detrimental regulatory arbitrage. These firms would prefer a minimum initial and maintenance margin requirement of 25%.

All members strongly believe, however, that a T+5 margin collection period is necessary in order to avoid the processing complications that would arise from carrying positions subject to different margin collection periods in a single account and processing stream. Firms are generally required to take a capital charge on T+5 under both SEC and CFTC net capital rules in the event that a customer fails to satisfy a demand for initial margin by that time.

These comments and the Associations' more specific proposals regarding the structure and other elements of the Commissions' rulemaking are discussed in greater detail below. We have also included in Appendix I to this letter responses to the questions on which the Commissions specifically requested comments. The Associations expect to separately submit to the Commissions more detailed information supporting certain recommendations made below, including detailed rule proposals that would integrate and implement the Associations' structural and related substantive comments.

I. Framework for the Application of Margin Requirements to Security Futures.

The Commissions' approach to margin requirements for security futures should be consistent with the approach they have adopted in the SIPC/Seg Rule Proposal.

The SIPC/Seg Rule Proposal would permit firms dually registered as full-purpose broker-dealers and as full-purpose FCMs ("Dual Registrants") to determine whether to carry a customer's security futures positions in a securities account, in accordance with applicable SEC regulatory requirements, or in a futures account, in accordance with applicable CFTC regulatory requirements. Flexibility in the selection of regulatory account structure is necessary in the first instance because it is not possible, except at extraordinary cost (if at all), simultaneously to comply with the SEC and CFTC regulatory requirements applicable to customer accounts. Limiting the resulting regulatory obligations to those that apply by their terms to the selected account structure is also critical because it maximizes the ability of Dual Registrants who have selected one

or the other account structure to use their existing trade processing, back office and regulatory compliance systems in conducting that customer business.[4]

Unavoidably, the hybrid characteristics of security futures and the unique statutory and regulatory regime applicable to them will necessitate a number of systems and operational modifications in order for firms to conduct this new activity. The Associations' members continue to work on identifying required modifications. The Associations cannot overemphasize, however, the importance of minimizing the number and scope of the modifications that firms must make to conduct this business, particularly modifications that involve fundamental changes and necessitate the integration of entirely new and exogenous systems into existing, integrated processing systems that are premised on fundamentally different processing concepts.

The application of a particular margining framework to customer accounts presents equivalent considerations.

A. Reg. T Should Not Be Applied to Security Futures Maintained in a Futures Account.

In light of the considerations referenced immediately above, the Associations do not believe that the application of the margin account requirements of Reg. T to a futures account can be justified by a cost benefit analysis. The imposition of Reg. T with respect to futures accounts would require the restructuring of FCMs' accounts and related systems changes. (See App. I, Q&A 2(a).) The Associations' members believe that the development costs and personnel resources necessary to develop and implement the systems and processes to comply with Reg. T in relation to futures accounts and to staff the ongoing compliance function would be considerable. (See App. I, Q&A 2(b).) While the Associations' members have not developed detailed specifications for the necessary changes and therefore have not quantified the extent of the costs and personnel resources that would be associated with such development, there is uniform agreement that such costs would be substantial and would, by any quantitative measure, significantly outweigh the benefits that would be derived from such an approach. (See App. I, Q&A 2(c).) Association members "guestimate" that any systems development effort for an individual firm would likely be measured in several thousands of personnel hours and would entail significant "opportunity" costs. Firms would also likely incur substantial ongoing personnel training and employment costs.

In addition, the application of Reg. T to futures accounts, particularly accounts that include futures other than security futures, would create numerous compliance problems under Reg. T. (See App. I, Q&A 2(a), 3 and 4.)

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[4] As noted in the joint comment letter of even date of the Associations, the Associations strongly endorse this aspect of the Commissions' SIPC/Seg Rule Proposal.

We note in this connection that the CFMA did not mandate the application of Reg. T to security futures maintained in a futures account (or in a securities account for that matter). Additionally, the application of Reg. T to futures accounts is not necessary to achieve the Commissions' relevant policy objectives. (See App. I, Q&A 9.) Indeed, we believe that the imposition of Reg. T with respect to security futures is inconsistent with Congress's goal of facilitating trading in security futures by January (or April) 2002. On the other hand, the Commissions' policy objectives and the CFMA's statutory mandate can readily be satisfied by adopting a new, stand-alone margin rule incorporating provisions described immediately below governing the conduct of financial relations with respect to security futures positions carried in a futures account.

The Associations recommend that the Commissions jointly adopt rules or rule amendments specifically applicable to security futures (which, whether in the form of a new stand-alone rule or amendments to existing rules, or a combination of the two, are referred to herein for convenience as the "SF Margin Rules") providing with respect to security futures carried in a futures account in accordance with proposed CFTC Rule 41.42 that:

(1) initial and maintenance margin requirements and acceptable margin collateral (and haircuts) applicable to security futures are to be established by the listing exchange (as is the case with listed security options under Reg. T);

(2) as a condition to the delegation to listing exchanges of margin setting authority, exchange margin rules would be subject to approval by the Commissions,[5] as in the case of listed security options (subject to an exception for the imposition of higher margin levels, which should be permitted to be implemented by immediate exchange action);[6]

(3) creditors would be obligated to comply with CFTC regulations and Self-Regulatory Organization ("SRO") requirements with respect to the consequences of and obligations arising from customer margin delinquencies;[7]

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[5] Although the Commissions' authority to require approval of certain rules is circumscribed under the CFMA, the Associations do not believe that these provisions limit the ability of the Commissions to require prior approval of exchange margin requirements for security futures. The Commissions are not required under the CFMA to delegate margin setting authority to the exchanges (although doing so would establish "consistency" vis-à-vis listed options), and therefore may, as a condition to the delegation, impose reasonable rule approval requirements.

[6] The Associations believe that listing exchanges should have the authority to raise margin levels when necessary by immediate action.

[7] Under current practice in the futures market, margin calls are made on T+1 and customers are expected to satisfy margin calls (unless made late in the day) on a same day basis. If a margin call remains

(4) the requirements described in clauses (1) – (3) would be required to comply with statutory parameters as to comparability, minimum levels, etc.;[8] and

(5) the account must be maintained in accordance with CFTC requirements applicable to futures accounts, including the capital implications of the failure to collect customer margin.[9]

SEC and CFTC (and related exchange) rules governing acceptable collateral, collateral haircuts, margin payment extensions or close-out requirements, daily pricing conventions (for determining current market value) and the like do not need to be identical. Whether the rules applicable to a futures account are consistent with those applicable to securities accounts should be evaluated by determining that the relevant standard does not create a material incentive for customers to carry security futures positions in a futures account rather than in a securities account.[10] It is not necessary that the application of these requirements to securities accounts and futures accounts be the same. The Associations believe that, in relation to these issues, current CFTC and exchange rules applicable to futures are sufficiently similar to the rules applicable to listed securities options that they do not create such material incentives. (See App. I, Q&A 9.)

A listing exchange that has not established a minimum initial and maintenance margin level complying with the SF Margin Rules should be prohibited from listing security futures for trading.

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unsatisfied after T+5, the carrying FCM is required to deduct the deficiency in computing its net capital under CFTC Rule 1.17. There are no CFTC, exchange or SRO provisions for extending the collection period and no requirement that an FCM liquidate the customer's positions after T+5. In contrast, if a securities customer fails to satisfy an initial margin call by T+5, unless an extension is granted by an SRO, positions of the customer adequate to satisfy the deficiency must be liquidated. If there is a remaining margin deficiency below SRO levels, a charge for the deficiency must be reflected in the carrying firm's net capital computation under SEC Rule 15c3-1 and must, in any event, be satisfied by T+15.

[8] Under this approach, it is important that in any adopting release the Commissions provide clear guidance to listing exchanges with respect to the minimum margin requirements that the Commissions would regard as "consistent" with those applicable to comparable listed security options, such as that the minimum requirement be no less than the level (20/25%) ultimately specified by the Commissions.

[9] Variation margin would be handled under this approach in a manner consistent with current practice and in the same manner we understand the Commissions contemplate for the handling of variation margin for security futures carried in a securities margin account. That is, daily variation margin would be payable in cash and may be used to margin other open futures positions, to the extent not withdrawn or needed to fund initial or maintenance margin requirements in the customer's account.

[10] See the discussion in Section I.B.6 below with respect to the issue of day trading and the potential application of margin requirements for pattern day traders.

Finally, the required margin levels for security futures under the rules of any SRO that has not expressly adopted applicable requirements should equal the requirements under the rules of the listing exchange.

B. Application of Reg. T to Security Futures Maintained in a Securities Account.

The Associations agree with the Commissions' proposal that security futures carried in a securities account should be governed by Reg. T, subject to the security futures-specific modifications that are mandated by the CFMA and certain necessary conforming changes identified below.[11] Accordingly, the Associations recommend that the SF Margin Rules require financial relations with respect to security futures carried in a securities account in accordance with proposed SEC Rule 15c3-3(o) to be recorded and conducted in accordance with the provisions of Reg. T, as modified by the provisions summarized below:[12]

(1) initial and maintenance margin requirements applicable to security futures carried in a securities account would be established by the listing exchange (as is the case with listed securities options under Reg. T);

(2) the margin requirements described in clause (1) would have to comply with the CFMA's statutory parameters as to comparability, minimum levels, etc.;[13]

(3) as a condition to the delegation to listing exchanges of margin setting authority, such rules would be subject to approval by the Commissions, as in the case of listed security options (subject to an exception for the imposition of higher margin levels, which should be permitted to be implemented by immediate exchange action).[14] (See App. I, Q&A 24.)

In addition, the Associations believe that the following conforming modifications and clarifications to Reg. T are necessary to accommodate security futures:

(1) Variation Margin. The Associations understand that, as contemplated under the Proposed Rule, variation margin (reflecting daily changes in the

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[11] The Commissions clearly have the necessary authority under the FRB Delegation Letter to make any necessary conforming changes.

[12] The Associations note that the security futures-specific modifications to Reg. T may be codified as modifications made directly to Reg. T, or. as exceptions and amendments to Reg. T codified in separate SF Margin Rules that cross-reference Reg. T.

[13] See Note 8 above.

[14] The Associations encourage the Commissions to use their delegated authority to accomplish this result to the maximum extent permissible under the Securities Exchange Act of 1934.

mark-to-market value of security futures positions) will be payable in cash daily by and to customers, as is currently the practice with futures generally. The Commissions should therefore clarify that the margin account can be debited and credited directly in the amount of variation margin (and related fees and expenses). (See App. I, Q&A 8.) In light of some confusion that seems to have arisen in relation to this issue, the Commissions may also wish to clarify that variation margin can be used to margin open positions, to the extent it is not withdrawn from the account (or offset against account debits).[15]

It is equally important that the Commissions' SF Margin Rules ensure that SRO margin requirements, such as NYSE Rule 431, accommodate the contemplated treatment of variation margin under Reg. T and the CFTC and listing exchange rules and do not create obstacles to the contemplated treatment.

(2) Arbitrage Positions. The Commissions should clarify that, under Section 220.6(b) of Reg. T, arbitrage positions comprised in part of one or more security futures contracts qualify as *bona fide* arbitrage positions eligible for good faith treatment. (See App. I, Q&A 12.)

(3) Special Memorandum Account. The Commissions should clarify that special memorandum account ("SMA") credits may be created for variation margin credits. (See App. I, Q&A 7.)

(4) Day Trading.[16] The Associations' members are not in complete agreement with respect to the potential application of margin requirements to day traded security futures positions, including positions carried in a futures account. Certain members believe that the credit risks associated with the use of security futures for pattern day trading should be addressed by SRO margin requirements. At the same time, the application of day trading margin requirements in the case of security futures may necessitate potentially significant systems development. This is particularly true in the case of positions carried in futures accounts for which there is no equivalent margin requirement. (See App. I, Q&A 12.)

Certain members believe that the practice of settling margin calls on T+1 significantly mitigates the risks otherwise associated with day trading and that firms have and use internal risk management controls including

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[15] This treatment would be equally applicable to security futures carried in a futures account.

[16] These comments relate to security futures whether carried in a securities account or in a futures account.

position limits, order size limits and profit and loss limits that are adequate to manage the risks presented by customers who pattern day trade.

Inasmuch as the Associations recommend that any such margin requirements be adopted by the listing exchanges (or by SROs), we anticipate commenting on any day trading margin proposals (or the absence of such proposals) in the context of such exchange and SRO rulemakings.

II. Security Futures Margin Levels.

As noted above, margin requirements address both the systemic and the individual broker's credit risk implicit in the potential leverage afforded by products such as security futures and options and in the financing of other securities positions. The amount of credit risk associated with an individual security futures contract or any security is related to the price volatility and therefore the specific market risk characteristics of the relevant contract or security. As a result, the margin requirements applicable to security futures and other securities should reflect their specific risk characteristics. The most effective way to accomplish that result is through the use of a risk-based system of portfolio margining.

Portfolio margining systems are capable of incorporating parameters necessary to establish compliance with minimum requirements or with other rules governing the recognition of risk offsets. Portfolio margining systems are also capable of ensuring true comparability, and avoiding detrimental regulatory arbitrage, by giving equivalent or proportional treatment to products representing equivalent or related units of risk.

For these reasons, the Associations urge the Commissions in the strongest terms to facilitate the implementation of portfolio margining at the earliest possible time, consistent with the recommendations of the FRB Delegation Letter. To this end, the Associations recommend a phased-in implementation of portfolio margining incorporating first steps that may be readily implemented in connection with the anticipated launch of security futures, as described in Section II.B below.

A. Outright Margin Levels.

To the extent that it is necessary to establish static minimum initial and maintenance margin levels for security futures, the Associations' members agree that these levels should be informed by several considerations. These include: (a) the explicit statutory mandates under the CFMA; (b) prudential credit risk management considerations; and (c)

the extent to which the relevant margin levels are sufficiently comparable to economically equivalent transactions to avoid detrimental regulatory arbitrage.[17]

The Commissions have proposed implementing a 20% minimum initial and maintenance margin requirement. Certain members of the Associations agree with the Commissions' recommended 20% minimum initial and maintenance margin requirements. These members are of the view that the 20% level is consistent with the levels applicable to listed security options, and is consistent with the intent of the CFMA. These members further believe that a 20% level, in combination with the prevailing T+1 settlement of margin calls, is prudent and that individual firms can unilaterally impose higher margin requirements on customers where they deem it prudent to do so from a credit risk management perspective.

Other members share a concern that a 20% minimum level is too low, even in the context of a T+1 margin settlement cycle, and recommend that the Commissions adopt a 25% minimum margin requirement.[18] These members believe that a 20% requirement fails to take account of the varying volatility/share price profiles of equity securities and the credit risk implications of these differences.[19] (See App. I, Q&A 23.)

These members believe that these levels also are not "consistent" with the margin requirements applicable to listed security options. These members note that a comparable option position consists of a long (short) call/short (long) put option pair struck at the forward price of the underlying security. The initial margin requirement applicable to such a position is equal to the sum of 20% *plus* the market value of the short option which, on trade date would equal the short option premium.[20] Comparison of the

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[17] As noted above, the Associations recommend that, as in the case of listed security options, outright margin levels (and strategy-based margin levels) should be established by the listing exchange, subject to the statutory constraints (*i.e.*, consistency with those established for listed options) imposed by the CFMA. These comments should be understood against that background.

[18] The Associations' members expect that the exchanges intending to list security futures will require daily variation margin and that the prevailing margin settlement cycle will apply to security futures.

[19] These members believe that the application of SPAN, as currently calibrated by futures exchanges, would apply margin requirements generally higher than 20% for the securities likely to be subject to security futures trading.

[20] These members recognize that the CFMA imposes a requirement that stock futures margin be consistent, exclusive of premium, with the margin required for listed options. As noted above, a put/call pair involves: (1) the payment of a premium for the long option, (2) receipt (subject to clause (3)) of a premium for the short option, and (3) margin equal to the sum of 20% plus the short option market value. The CFMA requirement may be read as requiring that the net impact of the premium payments in clauses (1) and (2) be disregarded and that the amount in clause (3) form the sole basis for comparison. The amount in clause (3) is the applicable margin requirement, notwithstanding the fact that it incorporates an amount equal to the short option premium on the trade date. Under this view, "compatible" option margin requirements would be significantly higher than 20%.

proposed 20% margin requirement for security futures to the higher margin requirement applicable to a naked short option yields an even starker contrast. An option struck at the forward price has a delta, and therefore price volatility, that is roughly half that of a similar maturity futures contract on the same underlying security, yet would be subject to higher margin requirements than that futures contract. (See App. I, Q&A 21, 22.)

These members further believe that the described margin discrepancies could create a material inducement for customers to trade in security futures markets rather than in the markets for listed options or cash securities, to the detriment of the adversely affected markets.

The Associations' members uniformly agree, however, that a T+1 margin settlement cycle and a T+5 collection period are appropriate periods for security futures. Given that the initial margin collection period for securities and listed securities options is T+5, and that, as a result of required capital charges, futures have an effective collection period of T+5, the Associations' members feel strongly that a T+5 collection period should also apply to security futures. A different result would necessitate significant additional programming by firms and would greatly complicate, delay and increase the cost of security futures margin compliance. Additionally, while an extension of the customary T+1 margin settlement cycle for security futures would, in the Associations' view, significantly increase systemic risk, the imposition of a T+5, rather than a T+3 collection period would not, in the Associations' view, contribute materially to increased systemic risk.

B. Portfolio Margining.

Ultimately, the Associations believe it is important to implement a portfolio margining framework under which the margin requirements for portfolios comprising securities, security options and security futures would be determined through a risk-based analysis. Under such a framework, products representing equivalent or related units of market risk would be subject to equivalent or proportional margin requirements.[21] The Associations' members also believe that the disparities in view described above with respect to static minimum margin levels can be bridged and relevant policy concerns addressed through an appropriate portfolio-margining framework. This objective was clearly endorsed by the FRB in its delegation to the Commissions of security futures margin rulemaking authority. Nonetheless, while the Associations believe this objective is achievable within a reasonable period, we recognize that there are many complex issues to be resolved. As a result, the Associations recommend the following first step of a phased-in approach, an approach, which the Associations believe, can be implemented immediately.

[21] As noted in Appendix I, the Associations do not believe that it will be necessary to impose limitations on the firms that may utilize portfolio margining or the customers for whom it may be used. To the extent that firms are permitted to use proprietary models for portfolio margining, validation of such models would be appropriate. (See App. I, Q&A 13,14.)

1. Use of SPAN for Security Futures Positions Carried in a Futures Account.

As noted by the Commissions, the CFTC has previously approved the use of the Standard Portfolio Analysis of Risk ("SPAN") system for establishing the initial and maintenance margin requirements for portfolios of futures contracts.[22] The futures markets have had extensive experience with the use of SPAN, and SPAN has performed reliably, even in periods of extreme and sustained market volatility. SPAN establishes margin levels that are reflective of prevailing trends in volatility and can be calibrated to ensure that minimum margin requirements are satisfied, notwithstanding the fact that implied volatility statistics might imply lower margin levels. SPAN can also be configured to incorporate parameters for permissible risk offset recognition based on comparability and minimum correlation metrics.

Enabling FCMs to continue to use SPAN for establishing the margin requirements for their customer futures account would also have the important benefit of minimizing disruption to the existing systems and processes used by firms for futures transactions and facilitating the commencement of trading in security futures. The Associations therefore urge the Commissions to approve the use of SPAN for establishing the initial and maintenance margin requirements for security futures contracts maintained in a futures account, subject to two parameters. These parameters would be designed to ensure, *inter alia*, consistency with security futures positions booked in a securities account during the phase-in period.

First, SPAN would be permitted to continue to use historical volatilities to establish margin levels for security futures, subject to a minimum level equal to the minimum margin requirement ultimately established for security futures. Second, SPAN would be required to incorporate parameters for permissible risk offset recognition based on comparability of treatment for other securities and minimum correlation metrics. The Associations' members stand ready to work with the Commissions and interested exchanges in defining these parameters.

2. Use of TIMS for Broad-Based Index Options and Security Futures Carried in a Securities Account.

As noted by the Commissions in the Release, the SEC has also approved the use of the Theoretical Intermarket Margin System ("TIMS") for equity and non-equity option positions of Options Clearing Corporation ("OCC") clearing members and has permitted the use of TIMS for establishing portfolio margining requirements for option market

[22] The Associations specifically refer to SPAN because they are familiar with that system. Reference to SPAN is not intended to preclude the use of any other system to calculate portfolio margin requirements.

makers with respect to options and futures positions involving broad-based stock indices.[23]

The Associations believe that TIMS and SPAN would not produce results so different, given the application of a common minimum margin requirement, that their use would create a material incentive for customers to carry positions in one type of account rather than another. Although the approach used under TIMS is somewhat different than that used under SPAN, TIMS can also be calibrated to model the price impact of a range of positive and negative price moves that would correspond statistically to volatilities and confidence intervals used under SPAN. (See App. I, Q&A 15.) Like SPAN, TIMS has been used successfully by the industry for an extended period and has also functioned well in periods of extreme and sustained volatility.

The Associations therefore urge the Commissions to approve the use of TIMS for establishing the initial and maintenance customer margin requirements for securities, security futures contracts and broad-based index options carried in a securities account.[24] The Associations' members stand ready to work with the Commissions and interested exchanges in working through a broadened implementation of TIMs.

3. Portfolio Margining and SRO Rules.

As the Commissions are aware, the implementation of portfolio margining will require a diligent and sustained multilateral effort, including the participation of SROs. The implementation of portfolio margining will accomplish little if conforming amendments are not made to rules such as NYSE Rule 431 and NASD Rule 2520. The Associations thus urge the Commissions to lead a broad-based industry effort to establish appropriate parameters for the use of portfolio margining systems that would satisfy all applicable initial and maintenance margin requirements. It is critical in this regard that no single SRO be permitted to preclude the use of an acceptable system of portfolio margining approved by the Commissions. The Associations therefore recommend that the SF Margin Rules prohibit SROs from imposing margin requirements that would effectively prevent a member's use of a portfolio margining system that has been approved by the Commissions.

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[23] The Associations refer to TIMS specifically because they are familiar with that system. The Associations do not intend to preclude the use of any other system to calculate portfolio margin requirements.

[24] Of course, the use of SPAN or TIMS would be permissive, and firms would not be precluded from using outright or strategy-based margin requirements.

C. Strategy-Based Margin Levels.

The Associations believe that the strategy-based margin offsets proposed by the Commissions create disparities in the recognition of offsets involving cash equities, on the one hand, and securities futures, on the other hand. (See App. I, Q&A 19, 20, 22.)

III. Other Rulemaking Recommendations.

As noted above, the Associations recommend that the Commissions jointly adopt SF Margin Rules that would, in general terms:

(1) delegate security futures margin requirements to the listing exchanges, subject to approval by the Commissions, as is the case in listed options;

(2) establish the parameters (such as comparability) applicable to such margin requirements; and

(3) require financial relations with respect to security futures carried in securities accounts to be recorded and conducted in compliance with Reg. T (as in effect from time to time), subject to the provisions described in clauses (1) and (2) and certain conforming amendments.

Appendix I describes certain additional requirements for the SF Margin Rules in greater detail.[25]

The Associations believe that the approach adopted by the Commissions is flawed in certain respects.

Preliminarily, the Associations note that many difficulties are created by the structure of the Proposed Rules. For example, the Proposed Rules incorporate certain exceptions to the proposed security futures margin requirements that are already exceptions to Reg. T (for example, exceptions for portfolio margining and exempt borrowers). However, there are other exceptions to Reg. T that are not referenced, creating confusion as to the potential negative inferences to be drawn with respect to those exceptions that are not referenced.

Additionally, the SF Margin Rules must establish margin requirements applicable both to securities accounts and futures accounts. As noted above, the Associations believe that futures accounts should not be subject to Reg. T. As a result, at least those provisions of the SF Margin Rules applicable to security futures carried in a futures account should be codified in regulations other than Reg. T, and should not incorporate Reg. T by reference.

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[25] The Associations note, in particular, that the proposed "market maker" exception should be revised to eliminate the customer business requirement. (See App. I, Q&A 17(a).)

Provisions establishing the margin requirements applicable to security futures carried in a securities account, and related conforming amendments to Reg. T could be codified either as part of Reg. T or as part of one set of regulations applicable to all security futures. One advantage to codifying the provisions applicable to security futures carried in a securities account in Reg. T is that it would maximize the likelihood that changes to Reg. T affecting securities and security futures will be harmonized.

Codifying all the rules applicable to security futures in one set of regulations outside of Reg. T, on the other hand, maximizes the likelihood that harmonization will be maintained between the margin treatment of security futures carried in a futures account and securities futures carried in a securities account. Other reasons to codify all SF Margin Rules in one stand-alone set of regulations (incorporating Reg. T by reference with respect to security futures carried in a securities account) include the following considerations:

The relevant margin requirements for security futures are both initial and maintenance requirements, whereas Reg. T is only an initial margin rule. There are, in addition, a variety of provisions that will apply only to security futures and not to other securities under Reg. T, as well as some modifications to Reg. T that will be specific to security futures and will not apply to other securities. Finally, neither the CFMA nor the FRB Delegation Letter authorized the Commissions to amend Reg. T directly.

Notwithstanding the foregoing, the Associations believe that all these considerations are secondary in importance to the need to ensure that the SF Margin Rules are substantively appropriate and do not introduce unnecessary and costly barriers to the commencement of security futures trading by the Associations' members. The Associations believe it is possible to accomplish that result, and to maintain the desired consistency over time, under either approach.

Finally, the Associations urge the Commissions to establish a framework within which the Commissions can respond, on an expeditious and coordinated basis, to requests for exemptive and interpretative action in relation to security futures margin requirements.

IV. Conclusion

The Associations again commend the Commissions and their staffs for the work they have done in addressing these difficult issues. The Associations' members would be pleased to provide such additional assistance going forward as the Commissions may request to facilitate the implementation of security futures trading. Should you have any questions, please feel free to contact the Chairman of the Joint SSF Steering Committee of the Associations, Jonathan Barton, of Morgan Stanley, at (212) 761-8805.

Very Truly Yours,

John M. Damgard President Futures Industry Association Association	Mark E. Lackritz President Securities Industry

cc: Commodity Futures Trading Commission

Honorable James E. Newsome, Acting Chairman
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable Thomas J. Erickson

Securities and Exchange Commission

Honorable Harvey L. Pitt, Chairman
Honorable Laura S. Unger
Honorable Isaac C. Hunt, Jr.

APPENDIX I

Q 1 The Commissions request commenters' suggestions on alternative ways to satisfy the statutory requirement that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures, are and remain consistent with the requirements of Regulation T. In particular, commenters are asked to discuss the advantages and disadvantages of issuing a rule that incorporates Regulation T by reference, as compared to issuing a stand-alone rule that would include requirements of Regulation T insofar as they are relevant to security futures. With respect to the stand-alone alternative, commenters are asked to consider any potential issues arising from the Federal Reserve Board's on-going authority to amend or interpret Regulation T and how such a stand-alone rule would ensure that the margin requirements for security futures held in either a securities account or a futures account would remain, over time, consistent with Regulation T. Commenters are asked to explain the meaning they ascribe to the term "consistent," when discussing means for satisfying the statutory requirement.

The Members of the Associations believe that the margining regime for security futures should recognize the link between the customer protection and insolvency scheme elected by or on behalf of the customer and be consistent with the margin rules and procedures that currently exist within that scheme. The rules should also recognize that maintenance rules applicable to securities margin accounts do not cover futures accounts held at FCMs. We are not troubled by the possibility that the Federal Reserve, either directly or through use of its authority to delegate such matters to the Commissions, will amend or interpret Regulation T in a manner inconsistent with the manner in which positions are margined in a futures account. We have found both the Federal Reserve and the Commissions to be very thoughtful about proposed amendments to the margin regulations and are confident that either directly, or through the public comment process, appropriate consideration would be given to keeping the various regulations consistent.

There is a difference in views among the Member firms as to whether it would be most efficient for the Commissions to implement their changes by amending the existing margin regulations in the case of securities margin and adopting a new rule to address margining of security futures or by adopting a single, stand-alone rule that would address both. Members advocating amendment of existing rules argue that that method would be simplest and best able to harmonize with other changes in the margin rules as they evolve over time. Those Members who advocate implementing changes through a single, stand-alone rule which would address both futures accounts and securities accounts argue that that method facilitates the ability of the Commissions to maintain comparable treatment for security futures booked in the two different types of accounts

Q 2 The existing customer account structure used by futures commission merchants ("FCMs") offers one type of customer account into which all customer property, including cash and other assets, is deposited. FCMs are not currently subject to Regulation T and, therefore, do not delineate accounts in accordance with Regulation T.

(a) Would the application of Regulation T account requirements to FCMs, to the extent they hold customer positions in security futures, necessitate the restructuring of FCM account systems?

We believe that the imposition of Regulation T to FCMs in relation to security futures would require some restructuring of account systems at the FCMs. Among other things, imposition of the Regulation would require that the securities futures be segregated from the non-securities futures, with the former being held in a margin account and the latter (including futures on broad-based indices) in a good faith account. Because security futures could not be held with other futures, customers would receive two account statements that most likely would confuse customers.

(b) In addition to the Regulation T account structure, what other requirements of Regulation T would necessitate operational or other changes for FCMs that are notice-registered broker-dealers?

FCMs would need to make systems changes and to have personnel (*i.e.*, margin clerks) to perform margin calculations required by Regulation T. Processes would also need to be developed to track, age and file for extensions with respect to margin calls. FCMs currently do not have Special Memorandum Accounts ("SMAs"), although FCMs would, as a practical matter, probably need to establish an SMA in order to facilitate margin calculations and cash flows with customers (keeping in mind that SMAs are not required under the current or proposed rules). We do not believe that having an SMA provides any competitive advantage over not having an SMA when initial and maintenance margin levels are the same.

(c) What are the estimated costs associated with such changes?

The costs associated with making securities futures accounts subject to Regulation T could be very high, particularly for those FCMs that are notice-registered broker-dealers. The costs are concentrated in two areas: systems development and operations personnel training. In all likelihood, FCMs would need to hire staff who have experience calculating margin under Regulation T and NYSE Rule 431 ("Rule 431") or Rule 2520 of the National Association of Securities Dealers, Inc. ("NASD") in order to accommodate a Regulation T account structure. The futures industry believes that the difficulty of implementing the proposed margining requirements in futures accounts could put FCMs at such a competitive disadvantage that they will choose not to offer security futures to their clients.

Q 3 Can a futures account be considered a Margin Account under Regulation T? If not, how would an FCM modify its futures accounts to satisfy Regulation T requirements for Margin Accounts?

As noted above, Regulation T would normally require that security futures be effected in a margin account and non-securities futures be effected in a good faith account. Treating the futures account as a margin account may require a number of potentially extensive amendments to Regulation T (e.g., provisions prohibiting a customer from having more than one margin account with a creditor and limiting the types of non-securities transactions in a margin account). If the futures account were considered to be a margin account, broker dealers who are also FCMs would be required to combine the securities accounts with futures accounts, which would be impermissible under existing definitions.

Futures accounts probably would be considered to be "Good Faith/Nonpurpose Accounts" as defined under Section 220.6(e)(1)(i) of Regulation T. Even if security futures were permitted to be carried in the good faith account, clarification would be needed to ensure that futures, including securities futures, would not be subject to the requirement that the carrying broker-dealer obtain a "non-purpose statement" on a trade by trade basis for positions in the account (other than those in respect of foreign exchange and commodities). One possible way to address this would be to clarify that all futures contracts are "commodities" within the meaning of Section 220.6.

Q 4 In order to comply with Regulation T, would FCMs need to establish Regulation T accounts other than margin accounts? If so, what would be the costs and operational feasibility of establishing such accounts?

FCMs would not be required, but would probably choose, to establish an SMA account in conjunction with the margin account. The addition of the SMA would, indirectly, increase the cost of margin calculation since administration of the SMA requires a separate calculation (including a different means of measuring current market value than that used to calculate Regulation T margin). As noted below, we anticipate that application of Regulation T and, if required, Rule 431 and NASD Rule 2520, to futures accounts would impose significant costs on FCMs through systems improvements and the addition of expert personnel (*i.e.*, margin clerks) to carry out the necessary calculations.

Q 5 What benefits to FCM customers or others can be expected if an FCM converts to the Regulation T account structure?

There are no apparent benefits.

Q 6 What benefits to FCM customers or others can be derived from application of other provisions of Regulation T?

Regulation T would allow customers to use any margin security to meet margin calls, and Rule 431 or NASD Rule 2520 (assuming it would be applied in tandem to cover maintenance margin) would allow customers to use any freely tradable stock to meet maintenance margin calls. As a result, customers would have wider choices in the type of collateral they may post.

Q 7 How should the SMA work in the context of security futures?

The SMA calculation should work the same way it does now for stock trades. The amount of the charge or release should be calculated based on the value of the security future at the time of the trade. Note that the calculation time is different for the SMA than it is for the margin account maintenance calculation, which looks to the value as of closing price (rather than the value as of the time of the trade).

Q 8 Are there any other requirements under Regulation T that are inappropriate for security futures?

Regulation T would need to be amended to clarify when variation margin debits may be made to a margin account. *See, e.g.*, Section 220.4(f)(1). Because the Regulation is interpreted to be all-inclusive (and the proposed changes do not currently speak to the ability of a broker-dealer to debit the account in respect of debits relating to security futures), the Commissions should add language to clarify that a broker-dealer would be entitled to debit a margin account for variation margin and for charges and costs incurred by the broker in carrying security futures in a customer's margin account, including costs associated with meeting delivery obligations under the futures contracts and exchange or clearing house fees associated with the positions.

The Commissions need to address how the current SRO maintenance rules (i.e., NYSE Rule 431 and NASD Rule 2520) would apply to security futures held in a securities margin account. Rule 431 supplements the requirements of Regulation T in a number of important respects, including imposition of the maintenance requirements with respect to customer margin accounts, imposition of higher *initial* margin requirements in certain cases (*e.g.*, transactions in illiquid securities, and establishment of both initial and maintenance margin-setting authority with respect to certain instruments, such as options). Moreover, Rule 431 imposes different requirements than Regulation T with respect to calculation of margin. For example, Rule 431 permits a broker-dealer to combine a customer's margin account with its other accounts at the broker-dealer in determining compliance with the maintenance requirements. Finally, although Rule 431 primarily deals with maintenance margin requirements, the Rule imposes initial margin requirements with respect to new securities transactions to the extent that the Regulation T level is lower than the Rule 431 levels. The Rule provides that a customer must deposit margin at least equal to the *greater of* (1) the amount specified in Regulation T, (2) the amount specified as maintenance margin by Rule 431(c), (3) such greater amount

as the NYSE may from time to time require for specific securities, or (4) $2,000 (but not in excess of the cost of any securities purchased). To the extent that Rule 431 applies to security futures, this language would suggest that initial margin for the product would, by definition, be at least 25% (*i.e.*, the minimum level specified in Rule 431(c)). [In order to achieve parity with the margin levels imposed on futures accounts, the Commissions must either clarify that this provision would not apply to security futures, raise minimum initial margin levels for both types of accounts to 25% or prevail upon the NYSE to change Rule 431. Given the broad authority granted by the Federal Reserve to the Commissions to regulate margin for security futures under Section 7(c)(2) of the Exchange Act, we believe that the Commissions may and should ensure that exchanges establish consistent rules governing maintenance margin in the securities account.

Under a plain reading of the Rule, Rule 431 would appear to cover securities futures booked in a margin account of a NYSE-member broker-dealer. In addition to the manner in which the Rule incorporates the Regulation T requirements, several other parts of the Rule would need to be clarified to explain how provisions apply to security futures. For example, the Rule should specify clearly whether a security future would be treated as a stock, a bond, an option or something new, and what maintenance level should apply.

The approach used in the proposed rules is largely silent on how the specified minimum maintenance margin level would be applied. We believe that attention needs to be given to maintenance margining under both a futures regime and a securities regime. In our experience, maintenance calculations, the timing of calls and the posting levels are far more important than initial margin. In addition, we believe that implementation of maintenance margining, because of the variation, tends to be more complex under either customer protection scheme than implementation of initial posting and calculation requirements and, thus, needs to be worked through promptly to accommodate an April 2002 launch for security futures.

We believe that initial and maintenance margin requirements and margin collection periods applicable to security futures carried in a securities account should be established by the listing exchange. As an interim or default measure, acknowledging it may take time for the exchanges to evaluate and amend their rules to establish adequate mechanics for maintenance margining of security futures, we recommend that the Commissions adopt a "default" provision which would provide that security futures be subject to minimum initial and maintenance requirements provided by the Commissions and clarify that security futures booked in the margin account would be subject to the provisions of Rule 431 and NASD Rule 2520 (other than the minimum requirements in Rule 431(b) and (c) and in NASD 2520(b) and (c)).

Q 9 Without applying Regulation T account requirements, could the existing rules applicable to futures accounts satisfy the statutory requirement that the margin requirements (other than levels of margin) including the type, form, use of collateral for security futures are and remain consistent with Regulation T?

We believe that it is within the CFMA's mandate that margin regulations for security futures be "consistent with" Regulation T for the Commissions to provide two separate margining regimes for security futures, depending upon whether the instruments are booked in a securities account or a futures account. We also believe that reliance upon the existing rules governing margining within the futures account (which rules rely upon SPAN margining and not upon the position-by-position approach currently applied by Regulation T) would meet the statutory requirement. In our view, the Congressional language requires that the Commissions adopt margin regulations which (1) have both initial and maintenance margin requirements, (2) provide for standardized timing for margin calls, (3) establish standards for treatment of cash and other asset flows in and out of the account, including procedures for daily valuation of positions and for withdrawals of excess collateral and (4) provide for the same margin levels regardless of which type of account the positions are booked in. We do not find any evidence that Congress believed that either type of account structure or margining regime was superior to the other. Rather, we think that Congress was concerned about providing a margining system sufficient to prevent systemic risk. In addition, Congress wanted to ensure that the margin levels were substantially equivalent for security futures and listed options.

Based on the tight timetable that Congress adopted for trading of security futures (originally scheduled to be authorized on a limited basis beginning 8 months after enactment and on full-market basis 12 months after enactment), we believe that Congress wanted the regulators to adopt regulations which could be implemented quickly and pragmatically. This type of timetable would be wholly inconsistent with the Commissions' current proposal to superimpose Regulation T on futures accounts. We believe that the Commissions' proposal would require a complete overhaul of the account structure and supporting systems at both FCMs and broker-dealers, although FCMs would be most acutely affected. We believe that the Commissions could (consistent with the CFMA) and should adopt parallel rules that rely on existing margin procedures within the different account types but which apply consistent margin levels.

Q 10 How would broker-dealers, including FCMs that are notice-registered broker-dealers, and members of national securities exchanges structure customer accounts if Regulation T were not incorporated by reference into the margin rules for security futures?

Under a dual margining regime, notice-registered broker-dealers would be subject to CFTC rules applicable to margin requirements for futures accounts. Similarly, under our proposal, Dual Registrants would be subject to the CFTC, listing exchange and SRO rules applicable to futures margining to the extent that security futures were booked in a futures account but would be subject to Regulation T, listing exchange and SRO margin requirements to the extent that security futures were booked in a securities account. The

CFTC rules governing futures accounts would treat security futures similarly to any other financial futures product booked in the account except that the minimum initial and maintenance levels would be those established by the Commissions or by SRO rule (and approved by the Commissions). Segregation, the timing of margin calls and the type of collateral that could be posted in the futures account would be governed by the existing CFTC rules applicable to all financial futures products booked in the futures account.

Q 11 (a) If the Commissions were to issue stand-alone rules that were parallel to Regulation T, how would commenters recommend that the Commissions incorporate the Federal Reserve Board's existing and future interpretations of Regulation T into such stand-alone rules?

As described previously, we do not believe that the CFMA requires the Commissions to apply Regulation T to futures accounts. We believe that the Commissions should adopt modifications to the existing regimes for futures accounts and securities accounts, respectively, to customize those rules for the particular product and provide consistency as to margin levels. These modifications should build on the existing infrastructures and rules rather than attempt to superimpose new rules or structures on the two existing frameworks.

(b) How would stand-alone rules impact the way securities firms calculate margin requirements for securities other than security futures?

One of the primary advantages of using the existing margining frameworks to establish rules for security futures is that the rules already define the necessary mechanics of margin calculation and posting. In addition, firms themselves have the necessary infrastructures, both in terms of systems and personnel, to support margining within the framework. Firms would be able to use existing systems with a minimal amount of modification to take account of the different margin level as well as any other minor adjustments to the rules due to the specific attributes of the product.

(c) Is there a risk of inconsistent application of the same rules?

We are not concerned that firms will apply stand-alone rules in an inconsistent manner. We believe that firms are more likely to apply the rules appropriately and accurately if the rules build off of the existing regimes for margining the two different types of accounts.

(d) What implications would this approach have for compliance with such rules?

We believe that there will be far greater ability for firms to comply with margin requirements for security futures if the Commissions build them into the two existing frameworks. To the extent that the Commissions go forward with their proposal to apply Regulation T to futures accounts, we believe that it will result in numerous errors, significant administrative burdens and a substantial delay in firms' ability to begin

trading the product due to required systems changes. We do not believe that the costs associated with adopting this sort of "forced" framework would have any attendant benefits.

Q 12 Should the proposed rules incorporate any special requirements for specific types of transactions or trading activity (e.g., day trading) that may be imposed under the margin rules of the SROs?

One of the changes we believe the Commissions should consider in respect of Regulation T is the application of the arbitrage provisions, contained in Section 220.6(b), to arbitrage transactions involving security futures. We think that the rules should be revised to clarify that *bona fide* arbitrage transactions involving security futures on the one hand and cash equities on the other would be eligible for good faith treatment. The purpose of allowing arbitrage in the good faith account is to facilitate the equalization of prices of the same securities in different markets and to eliminate non-economic differences in prices between closely related securities. We believe that there will be opportunities to arbitrage price levels between security futures and the corresponding cash equity position, and we believe that such arbitrage will be useful in reducing the amount of any disparity in trading level. Currently arbitrage transactions where one side of a position is not a "security" within the meaning of the Securities Exchange Act of 1934, as amended (the "Exchange Act") are not eligible to be booked in the arbitrage account as both the long and short positions must be a "security." Although the definition of "security" in the Exchange Act would seem to include security futures, in light of interpretive issues that have arisen in the context of listed options, which are also "securities" within the meaning of the Exchange Act, the Staff should clarify that arbitrage transactions involving security futures would be eligible for good faith margin treatment. We would also advocate liberalization of Regulation T generally to allow an index futures vs. securities position (*e.g.*, ETF vs. index futures) to be booked through the good faith account as an arbitrage transaction.

The Associations' members are not in agreement with respect to the potential application of margin requirements to day traded security futures positions. Members agree that the provisions of Regulation T which relate to day trading should not apply to security futures since those provisions refer only to instruments booked in the cash account and security futures, given their levered nature, are not proposed to be and should not be allowed to be booked in a cash account.

Rule 431 and NASD Rule 2520 contain special provisions relating to day trading. The Associations believe that, in analyzing the impact of these Rules to security futures, the Commissions should keep in mind the goals of achieving comparable treatment for economically similar instruments as well as the credit risks associated with day trading, particularly in respect of pattern day traders. Members urge the Commissions not to move precipitously to apply existing day trading rules, however, in light of the potentially significant systems development costs (particularly in respect of positions carried in the futures accounts). The Associations recommend that application of any existing or new day trading requirement to security futures be adopted by the listing exchanges (and applicable SROs) as and when appropriate in light of the trading experience. We would

anticipate commenting on any day trading margin proposals in the context of such exchange and SRO rule making proposals.

Q 13 Should there be any restrictions on a firm's eligibility to offer a portfolio margining system to its customers? If so, what types of restrictions are appropriate?

The Associations do not believe that there should be restrictions on the eligibility of a firm to offer portfolio margining with respect to all securities, including options and futures, in a customer's account. In December 1997, the Federal Reserve, consistent with authority granted to it by Congress, amended Regulation T to exempt financial relations between a customer and a broker-dealer to the extent that they comply with a portfolio margining system under rules approved or amended by the SEC. The Federal Reserve did not impose limitations on use of portfolio margining. We believe that, the Federal Reserve recognized that margining on a position-by-position basis, as Regulation T currently does, is a crude method of margining (particularly with respect to derivative instruments) and results in over collateralization without reduction of market risk to the broker-dealer carrying the position. (*See* Regulatory Competition and the Efficiency of Alternative Derivative Product Margining Systems, Paul H. Kupiec and A. Patricia White, February 1996, Finance and Economics Discussion Series, Division of Research and Statistics Division of Monetary Affairs, Federal Reserve Board, Washington D.C.) We support the Federal Reserve's endorsement of portfolio margining. We do not believe that small firms are inherently less able to use portfolio margining than large firms. As a general matter, portfolio margining is no more complicated to apply or to understand than the strategy-based method in Regulation T. Both systems require specially trained personnel and a solid systems infrastructure. A number of small FCMs have successfully applied SPAN to customer futures accounts and have built, often through outsourcing, robust infrastructures to ensure proper application of the model.

We believe that a portfolio margining system could allow for use of a firm's proprietary model. To the extent that a proprietary model were used, the model would have to be validated by the applicable SRO with primary oversight for the firm, examinable by regulators and maintained by a discrete risk management group within the firm. To the extent that the Commissions are concerned that allowing use of a proprietary system would either create a disadvantage for smaller firms as compared to larger firms or make examination difficult (because proprietary systems would be customized and, thus, vary), the Associations would, as an alternative, support use of a standardized portfolio margining model, such as TIMS or SPAN, using historical volatility inputs. Firms could be examined on their application of the standardized model.

Q 14 Should there be any restrictions on a customer's eligibility to use portfolio margining? If so, what types of restrictions are appropriate.

We do not believe that there is any reason to restrict a customer's eligibility to use portfolio margining. Futures customers, including retail customers, are currently subject to a portfolio margining-type system. Inclusion of retail customers in this system has not

resulted in losses. To the extent that firms are concerned that smaller customers are less able to bear the risk of loss, the rules should allow for firms to input higher volatility levels for the underlying stocks and, thereby, generate higher "house" margin levels.

Q 15 (a) Should a firm be permitted to elect to use either SPAN or TIMS to calculate security futures margin requirements?

We believe that both TIMS and SPAN are legitimate, well-functioning systems and either one or both could be appropriately adapted for security futures. To the extent that security futures are booked in a futures account, we would prefer that the Commissions allow for continued use of SPAN since the systems and infrastructure for those accounts are currently set up to use that methodology. It is important that whichever system is selected, the methodology applies to all assets held in the account. It will not be feasible to apply portfolio margining only to security futures or to security futures and some other select subset of assets held in the futures or securities margin account.

(b) Would the use of SPAN and TIMS result in significantly different margin requirements for the same account?

Both SPAN and TIMS are margin calculation systems that, although different in methodology, are able to produce results that are broadly similar. Each calculates margin for a portfolio of different assets using a given set of parameters and inputs relating (depending on the system) to changes in underlying price, volatility, "extreme price change" and time to maturity. The two models will produce substantially similar results if statistically comparable inputs (*i.e.,* price range and volatility) are applied. The most important input for SPAN is the volatility of the underlying stock or basket of stocks. The most important input for TIMS is the range of positive and negative price changes over which portfolio losses are calculated. To the extent that the Commissions wish to ensure establishment of consistent margin levels across firms, they should be, able to achieve that result, even if firms use proprietary portfolio margining models, by, for example, mandating a uniform volatility input, such as historical volatility levels.

(c) Are there other portfolio margining systems that the Commissions should consider?

The Options Clearing Corporation is currently engaged in utilizing a Monte Carlo simulation to determine margin requirements at the clearing level. While this may be a more economically defensible portfolio margining system than TIMS or SPAN, we have serious doubts about the ability of most bookkeeping systems to be able to perform the necessary calculations on a timely basis for a material number of accounts. Accordingly, we believe that either a proprietary system or a less complex system, such as SPAN or TIMS, should be selected as the appropriate portfolio margining method for the securities margin account.

Q 16 What costs would be incurred in order for firms to set up and operate a portfolio margining system? How would the costs of using a portfolio margining system differ from the costs of using the proposed strategy-based approach?

The answer to this question depends largely upon the methodology selected. The system that would require the lowest implementation costs would be continued application of SPAN to futures accounts (incorporating security futures in the methodology). To the extent that the rule would allow for use of proprietary portfolio margining models, implementation would also involve minimal set up and operational costs for firms, both in respect of the futures account and in respect of the securities margin account. Firms would need to spend time and effort validating the model and educating regulatory examiners on the model used by them. To the extent that the Commissions elect to apply a standard model, like SPAN or TIMS, that is not already in use for an account to security futures, some systems work will be necessary to adapt the model to the security futures product as well as to the other securities products booked in the account. Implementation by broker dealers would require development of new or significantly upgraded systems.

In addition, to the extent that the portfolio margining methodology is applicable only to certain products, such as security futures, its ongoing administration will be difficult and costly. This type of application is likely to involve the highest costs from a systems perspective as well as the highest ongoing maintenance costs both to train personnel and properly monitor and value positions.

Q 17 (a) Do the criteria set forth in proposed CFTC Rule 41.43(b)(3)(iv)(C)(2) and proposed SEC Rule 400(b)(3)(iv)(C)(2) encompass all of the persons that would perform a market maker function in an electronic market?

The definition does not encompass all of the persons that would perform a market maker function in an electronic market. The proposed "market maker" exemption requires that the borrower "not directly or indirectly accept or solicit orders from any customer or provide advice to any customer…" We note, however, that there may be instances where a broker-dealer acting as a market maker is not necessarily precluded from carrying out a customer securities business. The rules of the International Securities Exchange, for example, permit a broker-dealer to act as a market maker and to carry out a customer business as long as it complies with applicable rules as to the separation of the two functions. We would recommend eliminating the customer business qualifier from the definition and limiting the definition to a broker-dealer that holds itself out as being willing to buy and sell for its own account on a regular and continuous basis.

(b) Is this provision equitable to both securities exchanges and futures exchanges trading security futures?

We do not believe that the appropriate question should be equity as between exchanges,

since exchanges themselves do not trade the instruments. We do believe that the proposed change is appropriate, albeit with the definitional change that we have recommended. As a general matter, allowing additional credit to support market maker participants should have a stabilizing effect on the applicable markets by ensuring that there is sufficient liquidity available to floor brokers and other market makers, particularly in the face of unusually volatile markets and market downturns.

Q 18 Is the proposed method for calculating current market value of a security future appropriate? If not, commenters are requested to suggest alternatives.

We do not think that it is appropriate to establish a new definition to set the value of a security future. Instead, we believe that security futures should be valued based on the same time frame and methodology applicable to other instruments booked in the applicable account. In the case of the securities margin account, "current market value" of a security is defined under Section 220.2. This definition provides that the trade date closing price (based upon the published closing price) is the value for purposes of calculating initial margin but that the actual trade proceeds (including commissions) is the value used for purposes of the SMA calculation. Like the Regulation T initial margin calculation, the value of a futures contract for purposes of determining margin is measured as at the close of business on the preceding trading day. This value is typically determined by a committee of the applicable exchange (based upon an average of transaction prices executed on the close) and is referred to as the "settlement price." As a general matter, the Regulation T use of current market value for initial margin purposes is roughly equivalent to the futures definition of "settlement price." We do not think that it is problematic that the SMA definition differs. In our view, it is most important that security futures be valued using the same methodology as all other instruments booked in the account (and, in the case of the securities account, using the same methodology as applied to other instruments relevant to the SMA). This consistency is important not only for operational reasons but also because the methodology has importance for a number of other definitions and calculations made with respect to the margining regime. For example, under Regulation T, "margin deficiency" and "required margin" are dependent upon "current market value" (all measured as of the close on trade date).

Q 19 (a) Are there offset positions in addition to those enumerated in the above chart that are consistent with margin requirements for comparable options, which the Commissions should consider adding to the list of permissible offsets?

We would advocate modification of the existing strategy-based rules to put security futures on a par with cash equities in connection with offsetting strategies in listed options.

As we discussed above, we believe that the appropriate way to take account of risk offsets is through a sound portfolio margining system. Moreover, we do not believe that listed options are necessarily comparable to security futures. We believe that the analogous position would be listed cash equities.

(b) Are there offset positions included in the above chart, which the Commissions should consider deleting from the list of permissible offsets?

We believe that the Commissions should allow the same offsets for security futures as for cash equities. Basket offsets (*e.g.*, stocks vs. futures), for example, should not be allowed for security futures when they are not allowed for single equities. We do not, however, think that it is worthwhile at this juncture to expand the specific offsets and strategies contained in Regulation T. Rather, we believe the appropriate vehicle to recognize the economic correlations between baskets of stocks and security futures and aggregated instruments (such as index-based futures and exchange traded funds), as well as the appropriate vehicle to address economic correlations of all instruments in the margin account, is portfolio margining, which we strongly endorse. In the interim, we believe that the Commissions should work with the NYSE and the NASD to amend their rules relating to options strategies and margining to reflect the addition of security futures as a possible offset. We believe that these rules should be revised to provide parity between cash equities and security futures for option strategy offset purposes.

Q 20 Have the Commissions appropriately taken into account the overall risk of a position for the specified offset positions?

Subject to the comments above, we believe that the Commissions' general approach as applied to a securities margin account is a good interim step until a robust portfolio margining regime, applicable to all products in the securities margin account, can be approved by the Commissions and implemented by member firms. As we have noted above, we do not believe that the approach reflected in the proposed rules should be applied to security futures booked in the futures accounts. In addition, we believe that, in order to make the Commissions' Regulation T approach workable in the margin account prior to the adoption of appropriate rules governing maintenance margin by the SROs and exchanges, the Commissions need to define the application of maintenance margin to the account (which we believe that they may do under the authority delegated to them by the Federal Reserve pursuant to Section 7(c)(2) of the Exchange Act). In particular, the Commissions need to clarify that security futures would be subject to Rule 431 and Rule 2520, except that the minimum initial and maintenance requirements set forth in those Rules (*see, e.g.*, Rule 431(b) and (c)) would be replaced by the Commissions' specified minimum levels for the product (absent any later rule changes by exchanges or SROs to increase such levels).

Q 21 Are the proposed minimum margin levels prudential and efficient in meeting the objectives of preserving the financial integrity of security futures markets and preventing systemic risk?

There is disagreement among member firms regarding whether the minimum margin levels proposed by the Commissions are sufficient to prevent significant systemic risk. Some member firms have expressed concern that security futures positions would be significantly under-margined under the Commissions' proposal and could result in attendant losses to market participants. These firms also argue that a 20% minimum margin level would incentivize customers to invest in security futures rather than equivalent listed options pairs or listed equities. Other member firms believe that the 20% minimum level for both initial and maintenance margin selected by the Commissions is disproportionately high as compared with other financial futures contracts and should not be raised above the level which was dictated as a minimum by Congress. These firms note that margin levels for most non-security, financial futures contracts (such as equity index futures contracts) average well below 20%.

Member firms agree that the appropriate long-term solution to the difference in views is to apply a risk-sensitive, portfolio-based margining methodology to securities booked in a securities margin account which would be similar to the risk-based, portfolio margining methodology applied by CFTC regulation to futures accounts. After portfolio margining has been developed for and implemented in the securities margin account, we believe that the minimum margin levels for security futures should be eliminated. We all believe that the most appropriate method to balance risk and efficiency for margin is through a risk-based, portfolio margining methodology. We urge the Commissions to work with the securities exchanges, the securities clearing houses, the NASD, and the industry to develop a workable approach that would cover instruments booked in the securities margin account, including security futures. We agree with the sentiment expressed by the Federal Reserve in its letter of March 6, 2001 to the Commissions that the creation of security future products provides an important opportunity "to develop more risk-sensitive, portfolio-based approaches for all securities, including secur/ity options and security futures products."

Q 22 Are there other ways of meeting the comparability standard in setting margin levels for offsetting positions? For example:

(a) Is it necessary to consider a long or short security futures position to be comparable to a long or short position in an underlying security for the purpose of determining margin for offset positions that only involve security futures and options contracts? If not, commenters are asked for specific recommendations on alternatives.

We believe that it is appropriate to consider a long or short security futures position to be comparable to a long or short position in the underlying cash equity. Security futures ought to behave exactly like the underlying stock; the risk of loss in either product ought to be the same assuming a liquid futures market. As a result, we believe that the value of security futures for offset or in strategies ought to be the same as that allowed to cash equities.

(b) Does the comparability standard necessitate that initial and maintenance margin requirements for strategy-based offsets be set at different levels?

No. Initial and maintenance margin should be the same. This is consistent with the treatment accorded to both listed and over-the-counter options by Regulation T and Rule 431. Applying the same levels to initial and maintenance would also facilitate creating a rule parallel to the securities margin account rule within the futures margining regime. Since margin for a contractual obligation (like a futures contract) is not an extension of credit, but rather the posting of a performance bond, the concept of initial futures margin is very different from the concept of initial margin in the context of a margin loan by a broker-dealer. This is particularly true when a risk-reducing new position is added to the portfolio. To the extent that a rule were to require a higher level of initial margin than maintenance margin in respect of listed derivatives positions, a customer who elected to offset its risk exactly by entering into an offsetting trade would be required to post additional margin when purchasing or selling the new position, even though the overall risk of the portfolio falls dramatically as a result of the offset.

Q 23 Are the proposed time limits for collection of margin appropriate for security futures?

We believe that the proposed time limits for collection of margin are impractical since they are inconsistent with the time periods applicable to other products booked in the accounts. In order for firms to be able to properly administer margin within customer accounts, it is important that time limits applicable to margin calls be consistent across all products booked in the same account structure. We believe that the time limits set forth in Section 220.4(c)(3) of Regulation T, *i.e.*, 2 business days beyond the standard settlement cycle, or T+5, should apply to all securities products, including security futures, booked in the securities account. Similarly, we believe that the shorter time

period, *i.e.*, one trading day, applicable to settlement of margin calls within the futures account ought to apply to margin calls effected from that account.

> **Q 24 Are there preferable alternative methods for meeting the dual filing requirements for margin rule changes? For example, should designated contract markets and DTFs file a rule certification with the CFTC at the same time as the proposed rule change is submitted to the SEC, and then file a new certification only if the proposed rule change is modified? Or, should an entity be able to choose whether to file a certification with the CFTC after SEC approval of such proposed rule change or at the same time as filing the proposed rule change with the SEC? Commenters are asked to be specific with respect to the costs and administrative convenience of the proposed procedures or any alternative procedures they submit for the CFTC's consideration.**

We believe that it is problematic that securities exchanges, unlike futures exchanges, cannot raise margin levels in an expedited manner as market conditions dictate. Under new Section 19(b)(4)(7) of the Exchange Act, rule changes by futures exchanges, including changes to increase margin levels, become effective upon filing (although they are subject to certain abrogation rights). Rule changes, including proposals to increase margin levels, submitted by securities exchanges typically do not become effective until publication for comment and review by the SEC. In light of the disparity in treatment as well as the need, from time to time as market conditions dictate, to raise margin levels, we request that the SEC be responsive to SRO rule filings in this area and act quickly to allow them to take effect. The SEC should also consider whether the CFMA and the FRB Delegation Letter together provide the SEC additional flexibility in this area.

<u>**Non-Numbered Questions:**</u>

> **The CFTC invites public comment on the application of the cost-benefit provision of Section 15(a) of the CEA in regard to the proposed rules. Commenters are also invited to submit any data that they may have quantifying the costs and benefits of the proposed rules.**
>
> **The SEC requests comments on all aspects of this cost-benefit analysis, including identification of any additional costs and/or benefits of the proposed rules. The SEC encourages commenters to identify and supply any relevant data, analysis and estimates concerning the costs and benefits of the proposed rules.**
>
> **The SEC requests comments, data, and estimates on all aspects of the costs of implementing Regulation T provisions pertaining to security futures.**

The SEC requests comments, data and estimates on all aspects of the costs associated with the margin level described in Proposed SEC Rule 402(b)(1).

We believe that the proposed rules, particularly the imposition of Regulation T to the futures account, impose significant systems, personnel and training costs on firms without any attendant benefits. None of the public policy benefits that have been attributed to Regulation T, *e.g.*, protection of broker-dealers against excessive credit exposure to customers, protection of investors against excess securities credit, regulation of the amount of the nation's credit resources dedicated to speculation in securities (and, accordingly, away from other, more productive uses), and protection of securities markets from undue fluctuations and disruptions caused by excess credit, are met by this proposal. Given the burden of building a separate infrastructure to deal with the product in the futures account, the imposition of different margining periods for the product within the margin account and the complete lack of clarity regarding how Rule 431 would apply to the product, the Associations believe that introduction of security futures under the proposed rules would result in a significant increase in systemic risk.

The proposed rules have not properly identified the risks inherent in the product. The strategy-based requirements, which we agree are appropriate for security futures in the context of a margin account (as an interim measure pending adoption of an appropriate portfolio margining regime to cover all products booked in the margin account), should be made consistent with Rule 431. In addition, the requirements, particularly those relating to offsets, should recognize that security futures are the economic equivalent of cash equities. Treatment of security futures in the same manner as cash equities would reduce the risk of creditor losses on concentrated positions.

The SEC requests comments, data, and estimates on all aspects of the costs associated with the proposed calculations for margin on security futures, including whether Proposed SEC Rule 402(b)(1) under the Exchange Act is likely to require these entities mentioned above to increase the number of staff, or result in additional resource burdens, to perform and implement the required calculations.

As discussed above, the Associations believe that application of the proposed rules to futures accounts would require FCMs to increase the overall size of their margin staff and would require them to hire new personnel who are expert in carrying out calculations under Regulation T and Rule 431.

The notification requirement under Proposed SEC Rule 402(e) is likely to result in various minor costs, including personnel time for preparing the notification by any means of communication, and sending such notification by a broker, dealer, or member of a national securities exchange that is required to send a notification to its creditor because it has ceased be an exempted borrower. The SEC requests comments and estimates on the costs associated with this notification requirement.

The Associations do not have any comments.

The SEC requests comments, data, and cost estimates relating to the time limits for collection of margin requirements.

To the extent that Regulation T is amended to allow for different time periods for margin collection for security futures, there would be significant costs incurred by broker-dealers in administering the non-conforming rules. Moreover, as a definitional matter, it is unclear how margin calculations could be accurately performed for the account since Regulation T does not allow for two different margin calls in respect of any trading day. Under Regulation T, calls are made on a net basis based on equity and margin deficiency on a given day.

To assist the SEC and the CFTC in their evaluation of the costs and benefits that may result from the proposed rulemaking, commenters are requested to provide analysis and data relating to the anticipated costs and benefits associated with the proposed rules. Specifically, the SEC and the CFTC request commenters to address whether the proposed rules would generate the anticipated benefits or impose additional costs on U.S. investors or others.

The proposed rules would impose additional costs and burdens on investors since they do not accommodate offsets within an existing account type and, thus, are likely to promote establishment of multiple accounts. Investors would have the credit exposure caused by maintaining multiple accounts and will be burdened by having to receive multiple account statements. Moreover, the complication of imposing Regulation T to a futures account is likely to lead to customer confusion.

To assist the SEC and the CFTC in their evaluation of the costs and benefits that may result from the proposed rulemaking, commenters are requested to provide analysis and data relating to the anticipated costs and benefits associated with the proposed rules.

All of the elements of the Exchange Act margining, customer protection and insolvency framework work together, and it does not make sense to use one piece of the framework in isolation.

The margining, customer protection and insolvency framework for FCMs contained in the Commodity Exchange Act (the "CEA") and the CFTC's rules under the CEA are fundamentally different from those established for broker-dealers under the Exchange Act. Unlike Regulation T, the CFTC does not impose an account based margining system or impose margin on a position by position basis. In addition, FCM customers do not get the benefit of SIPC insurance in the event of an insolvency but rely, instead, on rigid segregation rules.

The Exchange Act regime and the CEA regime are both effective and legitimate approaches to regulation and have resulted in relatively few broker-dealer or FCM bankruptcies. We strongly support the joint decision to allow customers trading security futures to elect which regime to use. We believe that that election should give the customer all of the benefits of the particular regime that they have elected, including margining (as distinct from the actual margin levels). We do not believe that it makes sense to pull discrete pieces from one of the regimes (such as Regulation T) and super-impose them on the other regime.

We believe that requiring market participants to retool futures accounts to superimpose Regulation T margining will result in extremely high costs without any attendant benefits. We agree with the findings of Paul H. Kupiec and A. Patricia White in a study performed by them of Portfolio Margining Systems that "The portfolio margining system embodied in SPAN (*i.e.*, the Standard Portfolio Analysis of Risk system used for all currently traded futures contracts at both the clearing level and the customer level) provides substantially the same market risk protection as the strategy-based system of Reg T…." We do not believe the costs involved in requiring retooling of the futures systems or the potential customer confusion caused by combining one regulatory regime with another are outweighed by any benefits provided by Regulation T, which we believe produces imprecise and, at times, overly conservative results. We strongly recommend that the CFTC and the SEC adopt margin rules that recognize that the margining regime to be applied flows from the type of account into which the positions are booked, *i.e.*, futures account vs. a margin account.

The SEC requests comments on the impact of the proposed rules on competition, efficiency and capital formation.

The SEC invites commenters to address whether the proposed rules would have a significant economic impact on a substantial number of small entities, and if so, what would be the nature of any impact on small entities. The SEC requests that commenters provide empirical data to support the extent of such impact.

The proposed rules will impede the ability of broker-dealers and FCMs to roll out security futures on a timely basis and may lead firms that would otherwise have offered the product to decide not to offer the product at all. The proposal will require a significant amount of systems development work, particularly by FCMs. The personnel and ongoing administrative costs to FCMs in implementing the rules would also add to

overhead at a time when firms are in the midst of an economic recession and are looking to cut costs.

The proposal is likely to increase the number of errors made in calculating margin in any account that contains security futures. This risk is applicable to both securities margin accounts and to futures accounts. Because the proposed rule singles out security futures under both regimes, rather than piggy-backing on the existing infrastructure and treating security futures in a manner similar to other products covered by the regime, more manual oversight and intervention will be required to implement the rule. One example of how the proposal will increase the administrative burdens on personnel monitoring margin accounts is the requirement that margin calls for security futures be made over a different time period than margin calls for other positions held in the account. This requirement will make it significantly more difficult for broker-dealers, particularly smaller broker-dealers having smaller margin staffs, to accurately calculate the required margin for the account and ensure that calls have been made and met on a timely basis. Firms maintaining futures accounts will also have difficulties and a high risk of error in making margin calls given the different regime that the proposed rules impose on security futures. FCMs will have to carry out a minimum of two margin calculations – one for all of the futures positions held in the futures account and another for the security futures positions. Given that most FCMs are not also broker-dealers, they are unlikely to have personnel in place who understand the implementation of Regulation T and the mechanics of making margin account style calls.

The proposal also creates a substantial amount of legal uncertainty. The most noticeable example of this is the failure of the proposal to address how Rule 431 would be applied to security futures in the context of a margin account.

Finally, the proposal undermines the efficiencies currently in place within the futures account structure, which relies on portfolio margining. Rather than building on the strengths of the existing margining systems (such as the efficient and risk-appropriate portfolio margining regime adopted by the futures industry), the rule attempts to put into place a new framework which builds exclusively on one component of the existing securities account margining regime.