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Customer Margin Rules Relating to Security Futures; Proposed Rules

COMMODITY FUTURES TRADING COMMISSION

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–44853; File No. S7–16–01]

RIN 3235–A122

Customer Margin Rules Relating to Security Futures

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

ACTION: Joint proposed rules.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'') and the Securities and Exchange Commission (''SEC'') (collectively, ''Commissions'') are proposing rules that would establish margin requirements for security futures. The proposed rules would preserve the financial integrity of markets trading security futures, prevent systemic risk, and require that the margin requirements for security futures be consistent with the margin requirements for comparable exchange traded option contracts.

DATES: Comments must be received on or before November 5, 2001.

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

CFTC: Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581, Attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418–5521, or by e-mail to secretary@cftc.gov. Reference should be made to ''Customer Margin for Security Futures.'' All comment letters will be posted, as submitted, on the CFTC's Internet web site (http://www.cftc.gov).

SEC: Persons wishing to submit written comments should send three copies to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–16–01; this file number should be included on the subject line if e-mail is used. Comment letters received will be available for public inspection and copying in the SEC's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549–0102. Electronically submitted comment letters will be posted on the SEC's Internet web site (*http://www.sec.gov*). The SEC does not edit personal identifying information, such as names or e-mail addresses, from electronic submissions. Submit only the information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT:

CFTC: Phyllis P. Dietz, Special Counsel; or Michael A. Piracci, Attorney, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Telephone: (202) 418–5000. E-mail: (PDietz@cftc.gov); or (MPiracci@cftc.gov).

SEC: Hong-anh Tran, Special Counsel, at (202) 942–0088; Jennifer Colihan, Special Counsel, at (202) 942–0735; Bonnie Gauch, Attorney, at (202) 942–0765; and Lisa Jones, Attorney, at (202) 942–0063, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION: The CFTC is proposing Rules 41.43 through 41.48, 17 CFR 41.43 through 41.48, and the SEC is proposing Rules 400 through 404, 17 CFR 242.400 through 242.404, under authority delegated by the Federal Reserve Board pursuant to the Exchange Act.[1]

I. Introduction

The Commodity Futures Modernization Act of 2000 (''CFMA''),[2] which became law on December 21, 2000, lifted the ban on single stock and narrow-based stock index futures (''security futures''). In addition, the CFMA established a framework for the joint regulation of these newly-permissible products by the CFTC and the SEC.

To facilitate the issuance of rules governing customer margin for transactions in security futures products, the CFMA added a new subsection (2) to Section 7(c) of the Exchange Act[3] to provide the Federal Reserve Board with authority to prescribe regulations for brokers, dealers, and members of national securities exchanges extending or maintaining credit to or for, or collecting margin from, customers for security futures products.[4] Section 7(c)(2) of the Exchange Act further requires the Federal Reserve Board to prescribe rules establishing initial and

[1] All references to the Exchange Act are to 15 U.S.C. 78a *et seq.*

[2] Appendix E of Pub. L. No. 106–554, 114 Stat. 2763 (2000).

[3] 15 U.S.C. 78g(c)(2).

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

maintenance customer margin requirements imposed by brokers, dealers, and members of national securities exchanges for security futures products.[5] Alternatively, the Exchange Act provides that the Federal Reserve Board may delegate this rulemaking authority jointly to the Commissions.[6] The Federal Reserve Board so delegated its authority by letter dated March 6, 2001.[7] Accordingly, the Commissions are proposing initial and maintenance customer margin requirements, including the levels of margin, for security futures.[8]

The rules proposed by the Commissions under Section 7(c)(2) of the Exchange Act must satisfy the following four statutory requirements. First, the rules must preserve the financial integrity of markets trading security futures products. Second, they must prevent systemic risk. Third, the rules must require that: (1) The margin requirements for a security future be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act;[9] and (2) the initial and maintenance margin levels for a security future not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any exchange registered pursuant to Section 6(a) of the Exchange Act, other than an option on a security future.[10] Fourth, the rules must ensure 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 established by the Federal Reserve Board under Regulation T.[11]

As jointly proposed by the Commissions, the rules would:

- Establish the minimum initial and maintenance margin levels required for customers carrying a long or short security futures position at 20 percent of the ''current market value'' of such position.[12]
- Permit regulatory authority[13] rules to provide that customers with strategy-based offset positions involving security futures and one or more related securities or futures have minimum initial and maintenance margin levels lower than the aggregate margins for the components of an offset position, provided that such minimum margin levels are consistent with the margin requirements for comparable offset positions involving exchange-traded option contracts.
- Provide that the requirements of Regulation T, other than margin levels, apply to financial relations between a creditor[14] and a customer with respect to security futures.
- Establish the time limits for the collection of initial and maintenance margin from customers; and
- Set forth the acceptable collateral for margining a security future transaction or position.

II. Description of the Proposed Rules

A. Applicability of Regulation T

Section 7(c)(2)(B)(iv) of the Exchange Act requires that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Federal Reserve Board pursuant to subparagraphs (A) and (B) of Section 7(c)(1) of the Exchange Act, *i.e.*, Regulation T.[15]

In analyzing how to implement the statutory mandate that margin requirements for security futures products are and remain consistent with Regulation T, the Commissions have discussed two possible approaches. The first approach, which is reflected in the proposed rules, would require that Regulation T apply to financial relations, including margin arrangements, between a creditor and a customer with respect to security futures and any related securities or futures contracts that are used to offset positions in such security futures, to the extent consistent with the proposed rules.[16]

This approach would ensure that existing and future Federal Reserve Board interpretations of Regulation T would apply. This approach is one way to ensure that margin requirements for security futures would remain consistent with Regulation T without further action by the Commissions.

A second approach would be to issue comprehensive ''stand-alone'' margin rules that would parallel Regulation T requirements for securities to the extent that such requirements are relevant to security futures. The stand-alone rules would apply to security futures and any related securities or futures contracts that are used to offset positions in such security futures. The stand-alone rules would not, however, apply to any other securities or futures transactions.

Regulation T establishes and defines the various types of accounts where securities subject to Regulation T may be carried and held. These accounts include the Margin Account,[17] SMA,[18] the Good Faith Account,[19] the Broker-

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

[6] *Id.*

[7] *See* Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to Mr. James E. Newsome, Acting Chairman, CFTC, and Ms. Laura S. Unger, Acting Chairman, SEC, March 6, 2001, reprinted as Appendix B to this proposal.

[8] Because Section 6(h)(6) of the Exchange Act provides that options on security futures may not be traded for at least three years after the enactment of the CFMA, the Commissions are not currently proposing margin requirements for options on security futures. 15 U.S.C. 78f(h)(6).

[9] 15 U.S.C. 78f(a).

[10] The proposed rules recognize that security futures can compete with, and be an economic substitute for, equity securities, such as equity options. Specifically, a synthetic futures contract may be created by two option contracts based on the same underlying instrument. To create a synthetic long (short) futures contract, an investor would buy (sell) a call option and sell (buy) a put option on the same underlying security, with the same expiration date and strike price.

[11] 12 CFR 220 *et seq.* Regulation T governs the initial margin requirements imposed by brokers, dealers, and members of national securities exchanges for all securities, other than exempted securities and security futures products. The rules of self-regulatory organizations (''SROs'') govern, among other things, maintenance margin requirements. Regulation T, among other things, establishes the securities that may be purchased on margin, sets the time frames within which initial margin requirements must be met, establishes and defines the types of accounts in which broker-dealers may record securities transactions, including the Margin Account, Cash Account, Special Memorandum Account (''SMA''), the Good Faith Account, and the Broker-Dealer Credit Account, and specifies the maximum loan value (*i.e.*, the maximum amount that may be loaned) of certain non-exempted equity securities, not including security futures products, that may be extended by brokers, dealers or members of national securities exchanges.

[12] The Commissions propose to define ''current market value'' in Proposed CFTC Rule 41.44(a)(2) and Proposed SEC Rule 401(a)(2), discussed *infra* notes 62–67 and accompanying text.

[13] The term ''regulatory authority'' means an SRO that is registered as a national securities exchange under Section 6 of the Exchange Act (15 U.S.C. 78f) or as a securities association under Section 15A of the Exchange Act (15 U.S.C. 78*o*-3). *See* Proposed CFTC Rule 41.44(a)(7) and Proposed SEC Rule 401(a)(7).

[14] The term ''creditor'' is used in this release and in the proposed rules to refer to brokers, dealers, and members of a national securities exchange that would be subject to the margin requirements for security futures. The use of this term and other terms, such as ''borrower,'' is not intended to indicate that there is an extension of credit involved in the margining of security futures. Rather, such terms are proposed to be used as a means to fulfill the statutory requirement that the margin requirements for security futures are and remain consistent with Regulation T. Regulation T uses the term ''creditor'' to refer to brokers, dealers and members of a national securities exchange that are subject to Regulation T requirements for customers' securities positions, including options positions. Margin requirements for short options positions represent a performance bond, as do the margin requirements proposed today for security futures.

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

[16] *See* Proposed CFTC Rule 41.43(b)(1); Proposed SEC Rule 400(b)(1).

[17] 12 CFR 220.4.

[18] 12 CFR 220.5.

[19] 12 CFR 220.6.

Dealer Credit Account, [20] and the Cash Account. [21]

More specifically, Regulation T requires all transactions to be recorded in a Margin Account, unless they are specifically authorized for inclusion in another account. [22] For example, margin in excess of the required margin under Regulation T and certain other items may be journaled as a credit to the SMA [23] where the credit would remain until the customer uses such credit by withdrawing it from the account or by applying the credit in the SMA as margin on a new securities transaction. [24] Certain broker-dealers also may effect or finance certain transactions for their owners, partners, or shareholders, or for other broker-dealers in a broker-dealer credit account. [25] Customers may also trade instruments other than securities, such as futures contracts and foreign currencies, in a Good Faith Account. [26]

Under the proposed rules, security futures transactions would be recorded in a Margin Account because the proposed margin level requirements represent a performance bond to guarantee contract performance by both the buyer and seller of such contract. Any daily net gain (or loss) on a security future (''settlement variation'') would be credited to (or debited from) the Margin Account. Broker-dealers registered with the SEC under Section 15(b)(1) of the Exchange Act [27] may journal any margin excess in the SMA.

The Commissions request comment on the extent to which Regulation T should apply to security futures.

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.

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?

(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?

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

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?

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?

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

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

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

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

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?

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?

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?

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

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

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

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?

B. Who Is Covered by the Proposed Rules

The principal purpose of the proposed rules is to regulate customer margin collected by brokers, dealers, and members of national securities exchanges related to customers' transactions in security futures, including the minimum amount of initial and maintenance margin that must be collected.[28] The proposal would require a broker, dealer, or member of a national securities exchange that effects transactions for a customer involving, or carrying an account for a customer containing, a security future to collect from such customer sufficient collateral to satisfy the margin requirements set forth in Proposed CFTC Rules 41.43 through 41.48, and Proposed SEC Rules 400 through 404.[29]

FCMs are brokers or dealers under the Exchange Act if they effect transactions in securities, including security future

[20] 12 CFR 220.7.

[21] 12 CFR 220.8.

[22] *See* 12 CFR 220.4(a)(1).

[23] The following entries represent credits to the SMA balance: (1) Dividend and interest payments; (2) Regulation T excess (the amount by which a customer's equity exceeds the initial Regulation T requirement); (3) deposits not needed to meet Regulation T margin calls; (4) deposits of securities (other than security futures) that carry loan value in the margin account; and (5) cash made available when a liquidation transaction releases funds for withdrawal from the margin account. *See* 12 CFR 220.5(b)(1)–(4).

[24] 12 CFR 220.5(b).

[25] 12 CFR 220.7.

[26] 12 CFR 220.6(e).

[27] 15 U.S.C. 78*o*(b)(1).

[28] *See* Proposed CFTC Rule 41.43(a); Proposed SEC Rule 400(a).

[29] *See* Proposed CFTC Rule 41.54(a); Proposed SEC Rule 402(a).

products, and they would therefore be subject to these proposed rules. Accordingly, such FCMs must register as broker-dealers under Section 15(b) of the Exchange Act.[30] The CFMA added Section 15(b)(11) to the Exchange Act,[31] which permits FCMs to register as broker-dealers by filing a written notice with the SEC for the limited purpose of trading security futures products, if certain conditions are met.[32] In addition, although certain natural persons that are members of designated contract markets registered under Section 6(g) of the Exchange Act[33] are exempt from the broker-dealer registration requirements, those persons are members of a national securities exchange and, as such, would be subject to the proposed rules.[34]

The rules would explicitly exclude certain categories of financial relations.[35] The proposed exclusions are described below.

C. Exclusions From Coverage

1. Financial Relations Between a Customer and a Creditor under a Portfolio Margining System

Section 7(c)(2)(B)(iii) of the Exchange Act[36] provides that the margin requirements for security futures must be consistent with the margin requirements for comparable exchange-traded options, and the initial and maintenance margin levels for a security future may not be lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded option. Accordingly, risk-sensitive/portfolio-based margining (''portfolio margining'') for security futures would be permissible to the extent it would be permissible for comparable exchange-traded options.

Regulation T by its terms does not apply to financial relations between a customer and a creditor to the extent that they ''comply with a portfolio margining system under rules approved or amended by the SEC.''[37] Moreover, Regulation T provides that the required margin for exchange-traded options shall be the amount or other position specified by the rules of the registered national securities exchange or registered national securities association authorized to trade the option, that have been approved, or amended, by the SEC.[38] Accordingly, if a portfolio margining system were developed by a registered national securities exchange or registered securities association, and approved by the SEC for exchange-traded options, a comparable portfolio margining system could be developed for security futures products.

The proposed rules[39] similarly do not apply to financial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules that have become effective in accordance with Section 19(b)(2) of the Exchange Act and, as applicable, Section 5c(c) of the CEA.[40]

Portfolio margining sets levels of margin by assessing the actual net market risk of specific market positions in specific securities or commodities. Under a portfolio margining system, the amount of required margin is determined by analyzing the risk of each component position in a customer account (*e.g.,* a class of option with the same expiration date) and by recognizing any risk offsets in an overall portfolio of positions (*e.g.,* across contracts on the same underlying instrument). So that adequate margin is deposited to cover extraordinary market events, one or more additional multipliers or other adjustments may be applied in calculating a customer's required margin. Depending upon the risks attributable to one or more positions, the amount of required margin may be greater than or less than the margin levels currently required for securities positions in a fixed-percentage strategy-based margining system.

The SEC and the CFTC have already approved exchange rules regarding a number of different portfolio margining systems for various purposes. The CFTC has approved portfolio margining using the Standard Portfolio Analysis of Risk (''SPAN'') system for all currently traded futures contracts, at both the clearing level and customer level.[41] In 1986, the SEC first approved The Options Clearing Corporation (''The OCC'') portfolio margining system, the Theoretical Intermarket Margin System (''TIMS''), for margin collected by The OCC for the non-equity option positions of The OCC clearing members.[42] In 1991, the SEC approved The OCC's use of TIMS for equity options.[43] Moreover, the SEC and CFTC have approved exchange rules that permit portfolio margining for options market makers in the context of limited cross-margining programs involving futures and options on broad-based stock indexes.[44]

Currently, the Chicago Board Options Exchange (''CBOE'') is working in cooperation with The OCC, the New York Stock Exchange (''NYSE''), the American Stock Exchange (''AMEX''), the Chicago Board of Trade (''CBOT''), and the CME to develop a pilot program that would provide an alternative method of margining (*i.e.,* a portfolio margining system) for certain customers[45] in broad-based stock index

[30] 15 U.S.C. 78*o*(b).

[31] 15 U.s.C. 78*o*(b)(11).

[32] *See* Securities Exchange Act Release No. 44730 (August 21, 2001), 66 FR 45138 (August 27, 2001) (SEC Release adopting amendments to its broker-dealer registration requirements for notice-registered broker-dealers and adopting Form BD–N).

[33] 15 U.S.C. 78f(g).

[34] *See* Proposed CFTC Rule 41.45; Proposed SEC Rule 402(a).

[35] *See* Proposed CFTC Rule 41.43(b)(3); Proposed SEC rule 400(b)(3). The Commissions note that there may be some factual circumstances that will satisfy the criteria of more than one exclusion.

[36] 15 U.S.C. 78g(c)(2)(B)(iii).

[37] 12 CFR 220.1(b)(3)(i).

[38] 12 CFR 220.12(f)(1).

[39] *See* Proposed CFTC Rule 41.43(b)(3)(i); Proposed SEC rule 400(b)(3)(i).

[40] 15 U.S.C. 78s(b)(2); 7 U.S.C. 7a–2(c). Pursuant to Sections 19(b)(1) and 6(g)(4)(B)(ii) of the Exchange Act (15 U.S.C. 78s(b)(1) and 15 U.S.C. 78f(g)(4)(B)(ii), respectively), rules implementing portfolio margining for security futures must be submitted to the SEC for approval in accordance with Section 19(b)(2) of the Exchange Act. Designated contract markets registered under Section 5 of the CEA and registered derivatives transaction execution facilities (''DTFs'') also must seek prior approval from the CFTC or provide notice by written certification to the CFTC, pursuant to Section 5c(c) of the CEA (7 U.S.C. 7a–2(c)). *See infra* notes 110–140 and accompanying text.

[41] The CFTC also has approved SPAN margining for all options on futures contracts. Developed in 1988, the SPAN margining system currently is used on more than 30 exchanges and clearing organizations worldwide, including the London International Financial Futures Exchange, which trades single stock futures contracts.

[42] *See* Securities Exchange Act Release No. 23167 (April 22, 1986), 51 FR 16127 (April 30, 1986).

[43] *See* Securities Exchange Act Release No. 28928 (March 1, 1991), 56 FR 9995 (March 8, 1991).

[44] To date, the Commissions have approved cross-margining programs between The OCC and the following futures clearing organizations: The Intermarket Clearing Corporation (1988); Chicago Mercantile Exchange (''CME'') (1989); Board of Trade Clearing Corporation (''BTCC'') (1991); Kansas City Board of Trade Clearing Corporation (1992); and Comex Clearing Association (1992). The Commissions also have approved cross-margining programs between the Government Securities Clearing Corporation and the following futures clearing organizations: the New York Clearing Corporation (1999); BTCC (2001); and CME (2001). For further discussion of cross-margining programs, *see* ''Eighth Annual Report to the Board of Governors of the Federal Reserve System on the Review of Stock Index Futures and Option Margining Systems by the Commodity Futures Trading Commission'' (June 2001), note 7 and accompanying text (available from the CFTC Office of the Secretariat).

[45] The pilot program currently being developed by the CBOE, The OCC, the NYSE, AMEX, CBOT and CME is contemplated to be available for (1) any registered broker or dealer registered with the SEC pursuant to Section 15(b)(1) of the Exchange Act; (2) any affiliate of a self-clearing Exchange Act Section 15(b)(1) registered broker-dealer; (3) any registered futures floor trader to the extent that listed index options positions hedge the trader's index futures and options positions; and (4) any person or entity that has or, establishes and maintains equity of at least five million dollars across all securities and futures accounts under his/her/its common ownership.

options and futures positions. The staffs of the Commissions are working with the participating regulatory authorities and their members to identify the regulatory and operational issues that need to be resolved to ensure successful implementation by the regulatory authorities of a portfolio margining system for securities futures products.[46] Among other issues, the Commissions would have to be satisfied that the portfolio margining system used to calculate customer margin requirements appropriately takes into account the trading characteristics and historical market performance of the applicable securities products, as well as the observed correlations among those products to the extent that offsets across various products are permitted. The Commissions would also need to be confident that the system provides a sufficient cushion of margin or capital against extraordinary price movements.

The Commissions strongly encourage the efforts of market participants to develop a portfolio margining proposal for security futures, and are committed to working with these participants to resolve any outstanding issues, as quickly as feasible. Such a portfolio margining system would also be responsive to the Federal Reserve Board's desire to encourage the development of more risk-sensitive, portfolio-based approaches to margining security futures products.[47]

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?

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

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

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

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

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?

2. Financial Relations Between a Foreign Branch of a Creditor and a Foreign Person

Financial relations between a foreign branch of a creditor and a foreign person involving foreign securities are excluded from the scope of Regulation T.[48] Similarly, Proposed CFTC Rule 41.43(b)(3)(ii) and Proposed SEC Rule 400(b)(3)(ii) specify that the proposed rules would not apply to financial relations between a foreign branch of a creditor and a foreign person involving foreign security futures.[49] This exclusion is designed so that financial relations between a foreign branch of a creditor and a foreign person involving foreign securities would be treated in a manner consistent with the way Regulation T treats such financial relations.

3. Margin Requirements Imposed by Clearing Agencies

Section 7(c)(2) of the Exchange Act gives the Federal Reserve Board the authority to prescribe regulations regarding the extension or maintenance of credit to or for, or the collection of margin from, any customer on any security futures product,[50] but it does not confer authority over margin requirements for clearing agencies. For this reason, in its delegation letter, the Federal Reserve Board stated that ''[t]he authority delegated by the Board is limited to customer margin requirements imposed by brokers, dealers, and members of national securities exchanges. It does not cover margin requirements imposed by clearing agencies on their members.'' [51] The margin rules of clearing agencies are approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[52] The CFTC has authority to ensure compliance with core principles for clearing organizations under Sections 5b and 5c of the CEA.[53]

Proposed CFTC Rule 41.43(b)(3)(iii) and Proposed SEC Rule 400(b)(3)(iii) would exclude from the proposed rules margin requirements that clearing agencies registered with the SEC or the CFTC impose on their members. The purpose of the proposed rules would be to clarify that these margin rules would not apply to clearing agencies registered with either the SEC or the CFTC.

4. Credit Extended, Maintained or Arranged by a Creditor to or for a Member of a National Securities Exchange or a Registered Broker or Dealer

a. Margin Arrangements With an Exempted Borrower

Proposed CFTC Rule 41.43(b)(3)(iv)(A) and Proposed SEC Rule 400(b)(3)(iv)(A) would exclude from the proposed rules' requirements margin arrangements between a creditor and a borrower with respect to the borrower's financing of proprietary positions in security futures, based on the creditor's good faith determination that the borrower is an ''exempted borrower.'' Regulation T defines an ''exempted borrower'' as a member of a national securities exchange or a registered broker or dealer, a substantial portion of whose business consists of transactions with persons other than brokers or dealers, and includes a borrower who: (1) Maintains at least 1,000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer; (2) earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or (3) earns at least 10 percent of its gross revenues on

[46] This pilot program would likely take a two-prong approach: (1) It would adopt a portfolio margining system that sets margin requirements for portfolios in a securities account consisting of positions in products based on U.S. domestic broad-based market indexes, including securities index options, securities index warrants, and marginable index Unit Investment Trusts (''UITs'') based on the greatest projected net loss of all positions in a ''class group'' or ''product group'' as determined by an options pricing model covering a specified range of market moves; and (2) it would adopt a cross-margining system that would apply a portfolio margining system to portfolios consisting of positions in products based on U.S. domestic broad-based market indexes, including securities index options and warrants, UITs, and index futures and options on index futures. The two prongs of the pilot are severable, and only the approval of the first prong—a portfolio margining system—is a precondition for using portfolio margining, rather than strategy-based margining, for security futures.

Before approving the cross-margining system, the Commissions would need to ensure that any such accounts are adequately protected against insolvency risks; in particular, relief from applicable securities and commodities customer protection regimes is necessary to facilitate cross-margining.

[47] In its delegation letter, the Federal Reserve Board requested that ''the Commissions provide an assessment of progress toward adopting more risk-sensitive, portfolio-based approaches to margining security futures products.'' It further stated that ''The Board has encouraged the development of such approaches by, for example, amending its Regulation T so that portfolio margining systems approved by the [SEC] 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* Appendix B.

[48] 12 CFR 220.1(b)(3)(iv).

[49] Regulation T defines the term ''foreign person'' to mean a person other than a United States person as defiend in Section 7(f) of the Exchange Act. *See* 12 CFR 220.2.

[50] 15 U.S.C. 78g(c)(2).

[51] *See* Appendix B.

[52] 15 U.S.C. 78s(b)(2).

[53] 7 U.S.C. 7a–1; 7 U.S.C. 7a–2.

an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer.[54]

The Regulation T criteria for an ''exempted borrower'' establish standards for the applicability of Section 7(c)(3)(A) of the Exchange Act, which exempts from federal margin rules ''credit extended, maintained, or arranged by a member of a national securities exchange or a broker or dealer to or for a member of a national securities exchange or a registered broker or dealer * * * a substantial portion of whose business consists of transactions with persons other than brokers or dealers.'' [55]

The Commissions propose under CFTC Rule 41.45(e) and SEC Rule 402(e) that once a person ceases to qualify as an exempted borrower under Regulation T, it would be required to notify the creditor of this fact before establishing any new security future positions. Under such circumstances, any new security future positions established by such person would be subject to the provisions of this proposed regulation.

b. Margin Arrangements With a Borrower Otherwise Exempt Pursuant to Section 7 of the Exchange Act

Under Section 7(c)(3) of the Exchange Act, the financing of the market making or underwriting activities of a member of a national securities exchange or a registered broker or dealer is exempted from the scope of federal margin regulation.[56] The Federal Reserve Board has expressed the view that certain futures floor traders, *i.e.,* those trading in the current open-outcry environment, act as market makers and therefore would be exempt under Section 7(c)(3) of the Exchange Act.[57] For clarity, the Commissions are proposing to specify under Proposed CFTC Rule 41.43(b)(3)(iv)(B) and Proposed SEC Rule 400(b)(3)(iv)(B) that credit extended by a broker, dealer or member of a national securities exchange that is exempt under Section 7(c)(3) of the Exchange Act [58] would also be excluded from the proposed rules.

c. Financial Relations Between a Creditor and a Member of a National Securities Exchange or Association

In addition, because the Commissions expect that certain members of national securities exchanges that use a screen-based trading system also will act as market makers, the Commissions are proposing to exclude from the scope of the proposed rules certain floor traders, floor brokers, and securities dealers who are exchange members and who have market maker obligations. Accordingly, the Commissions propose under CFTC Rule 41.43(b)(3)(iv)(C) and SEC Rule 400(b)(3)(iv)(C) to exclude from the scope of these proposed rules credit extended by a creditor to a member of a national securities exchange or a national securities association registered pursuant to Section 15A(a) of the Exchange Act [59] that does not directly or indirectly accept or solicit orders from any customer or provide advice to any customer in connection with the trading of securities futures and that is registered with such exchange or association as a security futures dealer, pursuant to regulatory authority rules approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[60] To take advantage of this exemption these regulatory authority rules would have to require such member: (1) To be registered as a floor trader or floor broker with the CFTC, or as a dealer with the SEC; (2) to comply with applicable SEC or CFTC net capital requirements; (3) to maintain records sufficient to demonstrate compliance with this proposed exclusion and the rules of the exchange or association; and (4) to hold itself out as willing to buy and sell security futures for its own account on a regular or continuous basis.[61] Finally, the regulatory authority's rules would have to provide for disciplinary action against a member for its failure to comply with the Commissions' margin rules or the rules of the exchange or association.

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?

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

D. Customer Margin Levels for Security Futures

This section describes how the Commissions propose that brokers, dealers, and national securities exchange members calculate the customer margin levels for security futures. Specifically, the Commissions propose to require both the seller and the buyer of a security future to provide and maintain, on a daily basis, cash or other acceptable assets equal to a percentage of the ''current market value'' of the security future.

1. Definition of Current Market Value

Currently, the initial and maintenance margin requirements for the sale of an at-the-money, uncovered put or call option are 100 percent of the option premium,[62] plus a fixed percentage of the value of the underlying financial instrument. The reference price used in determining the value of the underlying financial instrument when calculating the initial margin required on the sale of an uncovered option differs from the reference price used in calculating its maintenance margin. Specifically, to determine the initial margin required on the sale of an uncovered put or call option, the price used to determine the value of the underlying stock is the price at which the stock closed on the business day preceding the day on which the option is sold.[63] To determine the maintenance margin required at the end of a particular trading day for an uncovered, short put or call option, the price used is the price at which the underlying stock closed at the end of such trading day.[64]

The CFMA requires that the margin requirements for security futures be consistent with the margin requirements for comparable options contracts. For this reason, the Commissions are proposing to use a reference price for determining security futures margin consistent with the reference price used for determining margin on uncovered short options positions. Specifically, the Commissions are proposing to require that the daily settlement price of a security future be used to calculate both the initial and maintenance margin

[54] 12 CFR 220.2.

[55] *See* 15 U.S.C. 78g(c)(3)(A); *see also* 12 CFR 220.2.

[56] *See* 15 U.S.C. 78g(c)(3).

[57] In its March 6, 2001 letter, the Federal Reserve Board stated that ''[i]n the current open-outcry environment, the Board believes that floor traders act as market makers and therefore would be exempt [under Section 7(c)(3) of the Exchange Act].'' *See* Appendix B.

[58] 15 U.S.C. 78g(c)(3).

[59] 15 U.S.C. 78*o*–3(a).

[60] 15 U.S.C. 78s(b)(2).

[61] This provision incorporates the definition of ''market maker'' found in Section 3(a)(38) of the Exchange Act (15 U.S.C. 78c(a)(38)), which provides that a market maker is ''any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.''

[62] The option premium is the net sales proceeds of the option on the day the option is sold. *See* Amex Rule 462; CBOE Rule 12.3; and NYSE Rule 431.

[63] *Id.*

[64] *Id.*

requirements for such security future.[65] The Commissions believe that, for purposes of calculating margin requirements for a security future, using the daily settlement price for such future as the reference price is consistent with the use of the closing price of the underlying security used as the reference price for determining margin for equity options. For these reasons, the Commissions are proposing to use the daily settlement price of a security future as the reference price for calculating margin for such security future.

In addition, the Commissions believe that using the daily settlement price of a security future on the day of a transaction—rather than the daily settlement price on the day preceding the transaction—to calculate the initial margin is consistent with using the underlying stock's closing price on the preceding business day. The daily settlement price of a security future on the preceding business day, for example, may not exist if such security future were not available for trading on the preceding business day.

Finally, the Commissions propose to define ''current market value'' of a future on a single security, on any trading day, to be the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable number of shares per contract.[66] The Commissions propose to define ''current market value'' of a narrow-based security index future to be the product of the daily settlement price of such security future, as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.[67] Q 18 Is the proposed method for calculating current market value of a security future appropriate? If not, commenters are requested to suggest alternatives.

2. Twenty Percent of the Current Market Value

The Commissions propose that the minimum initial and maintenance margin levels required of customers for each security future carried in a long or short position be 20 percent of the current market value of such security future.[68] Under Section 7(c)(2) of the Exchange Act, the initial and maintenance margin levels for a security future must not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act.[69]

Currently, all listed options have the same margin requirements. For long, listed option contracts the purchaser is generally required to pay the full amount of such contract. The required initial and maintenance margin for short, at-the-money listed option contracts, where the underlying instrument is either an equity security (such as a stock or an instrument immediately convertible into a stock), or a narrow-based index, are 100 percent of the option proceeds plus 20 percent of the underlying security or index value.[70]

Unlike an options contract, however, a futures contract involves obligations of both parties to perform in the future—the buyer (long) to purchase the asset underlying the future and the seller (short) to deliver the asset. Thus, both the buyer and the seller of a futures contract must initially post and maintain, on a daily basis, margin to assure contract performance and the integrity of the marketplace. In addition, all market participants pay or receive daily settlement variation payments as a result of all open futures positions being marked to current market value by the clearing organization.

The Commissions propose that the initial and maintenance margin levels required of customers for each security future carried in a long or short position be 20 percent of the current market value of such security future[71] because 20 percent is the uniform margin level required for short, at-the-money equity options traded on U.S. options exchanges. Any national securities exchange or national securities association may, of course, impose higher margin level requirements on its members, and any broker, dealer, or member of a national securities exchange may impose higher margin level requirements on its customers.[72]

As noted elsewhere in this notice, the Federal Reserve Board has expressed the view that ''more risk-sensitive, portfolio-based approaches to margining security futures products'' should be adopted.[73] Pending adoption of such systems by regulatory authorities, however, the 20 percent level is consistent with the current requirements for comparable equity options.

3. Margin Offsets

The Commissions also propose to allow national securities exchanges or national securities associations to have rules that reduce the margin requirements for customers with certain security or futures positions that offset their security futures positions, provided that the resulting margin levels are not lower than the lowest customer margin levels required for comparable offset positions involving option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act.[74]

Currently, regulatory authority rules approved by the SEC permit lower maintenance margin requirements for stock positions that are part of hedging strategies with options positions.[75] The following hedging strategies, for example, currently have lower maintenance margin requirements for the overall combined position than would be the case if each component position in each of the hedging strategies described below were margined separately:

(1) Long put option/long stock;

(2) Long call option/short stock;

(3) Long stock/long put option/short call option (where the put and the call options have the same expiration date and exercise price);

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[65] Under Proposed CFTC Rule 41.44(a)(8) and Proposed SEC Rule 401(a)(8), the daily settlement price means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, as determined by the rules of the applicable exchange or clearing organization. This daily settlement price is used for calculating daily margin requirements. For physical delivery contracts, the settlement price on the last trading day may also be used as the invoice price for delivery of the security. For cash settled contracts, the final settlement price of a security future is directly based on the market for the underlying stock or security and may differ from the daily settlement price on the last trading day. *See* Securities Exchange Act Release No. 44743 (August 24, 2001), 66 FR 45904 (August 30, 2001).

[66] *See* Proposed CFTC Rule 41.44(a)(2)(i); Proposed SEC Rule 401(a)(2)(i).

[67] *See* Proposed CFTC Rule 41.44(a)(2)(ii); Proposed SEC Rule 401(a)(2)(ii). Under Proposed CFTC Rule 41.44(a)(1) and Proposed SEC Rule 401(a)(1), the term contract multiplier means the number of units of a narrow-based security index expressed as a dollar amount, in accordance with the terms of the security future.

[68] *See* Proposed CFTC Rule 41.45(b); Proposed SEC Rule 402(b).

[69] 15 U.S.C. 78g(c)(2).

[70] *See, e.g.,* Amex Rule 462; CBOE Rule 12.3; National Association of Securities Dealers (''NASD'') Rule 2520; NYSE Rule 431; PCX Rule 2.16; and Philadelphia Stock Exchange Rule 722.

[71] *See* Proposed CFTC Rule 41.45(b)(1); Proposed SEC Rule 402(b)(1).

[72] *See* Proposed CFTC Rule 45.45(b)(2); Proposed SEC Rule 402(b)(2).

[73] *See* Appendix B.

[74] *See* Proposed CFTC Rule 41.45(d); Proposed SEC Rule 402(d).

[75] *See* Securities Exchange Act Release Nos. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving SR–CBOE–97–67 amending CBOE Rule 12.3); 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving SR–NYSE–99–03 amending NYSE Rule 431); 43582 (November 17, 2000), 65 FR 70854 (November 28, 2000) (order approving SR–Amex–99–27 amending Amex Rule 462); and 43581 (November 17, 2000), 65 FR 71151 (November 29, 2000) (order approving SR–NASD–00–15 amending NASD Rule 2520).

(4) Short stock/short put option/long call option (where the put and the call options have the same expiration date and exercise price); and

(5) Long stock/long put option/short call option (where the put and the call options have the same expiration date, but the exercise price of the long put option is lower than the exercise price of the short call option).[76]

Because, however, the initial margin for equity securities is governed by Regulation T, the initial margin on the stock components of hedging strategies remains the same as initial margin for stock that is not part of a hedging strategy.[77] Thus, to initially purchase any one of these combined stock/option(s) positions on margin, a customer must satisfy the margin requirements individually for each of the securities that compose the hedging strategy. For example, when entering into a combined long call option position and a short position in the stock underlying the call option, a customer must pay for the call option in full[78] and satisfy the initial margin requirement for the short stock position, which is the greater of: (1) The amount specified in Regulation T; (2) the maintenance margin requirement under SRO rules for a short stock;[79] (3) such greater amount as the SRO may from time to time require for specific securities; or (4) the minimum equity required to be deposited under the SRO's rules.[80] However, for the customer to maintain the same long call option and short stock position, the customer need only maintain margin in its account equal to the lesser of: (1) 10 percent of the call option exercise price, plus 100 percent of any amount by which the call option is out-of-the-money; and (2) the maintenance margin requirement on the short stock position.[81]

Under this joint proposal, the Commissions propose that customers be permitted to offset positions involving security futures with certain related securities or futures. Such offsets would be available under regulatory authority rules approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[82]

When the SEC approved strategy-based offsets for options (that are comparable to the offsets proposed to be permitted for security futures in the chart below), the SEC found that it was appropriate for the SROs to recognize the hedged nature of certain combined options strategies and prescribe margin requirements that better reflect the risk of those strategies.[83–88] Furthermore, the SEC found that the SROs' proposals relating to strategy-based offsets involving options contracts were carefully crafted as they were based on the SROs' experiences in monitoring the credit exposures of options strategies. In particular, the SEC noted that the SROs regularly examine the coverage of options margin as it relates to price movements in the underlying securities and index components. Moreover, the SROs' proposals were thoroughly reviewed by the NYSE Rule 431 Review Committee, which is comprised of securities industry participants who have extensive experience in margin and credit matters. As a result of these factors, the SEC was confident that the SROs' proposed margin requirements were consistent with investor protection and properly reflected the risks of the underlying options positions.

The following table includes strategy-based offsets for security futures that the Commissions have preliminarily identified as consistent with those permitted for comparable offset positions involving options, and that would qualify for reduced margin levels. Although the levels are intended to be consistent with the margin levels for comparable offsets involving options, the Commissions recognize that the margin levels set forth in the table may not fully reflect the reduction in risk associated with the offsets.

	Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
1	Long security future or short security future.	Individual stock or narrow-based security index.	20% current market value of the security future.	20% current market value of the security future.
2	Long security future (or basket of security futures representing each component of a narrow-based securities index[1]) and long put option[2] on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus pay for the long put in full.	The lower of: (1) 10% of the the aggregate exercise price[3] of the plus put plus the aggregate put out-of-the-money[4] amount, if any; or (2) 20% of the current market value of the long security future.
3	Short security future (or basket of security futures representing each component of a narrow-based securities index) and short put option on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the short security future, plus the aggregate put in-the-aggregate money amount, if any. Proceeds from the put sale may be applied.	20% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any.[5]

[76] *See, e.g.,* NYSE Rule 431(f)(2)(G). In addition to these hedging strategies that affect the maintenance margin requirement for the underlying stock, there are strategies involving covered calls (long the underlying security and a short call option position) and covered puts (short the underlying security and a short put option position) in which there are no initial or maintenance margin requirements for the option component. There are also hedging strategies involving option-to-option offsets with lower initial and maintenance margin requirements.

[77] Regulation T requires that the initial margin for certain equity securities, other than exempted securities and security future products, be 50 percent of the current market value of the security. *See* 12 CFR 220.12(a).

[78] *See, e.g.,* NYSE Rule 431(f)(2)(C).

[79] The maintenance margin for a short stock is calculated as either: (1) $2.50 per share or 100% of the current market value (as defined in Regulation T), whichever amount is greater, of each stock short in the account selling at less than $5.00 per share; or (2) $5.00 per share or 30% of the current market value (as defined in Regulation T), whichever amount is greater, of each stock short in the account selling at $5.00 per share or above. *See, e.g.,* NYSE Rule 431(c).

[80] A customer is required to have equity of at least $2,000, except that cash need not be deposited in excess of the cost of any security purchased. *See, e.g.,* NYSE Rule 431(b).

[81] *See, e.g.,* NYSE Rule 431(f)(2)(G)(v).

[82] 15 U.S.C. 78s(b)(2). Implementation of such rules by designated contract markets registered under Section 5 of the CEA (7 U.S.C. 7) and registered DTFs also would be subject to the notice requirements of Section 5c of the CEA (7 U.S.C. 7a–2). *See infra* notes 110–121 and accompanying text.

[83–88] *See supra* note 75.

	Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
4	Long security future and short position in the same security (or securities basket) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the short stock or stocks.	10% of the current market value as defined in Regulation T of the stock or stocks underlying the security future.
5	Long security future (or basket of security futures representing each component of a narrow-based securities index) and Short call option on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregrate call in-the-money amount, if any. Proceeds from the call sale may be applied.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any.
6	Long a basket of narrow-based security futures that together tracks a broad based index and short a broad-based security index call option contract on the same index.	Narrow-based security index ..	20% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any. Proceeds from the call may be applied.	20% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any.
7	Short a basket of narrow-based security futures that together tracks a broad-based security index and short a broad-based security index put option contract on the same index.	Narrow-based security index ..	20% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	20% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any.
8	Long a basket of narrow-based security futures that together tracks a broad-based security index and long a broad-based security index put option contract on the same index.	Narrow-based security index ..	20% of the current market value of the long basket of narrow-based security futures, plus pay for the long put in full.	The lower of: (1) of 10% of the aggregate exercise price of the put, plus the aggregate put out-of-the-money amount, if any; or (2) 20% of the current market value of the long basket of security futures.
9	Short a basket of narrow-based security futures that together tracks a broad-based security index and long a broad-based security index call option contract on the same index.	Narrow-based security index ..	20% of the current market value of the short based of narrow-based security futures, plus pay for the long call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short basket of security futures.
10	Long security future and short security future on the same underlying security (or index).	Individual stock or narrow-based security index.	The greater of: 10% of the current market value of the long security future; or (2) 10% of the current market value of the short security future.	The greater of: 10% of the current market value of the long security future; or (2) 10% of the current market value of the short security future.
11	Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put and call must have the same exercise price. (Conversion).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from the call sale may be applied.	10% of the aggregate exercise price, plus the aggregate call in-the-money amount, if any.
12	Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put exercise price must be below the call exercise price. (Collar)	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from call sale may be applied.	The lower of: (1) 10% of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, any; or (2) 20% of the aggregate exercise price of the call, plus the aggregate call in-the-money amount, if any.

	Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
13	Short security future and long position in the same security (or securities basket) underlying the security future (or long position in a security immediately convertible into the same security underlying the security future, without restriction, including the payment of money).	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long stock or stocks.	10% of the current market value, as defined in Regulation T, of the long stock or stocks.
14	Short security future (or stock or basket of security futures representing each component of a narrow-based securities index) and long call option or warrant on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the short security future, plus pay for the call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short security future.
15	Short security future, Short put option and long call option. The short security future, short put and long call must be on the same underlying security and the put and call must have the same exercise price. (Reverse Conversion)	Individual stock or narrow-based security index.	20% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any, plus pay for the call in full. Proceeds from put sale may be applied.	10% of the aggregate exercise price, plus the aggregate put in-the-money amount, if any.
16	Long (short) a basket of security future, each based on a narrow-based security index that together tracks the broad-based index and short (long) a broad based-index future.	Narrow-based security index ..	20% of the current market value of the long (short) basket of security futures.	10% of the current market value of the long (short) basket of security futures.
17	Long (short) a basket of security futures that together tracks a narrow-based index and short (long) a narrow based-index future.	Individual stock and narrow-based security index.	The greater of: (1) 20% of the current market value of the long security future(s); or (2) 20% of the current market value of the short security future(s).	The greater of: (1) 10% of the current market value of the long security future(s); or (2) 10% of the current market value of the short security future(s).

[1] Baskets of securities or security futures contracts must represent exactly the same securities that comprise the index, and in the same proportion.

[2] Generally, for the purposes of these rules, unless otherwise specified, stock index warrants shall be treated as if they were index options.

[3] ''Aggregate exercise price,'' with respect to an option or warrant based on an underlying security, means the exercise price of an option or warrant contract multiplied by the numbers of units of the underlying security covered by the option contract or warrant. ''Aggregate exercise price'' with respect to an index option means the exercise price multiplied by the index multiplier. *See, e.g.,* Amex Rules 900 and 900C; CBOE Rule 12.3; and NASD Rule 2522.

[4] ''Out-of-the-money'' amounts must be determined as follows:

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

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

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

(4) For stock index put options and warrants, any excess of the product of the current index value and the applicable index multiplier over the aggregate exercise price of the option or warrant. *See e.g.,* NYSE Rule 431 (Exchange Act Release No. 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving SR–NYSE–99–03)); Amex Rule 462 (Exchange Act Release No. 43582 (November 17, 2000), 65 FR 71151 (November 29, 2000) (order approving SR–Amex–99–27)); CBOE Rule 12.3 (Exchange Act Release No. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving SR–CBOE–97–67)); or NASD Rule 2520 (Exchange Act Release No. 43581 (November 17, 2000), 65 FR 70854 (November 28, 2000) (order approving SR–NASD–00–15)).

[5] ''In the-money'' amounts must be determined as follows:

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

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

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

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

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?

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

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

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?

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.

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

4. Higher Margin Levels

Notwithstanding the proposed minimum initial and maintenance margin levels specified above, the Commissions further propose that the regulatory authorities may impose on their members initial and maintenance margin levels that are higher than the minimum margin levels specified in Proposed CFTC Rule 41.45(b)(1) and Proposed SEC Rule 402(b)(1).[89] This is to permit regulatory authorities to set higher margin levels as may, from time to time, be considered prudent by such regulatory authorities. In addition, regulatory authorities may permit their members to use a method for calculating required initial and maintenance margin that may result in margin levels that are higher than the minimum margin levels specified in those proposed rules.[90] Any such higher margin requirement would have to be filed with the SEC under Section 19(b) of the Exchange Act.[91] The Commissions also propose that a national securities exchange registered with the SEC under Section 6(g) of the Exchange Act (''Security Futures Product Exchange'') [92] or a national securities association registered with the SEC under Section 15A(k) of the Exchange Act (''Limited Purpose National Securities Association'') [93] may raise or lower the required margin level to a level not lower than that specified in Proposed CFTC Rule 41.45 and Proposed SEC Rule 402,[94] in accordance with Section 19(b)(7) of the Exchange Act.[95]

E. Time Limits for Collection of Margin

The Commissions also propose other margin requirements for security futures. Specifically, the Commissions propose that the amount of initial margin required by Proposed CFTC Rule 41.45 and Proposed SEC Rule 402 would be obtained as promptly as possible and in any event within three business days after the position is established, or within such shorter time period as may be imposed by applicable regulatory authority rules approved by the SEC in accordance with Section 19(b)(2) of the Exchange Act.[96]

Currently, Regulation T requires the collection of margin calls for certain securities covered by Regulation T within five business days after the position is established, and regulatory authority rules require the collection of maintenance margin as promptly as possible and in any event within fifteen business days.[97] To lower counterparty risk in transactions involving security futures, the Commissions are proposing shorter time periods than those permitted by Regulation T. Specifically, the Commissions are proposing a three business day time period.[98]

Further, the Commissions propose that the amount of maintenance margin required by Proposed CFTC Rule 41.45 and Proposed SEC Rule 402 would be obtained as promptly as possible and in any event within three business days after the margin deficiency is created or increased, or within such shorter time period as may be imposed by applicable regulatory authority rules approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[99]

Finally, the Commissions propose that the time limits for collection of initial margin may be extended upon application by the creditor to its examining authority [100] to the extent permitted by applicable regulatory authority rules approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act.[101]

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

F. Forms of Collateral

Section 7(c)(2)(B)(iv) of the Exchange Act requires that the margin requirements for security futures products (other than levels of margin), including the type, form, and use of collateral for security future products, are and remain consistent with the requirements established by the Federal Reserve Board in Regulation T pursuant to subparagraphs (A) and (B) of Section 7(c)(1) of the Exchange Act.[102] Regulation T requires a customer to deposit margin with its broker or dealer whenever securities transactions by the customer, on any given day, create or increase a ''margin deficiency'' [103] in the

[89] *See* Proposed CFTC Rule 41.45(b)(2)(i); Proposed SEC Rule 402(b)(2)(i).

[90] *See* Proposed CFTC Rule 41.45(b)(2)(ii); Proposed SEC Rule 402(b)(2)(ii).

[91] 15 U.S.C. 78s(b).

[92] 15 U.S.C. 78f(g). New subsection 6(g) of the Exchange Act provides an expedited process for an exchange that lists or trades security futures products to register with the SEC as a national securities exchange if that exchange (1) is a board of trade that has been designated as a contract market or is registered as a DTF; and (2) does not act as a market place for transactions in securities other than security futures products. The SEC has adopted rules prescribing the requirements for designated contract markets and DTFs to register as national securities exchange pursuant to Section 6(g) of the Exchange Act. *See* Securities Exchange Act Release No. 44692 (August 13, 2001), 66 FR 43721 (August 20, 2001).

[93] 15 U.S.C. 78*o*–3(k). A futures association registered under Section 17 of the CEA (7 U.S.C. 21) will be registered as a national securities association for the limited purpose of regulating the activities of brokers or dealers registered pursuant to Section 15(b)(11) of the Exchange Act (15 U.S.C. 78*o*(b)(11)) with respect to their activities in security futures products.

[94] 15 U.S.C. 78s(b)(2). *See* Proposed CFTC Rule 41.45(c); Proposed SEC Rule 402(c).

[95] 15 U.S.C. 78s(b)(7). *See infra* note 130 and accompanying text.

[96] *See* Proposed CFTC Rule 41.46(a); Proposed SEC Rule 403(a).

[97] *See, e.g.,* CBOE Rule 12.2.

[98] *See* Proposed CFTC Rule 41.46(a); Proposed SEC Rule 403(a).

[99] 15 U.S.C. 78s(b)(2). *See* Proposed CFTC Rule 41.46(b); Proposed SEC Rule 403(b).

[100] ''Examining authority'' with respect to a creditor is proposed to mean: (1) The regulatory authority of which such creditor is a member, if such creditor is a member of only one regulatory authority; (2) The regulatory authority designated responsibility by the SEC pursuant to 17 CFR 240.17d–1 for examining such creditor for compliance with applicable financial responsibility rules, if a regulatory authority is so designated; or (3) The regulatory authority designated in accordance with 17 CFR 1.52, if such creditor is a member of more than one regulatory authority and the SEC, pursuant to 17 CFR 240.17d–1 has not designated responsibility for examining such creditor for compliance with applicable financial responsibility rules. *See* Proposed CFTC Rule 41.44(a)(3) and Proposed SEC Rule 401(a)(3).

[101] 15 U.S.C. 78s(b)(2). The Commission expect such regulatory authority rules for security futures to be consistent with those rules currently in place for securities. *See, e.g.,* NYSE Rule 434; and NASD Rule 2520.

[102] 15 U.S.C. 78g(c)(2)(B)(iv).

[103] Regulation T defines ''margin deficiency'' as ''the amount by which the required margin exceeds

customer's margin account.[104] Under Regulation T, such a deposit must be made in the form of cash, margin securities, exempted securities, or any combination thereof, within one ''payment period'' [105] after the margin deficiency was created or increased.[106]

For dealings in security futures, the Commissions propose that, under Proposed CFTC Rule 41.47(a) and Proposed SEC Rule 404(a), a broker, dealer or a member of a national securities exchange may accept from a customer as collateral to satisfy its margin requirement, the following: cash, margin securities as defined in Regulation T,[107] exempted securities as defined in Section 3(a)(12) of the Exchange Act,[108] or other collateral permitted under Regulation T to satisfy a margin deficiency in the margin account.

The Commissions also propose under Proposed CFTC Rule 41.47(b) and Proposed SEC Rule 404(b) that nothing in the proposed rules would prevent a regulatory authority from prescribing margin collateral requirements (other than margin levels) including the type, form, and use of collateral for security futures, as long as those requirements are consistent with the requirements of Regulation T, subject to approval by the SEC in accordance with Section 19(b)(2) of the Exchange Act.[109]

Finally, the Commissions propose under Proposed CFTC Rule 41.47(c) and Proposed SEC Rule 404(c) that, for purposes of this section, security futures are not margin securities. This is to clarify that transactions and positions in security futures, like short options, would not have loan value for margin purposes. As is the case with short options, margin deposited on a long or short security future represents a performance bond to assure performance on such contract.

The daily gains and losses on security futures are either credited to the party that made a gain on such contract, or debited from the account of the party that had a loss, such that the margin in each party's account represents only the required amount of performance bond on such contract. Because it is not an asset, a security future cannot be put up as collateral for another security or futures transaction.

III. SEC and CFTC Rule Review Processes Relating to Margin Requirements for Security Futures Products

A. CFTC Rule Review Process and Procedures for Notification of Proposed Rule Changes Related to Margin

In general, designated contract markets, including ''notice-designated'' contract markets,[110] or registered DTFs that propose to make a rule change regarding their security futures margin requirements (other than proposed rule changes that result in higher margin levels) must submit the proposed rule change to the SEC for approval in accordance with Section 19(b) of the Exchange Act.[111] In addition, contract markets designated pursuant to Section 5 of the CEA and registered DTFs are also required under Section 5c(c) of the CEA to make certain filings with the CFTC regarding rule changes, including those for security futures products.[112] Because ATSs are not SROs under the Exchange Act, notice-designated contract markets that are ATSs are not required to submit proposed rule changes to the SEC for approval in accordance with Section 19(b) of the Exchange Act.

Section 5c(c) of the CEA provides for two alternative procedures by which such a designated contract market or registered DTF may implement a proposed rule change.[113] First, in accordance with Section 5c(c)(1) of the CEA, a proposed rule change may be implemented by providing the CFTC with a written certification that the proposed rule change complies with the CEA.[114] Second, Section 5c(c)(2) of the CEA provides that, before the implementation of a proposed rule change, an entity may request that the CFTC grant prior approval of the rule change.[115]

Proposed CFTC Rule 41.48(a) would require any notice-designated contract market that files a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with Section 19(b)(2) of the Exchange Act [116] to concurrently provide to the CFTC a copy of such a proposed rule change and any accompanying documentation filed with the SEC.[117] It is not required to provide any supplemental information, even if such information is subsequently provided to the SEC in the course of the SEC's review of the proposed rule change. The purpose of this proposed rule is to provide the CFTC, as a joint regulator of markets offering security futures products, with timely notification of a proposed rule change.

Proposed CFTC Rule 41.48(b) sets forth the notification process for contract markets designated pursuant to Section 5 of the CEA [118] and registered DTFs. The process by which such an entity is to notify the CFTC of having filed a proposed rule change with the SEC will depend on which procedure under Section 5c(c) of the CEA [119] the entity elects to follow.

Proposed CFTC Rule 41.48(b)(1) would apply to any designated contract market registered under section 5 of the CEA or registered DTF that elects to seek the prior approval of the CFTC for a proposed rule change, in accordance with Section 5c(c)(2) of the CEA.[120] In such case, the contract market or DTF would file its requests with the SEC and CFTC concurrently.

Under Proposed CFTC Rule 41.48(b)(2), an entity that elects to implement a proposed rule change by filing a written certification with the CFTC in accordance with Section 5c(c)(1) of the CEA [121] is required to provide a copy of the proposed rule change and any accompanying

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the equity in the margin account.'' 12 CFR 220.2. The ''required margin'' for a position in securities (other than security futures) is based on the ''current market value'' of the securities and determined in accordance with Section 220.12 of Regulation T. 12 CFR 220.12.

[104] 12 CFR 220.4(c).

[105] Regulation T defines ''payment period'' as ''the number of business days in the standard securities settlement cycle in the United States, as defined in paragraph (a) of Exchange Act Rule 15c6–1 (17 CFR 240.15c6–1(a)), plus two business days.'' 12 CFR 220.2. Currently, the standard securities settlement cycle under Rule 15c6–1 of the Exchange Act is three business days, resulting in a payment period under Regulation T of five business days.

[106] 12 CFR 220.4(c).

[107] Under Regulation T, margin securities include: (1) any security registered or having unlisted trading privileges on a national securities exchange; (2) any security listed on the Nasdaq Stock Market; (3) any nonequity security; (4) any security issued by either an open-end investment company or unit investment trust which is registered under Section 8 of the Investment Company Act of 1940; (5) any foreign margin stock; and (6) any debt security convertible into a margin security. 12 CFR 220.2.

[108] 15 U.S.C. 78c(a)(12).

[109] 15 U.S.C. 78s(b)(2).

[110] A notice-designated contract market is a national securities exchange registered pursuant to Section 6(a) of the Exchange Act (15 U.S.C. 78f(a)), a national securities association registered pursuant to Section 15A(a) of the Exchange Act (15 U.S.C. 78*o*–3(a)), or an alternative trading system (''ATS'') as defined in Section 1a(1) of the CEA (7 U.S.C. 1a(1)) that is designated as a contract market pursuant to Section 5f of the CEA (7 U.S.C. 7b–1).

[111] 15 U.S.C. 78s(b).

[112] 7 U.S.C. 7a–2(c). Notice-designated contract markets are exempt from the requirements of Section 5c of the CEA pursuant to Section 5f(b)(1)(D) of the CEA (7 U.S.C. 7a–2(b)(1)(D)).

[113] *See also* 66 FR 42256 (August 10, 2001) (CFTC rules implementing these procedures, codified in a new Part 40 of Title 17, Rules 40.5 and 40.6).

[114] 7 U.S.C. 7a–2(c)(1).

[115] 7 U.S.C. 7a–2(c)(2).

[116] 15 U.S.C. 78s(b)(2).

[117] The copy may be submitted to the CFTC electronically, by facsimile, or by delivery of a hard copy.

[118] 7 U.S.C. 7a–2.

[119] 7 U.S.C. 7a–2(c).

[120] 7 U.S.C. 7a–2(c)(2).

[121] 7 U.S.C. 7a–2(c)(1).

documentation that was filed with the SEC, concurrent with the SEC filing. Promptly after the SEC has approved the proposed rule change, the designated contract market or registered DTF will file the written certification with the CFTC.

The CFTC has considered an alternative procedure under which an entity would file its written certification with the CFTC at the same time as it files the proposed rule change with the SEC, rather than after the SEC approves the proposed rule change. This alternative could facilitate immediate implementation of the rule change once the rule is approved by the SEC. The CFTC notes, however, that if the proposed rule change were to be modified during the SEC approval process such that the rule approved by the SEC was not the same rule that had been certified to the CFTC, a new written certification would have to be filed before the rule, as approved, could be implemented.

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.

B. SEC Rule Review Process

National securities exchanges registered pursuant to Section 6(a) of the Exchange Act [122] and national securities associations registered pursuant to Section 15A(a) of the Exchange Act [123] must file proposed rule changes, including those related to the trading of securities futures products, with the SEC under Section 19(b)(1) of the Exchange Act.[124] Security Futures Product Exchanges [125] and Limited Purpose National Securities Associations [126] must submit proposed rule changes to the SEC in the following three circumstances.

First, Security Futures Product Exchanges and Limited Purpose National Securities Associations are required to submit proposed rule changes that relate to margin for security futures products, except for those that result in higher margin levels, under Sections 19(b)(1) and (b)(2) of the Exchange Act.[127] Section 19(b)(1) of the Exchange Act states that proposed rule changes are not effective unless approved by the SEC or otherwise permitted in accordance with the provisions of Section 19(b).[128] Section 19(b)(2) of the Exchange Act sets forth the standards by which the SEC must determine whether a proposed rule change submitted pursuant to Section 19(b)(1) of the Exchange Act must be either approved or disapproved.[129] Specifically, the SEC is directed to approve a proposed rule change if it finds that such proposed rule change is consistent with the requirements of the Exchange Act, and the rules and regulations thereunder applicable to such SRO, or to disapprove a proposed rule change if it cannot make such a finding.

Second, proposed rule changes by Security Futures Product Exchanges and Limited Purpose National Securities Associations that relate to higher margin levels, fraud or manipulation, recordkeeping, reporting, listing standards, or decimal pricing for security futures products, sales practices for security futures products for persons who effect transactions in security futures products, or rules effectuating such SRO's obligation to enforce the securities laws, must be submitted to the SEC pursuant to new Section 19(b)(7) of the Exchange Act.[130] A proposed rule change filed pursuant to this section may take effect when: (1) A written certification has been filed with the CFTC under Section 5c(c) of the CEA; [131] (2) the CFTC determines that review of the proposed rule change is not necessary; or (3) the CFTC approves the proposed rule change.[132] The SEC, after consultation with the CFTC, has the authority to summarily abrogate a proposed rule change that has taken effect pursuant to Section 19(b)(7)(B) of the Exchange Act [133] if it appears to the SEC that such rule change unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors.[134]

Finally, in the event that the SEC abrogates a proposed rule change, Security Futures Product Exchanges and Limited Purpose National Securities Associations would be required, pursuant to Sections 6(g)(4)(B)(iii) [135] and 15A(k)(3)(C) [136] of the Exchange Act, respectively, to refile the proposed rule change pursuant to the requirements of Section 19(b)(1) of the Exchange Act.[137]

The SEC must (within 35 days of the date of publication of notice of the filing of the proposed rule change, or within such longer period as the SEC may designate up to 90 days after such date if the SEC finds such longer period to be appropriate and publishes its reasons for so finding, or as to which the SRO consents) either by order approve the proposed rule change or, after consultation with the CFTC, institute disapproval proceedings.[138] Section 19(b)(7)(D)(ii) of the Exchange Act [139] states that the SEC must approve a

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[122] 15 U.S.C. 78f(a).

[123] 15 U.S.C. 78*o*–3(a).

[124] 15 U.S.C. 78s(b)(1).

[125] *See supra* note 92.

[126] *See supra* note 93.

[127] 15 U.S.C. 78s(b)(1) and (b)(2). *See* Sections 6(g)(4)(B)(ii) and 15A(k)(3)(B) of the Exchange Act (15 U.S.C. 78f(g)(4)(B)(ii) and 15 U.S.C. 78*o*–3(k)(3)(B), respectively). Proposed rule changes filed under Sections 19(b)(1) and (b)(2) of the Exchange Act are submitted pursuant to Rule 19b–4 and Form 19b–4. *See* 17 CFR 240.19b–4; 17 CFR 249.819.

[128] Section 19(b)(3) of the Exchange Act sets forth the categories of proposed rule changes that may take effect upon filing with the SEC. 15 U.S.C. 78s(b)(3).

[129] 15 U.S.C. 78s(b)(2).

[130] 15 U.S.C. 78s(b)(7). *See* Sections 6(g)(4)(B)(i) and 15A(k)(3)(A) of the Exchange Act (15 U.S.C. 78f(g)(4)(B)(i) and 15 U.S.C. 78*o*–3(k)(3)(A), respectively). Section 19(b)(7) of the Exchange Act grants to the SEC the authority to adopt rules regarding the filing of proposed rule changes by Security Futures Product Exchanges and Limited Purpose National Securities Associations. 15 U.S.C. 78s(b)(7). The SEC has adopted Rule 19b–7 and Form 19b–7 to establish procedures for filing proposed rule changes pursuant to Section 19(b)(7) of the Exchange Act. *See* Rule 19b–7, 17 CFR 240.19b–7, and Form 19b–7, 17 CFR 249.822; Securities Exchange Act Release No. 44692 (August 13, 2001), 66 FR 43721 (August 20, 2001).

[131] 7 U.S.C. 7a–2(c). Pursuant to Section 5c(c)(1) of the CEA (7 U.S.C. 7a–2(c)(1)), a registered entity may elect to approve and implement any new rule or rule amendment by providing the CFTC with a written certification that the new rule or rule amendment complies with the CEA.

[132] Pursuant to Section 5c(c)(2) of the CEA (7 U.S.C. 7a–2(c)(2)), a registered entity may elect to seek prior approval of the CFTC for any new rule or rule amendment.

[133] 15 U.S.C. 78s(b)(7)(B). Pursuant to this section, SEC action to abrogate a rule change will not affect the validity or force of the rule change during the period it was in effect.

[134] *See* Section 19(b)(7)(C) of the Exchange Act (15 U.S.C. 78s(b)(7)(C)). The SEC notes that it currently exercises similar authority pursuant to Section 19(b)(3)(C) of the Exchange Act (15 U.S.C. 78s(b)(3)(C)) with respect to proposed rule changes filed by the existing SROs, which are immediately effective upon filing pursuant to Section 19(b)(3)(A) of the Exchange Act (15 U.S.C. 78s(b)(3)(A)).

[135] 15 U.S.C. 78f(g)(4)(B)(iii).

[136] 15 U.S.C. 78*o*–3(k)(3)(C).

[137] 15 U.S.C. 78s(b)(1).

[138] 15 U.S.C. 78s(b)(7)(D)(i).

[139] 15 U.S.C. 78s(b)(7)(D)(ii).

proposed rule change that has been abrogated and refiled under Section 19(b)(1) of the Exchange Act [140] if the SEC finds that it does not unduly burden competition or efficiency, does not conflict with the securities laws, and is not inconsistent with the public interest or the protection of investors.

IV. Request for Comments

The Commissions solicit comments on all aspects of Proposed CFTC Rules 41.43 through 41.48 and Proposed SEC Rules 242.400 through 242.404. In addition, the Commissions are seeking responses to the numbered questions posed throughout this proposal.

Commenters are welcome to offer their views on any other matters raised by the proposed rules.

V. Paperwork Reduction Act

A. CFTC

The Paperwork Reduction Act of 1995 (''PRA'') [141] imposes certain requirements on federal agencies (including the CFTC and the SEC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The proposed rules do not require a new collection of information on the part of any entities subject to the proposed rules. Accordingly, the requirements imposed by the PRA are not applicable to the proposed rules.

B. SEC

The PRA does not apply because the proposed rules do not impose recordkeeping or information collection requirements, or other collections of information which require approval of the Office of Management and Budget under 44 U.S.C. 3501, *et. seq.*

VI. Costs and Benefits of the Proposed Rules

A. CFTC

Section 15(a) of the CEA [142] requires that the CFTC, before promulgating a regulation under the CEA or issuing an order, consider the costs and benefits of its action. By its terms, Section 15(a) does not require the CFTC to quantify the costs and benefits of a new rule or determine whether the benefits of the rule outweigh its costs. Rather, Section 15(a) simply requires the CFTC to ''consider the costs and benefits'' of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of the following considerations: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the CFTC could, in its discretion, give greater weight to any one of the five considerations and could, in its discretion, determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

The proposed rules constitute a package of related rule provisions. The rules establish the amount of initial and maintenance customer margin for transactions in security futures. The CFTC believes that the proposed customer margin requirements for security futures are, in accordance with the CFMA, consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act.[143] The CFTC is evaluating the costs and benefits of the proposed rules in light of the specific considerations identified in Section 15(a) of the CEA:

1. Protection of market participants and the public. In general, the proposed rules should further the protection of market participants and the public.

2. Efficiency and competition. As noted above, the proposed margin requirements are consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act, as required under the CFMA, and apply to all exchanges offering security futures. Accordingly, the proposed rules are not expected to have a negative impact on competition.

3. Financial integrity of futures markets and price discovery. The proposed rules should have a positive effect on the financial integrity of security futures markets by protecting against systemic risk.

4. Sound risk management practices. The proposed rules are consistent with sound risk management practices.

5. Other public considerations. The proposed rules would preserve the financial integrity of markets trading security futures and prevent systemic risk, thereby benefiting the public. The CFTC believes, however, that the rules fall short of achieving the maximum benefits at the lowest possible cost. The CFTC believes that portfolio margining for security futures would foster greater market efficiency and provide greater benefits to all market participants, without compromising the financial integrity of the markets or giving rise to systemic risk.[144]

After evaluating these considerations, the CFTC has determined to propose the rules discussed above. 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.

B. SEC

Section 7 of the Exchange Act, which governs the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security), was amended by the CFMA to add provisions related to margin for securities futures. On March 6, 2001, the Federal Reserve Board delegated its authority under Section 7(c)(2) of the Exchange Act to establish margin requirements for security futures to the SEC and CFTC. The SEC is proposing new Rules 400 through 404 under the Exchange Act to establish such margin requirements.

Specifically, the CFMA amended Section 7(c) of the Exchange Act to require that the rules preserve the financial integrity of markets trading security futures products, prevent systemic risk, and to require that: (1) The margin requirements for a security future be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act; [145] and (2) the initial and maintenance margin levels for a security future not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any exchange registered pursuant to Section 6(a) of the Exchange Act, other than an option on a security future, and to ensure 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 established by the Federal Reserve Board under Regulation T.

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

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[140] 15 U.S.C. 78s(b)(1).

[141] 44 U.S.C. 3501 *et seq.*

[142] 7 U.S.C. 19(a).

[143] 15 U.S.C. 78f(a).

[144] *See* Paul H. Kupiec and A. Patricia White, *Regulatory Competition and the Efficiency of Alternative Derivative Product Margining Systems,* 16 The Journal of Futures Markets 943 (1996).

[145] 15 U.S.C. 78f(a).

commenters to identify and supply any relevant data, analysis and estimates concerning the costs and benefits of the proposed rules.

1. Costs

There would likely be various administrative costs to brokers, dealers, and members of national securities exchanges attributable to Proposed SEC Rules 400 through 404. Further, brokers, dealers, and members of national securities exchanges that choose to effect transactions for customers involving, or carrying an account for a customer containing, a security future are responsible for assuring compliance with these proposed rules and thus would incur various costs. While the SEC is unable at this time to estimate the extent of the costs that the proposed rules engender, it has identified below areas where the proposed rules may impose costs.

a. Compliance With Regulation T

Proposed SEC Rule 400(b)(1) would apply Regulation T to financial relations between brokers, dealers, and members of national securities exchanges and their customers with respect to transactions in security futures and any related securities or futures contracts that are used to offset positions in such security futures, to the extent consistent with the proposed rules.[146]

Under this proposed rule, security futures transactions would be recorded in a Margin Account. The proposed margin level requirements represent a performance bond to guarantee contract performance by both the buyer and seller of such contract. Any settlement variation would be credited to (or debited from) the Margin Account.[147] The application of Regulation T provisions by brokers, dealers, or members of national securities exchanges to their customers' security futures positions would require these entities to incur certain costs, such as making systems changes, and hiring personnel, in adhering to Regulation T provisions.

The SEC requests comments, data, and estimates on all aspects of the costs of implementing Regulation T provisions pertaining to security futures.

b. Levels of Margin

Proposed SEC Rule 402(b)(1) sets the level of margin at 20 percent of current market value. The 20 percent level of margin is necessary to fulfill the statutory requirement that the margin requirements for security futures be consistent with the margin requirements for comparable options contracts traded on any national securities exchange registered under Section 6(a) of the Exchange Act.[148]

The SEC notes that the 20 percent margin level may appear to be high when compared to margining methodologies currently used for futures other than security futures. A potential cost of these higher margin requirements is that they may lead to reduced interest in trading security futures and, therefore, foregone hedging opportunities.

However, while margin requirements on non-security futures contracts generally range from 2–10 percent,[149] SEC staff, based on its analysis, estimates that applying traditional futures risk-based margining methods to security futures would require margin of greater than 10 percent.[150] Further, economic research has thus far not been able to establish a strong relationship between futures margin levels and interest in the product.[151] On the other hand, SEC staff estimates that the proposed margin levels would reduce the chances that a margin account would not contain sufficient funds to cover a given day's price movement from approximately 5 percent using traditional risk-based futures margining to 0.3 percent.[152] Therefore, while the margin levels proposed for security futures may impose a cost, the SEC believes that the proposed margin levels would lower chances of customer default and therefore lower systemic risk to the markets. For these reasons, and the statutory mandate that requires comparability between security futures margin and options margin, the SEC preliminarily believes that the proposed margin levels would be appropriate.

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).

c. Computation of Margin

Proposed SEC Rule 402(b)(1) would require that brokers, dealers, and national securities exchange members compute and ensure, on a daily basis, that the initial and maintenance margin levels for each customer's security future carried or held by such entity are 20 percent of the current market value of such contract. This requirement is designed to assure contract performance and the integrity of the marketplace.[153] In addition, all market participants pay or receive daily settlement variation payments (*i.e.,* the daily net gain or loss on a security future) as a result of all open futures positions being marked to current market value by the clearing organization.

The SEC believes that the daily required computation of the initial and maintenance margin requirements and the collection and disbursement of daily settlement variation for security futures by brokers, dealers, or national securities exchanges members would require these entities to program or reprogram their computer systems to implement the margin computations and the settlement variation procedures for securities futures. These entities may also incur additional data storage costs and resource costs associated with these calculations. 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.

[146] For discussion on Regulation T, and the accounts established thereunder, *see supra* notes 15–27 and accompanying text.

[147] Broker-dealers registered with the SEC under Section 15(b)(1) of the Exchange Act may journal any margin excess to the SMA. 15 U.S.C. 78*o*(b)(1).

[148] 15 U.S.C. 78g(c)(2)(B)(iii).

[149] Catrath, A., Adrangi, B and Alleder, M. (2001), *The Impact of Margins in Futures Markets: Evidence from the Gold and Silver Markets,* The Quarterly Review of Economics and Finance, 279.

[150] The SEC staff examined all securities with average daily trading volume greater than 50,000, using data from 2000 from the Center for Research in Security Prices (''CRSP''). Based on this data, the SEC staff calculated the daily price returns and the 30–day historical price volatility for each of the securities examined.

Based on the assumption that cash and futures prices typically move together, the SEC staff conducted a preliminary simulation, using actual security price movements as estimates for would be futures price movements. Based upon these security futures' price estimates, the staff determined the margin requirements for each of these security futures under both the 20 percent strategy-based approach and the traditional risk-based futures approach. The staff examined how often the funds attributable to margin requirements are insufficient to cover the daily price movements of these security futures. This is relevant to the examination of systemic risk because a necessary condition for customer default to occur is the depletion of the funds attributable to margin requirements (assuming no market risk to close out such position).

[151] For further details on these issues, *see* Fishe, R. P. H., Goldberg, L.G., (1986), *The Effects of Margins on Trading in Futures Markets,* Journal of Futures Markets, 261; Fishe, P.H., Goldberg, L.A., Gosnell, T.F. and Sinha, S. (1990), *Margin Requirement in Futures Markets: Their Relationship to Price Volatility,* The Journal of Futures Markets, 541.

[152] *See supra* note 150.

[153] For an in depth discussion of how margin would be computed under the proposed rules, *see supra* notes 62–88 and accompanying text.

d. Notification Requirements Regarding Exempted Borrowers

Proposed SEC Rule 400(b)(3)(iv)(A) would exclude from the proposed margin regulation margin arrangements between a creditor and a borrower with respect to the borrower's financing of proprietary positions in security futures, based on the creditor's good faith determination that the borrower is an ''exempted borrower.'' [154]

Proposed SEC Rule 402(e) would provide that once a broker, dealer, or a member of a national securities exchange ceases to qualify as an exempted borrower, it must notify the creditor (i.e., the broker, dealer, or a national securities exchange member holding the position) of this fact before establishing any new security future positions because any new security future positions would be subject to the proposed rules.

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.

e. Time Limits for Collection of Margin

Proposed SEC Rules 403(a) and (b) together would require that the amount of initial and maintenance margin required by the proposed rules be obtained as promptly as possible and, in any event, within three business days after the position is established, or within such shorter time period as may be imposed by applicable regulatory authority rules approved by the SEC in accordance with Section 19(b)(2) of the Exchange Act. The SEC believes that the brokers, dealers, or national securities exchange members that are effecting transactions in security futures will need to gather information to determine for each customer's account involving security futures when margin on such position must be obtained from its customers. The SEC requests comments, data, and cost estimates relating to the time limits for collection of margin requirements.

2. Benefits

The benefits of Proposed SEC Rules 400 through 404 are related to the benefits that will accrue as a result of the enactment of the CFMA. By repealing the ban on single stock futures and futures on narrow-based security indexes, the CFMA will enable a greater variety of financial products to be traded that potentially could facilitate price discovery and the ability to hedge. Investors will benefit by having a wider choice of financial products to buy and sell, and markets and market participants will benefit by having the ability to trade these products. These rules are a prerequisite to the commencement of trading in the new products, and therefore, they are also a prerequisite to any benefits that may derive from the availability of these products.

a. Benefits to Brokers, Dealers, and Members of National Securities Exchanges

Proposed SEC Rule 402(b)(1) would provide that the minimum initial and maintenance margin levels for each security future would be 20 percent of the current market value of such contract. Moreover, Proposed SEC Rule 404(a) would provide that a broker, dealer or member of a national securities exchange may accept as collateral cash, margin securities, exempted securities, or other collateral permitted under Regulation T to satisfy a margin deficiency in the margin account.[155] Proposed SEC Rule 404(b) further provides that a regulatory authority may prescribe margin collateral requirements (other than margin levels) including the type, form, and use of collateral for security futures, that are consistent with the requirements under Regulation T.[156]

The SEC preliminarily believes that the margin levels and other margin requirements proposed would provide sound protection from customer default by reducing chances of depletion of margin accounts, and therefore reduce systemic risk associated with the trading of these new products.

b. Benefits to Customers

Additionally, Proposed SEC Rule 402(d) would provide that customers be permitted to offset positions involving security futures with certain related securities or futures.[157] Such offsets would be proposed by regulatory authority rules that would be approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act if such offsets were consistent with the Exchange Act, including the requirement that margin requirements for security futures be no less restrictive than those imposed on options. These offsets likely would provide benefits to customers because such rules would recognize the hedged nature of the certain specified combined strategies and would permit lower margin requirements that better reflect the true risk of those strategies. Because security futures are new products, however, the SEC is unable at this time to quantify these benefits and therefore requests comments, data, and estimates regarding these benefits.

c. Regulatory Benefits

Proposed SEC Rule 400(b)(1) would provide, to the extent consistent with the proposed rules, that Regulation T applies to financial relations, including margin arrangements, between a creditor and a customer with respect to security futures and any related securities or futures contracts that are used to offset positions in security futures. This provision is designed to ensure that existing and future Federal Reserve Board interpretations of Regulation T would apply and that, therefore, margin requirements for security futures would remain consistent without further action by the Commissions.

C. Request for Comments

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.

VII. Consideration of Burden on Competition, Promotion of Efficiency, and Capital Formation

Section 3(f) of the Exchange Act [158] requires the SEC, whenever it is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action

[154] For a discussion of who is considered an ''exempted borrower,'' *see supra* notes 54–55 and accompanying text.

[155] For discussion on forms of collateral, *see supra* notes 102–109 and accompanying text.

[156] Such requirements would be proposed by regulatory authority rules approved by the SEC pursuant to Section 19(b)(2) of the Exchange Act, and as applicable, subject to notice to the CFTC in accordance with Section 5c(c) of the CEA.

[157] For an in depth discussion on offsets, *see supra* notes 74–88 and accompanying text.

[158] 15 U.S.C. 78c(f).

will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the SEC, in adopting rules under the Exchange Act, to consider the impact on competition of any rules it adopts.[159] Section 23(a)(2) of the Exchange Act further provides that the SEC may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[160] The rules proposed today would impose initial and maintenance margin requirements on brokers, dealers and members of national securities exchanges that collect customer margin for security futures. The SEC has considered the proposed rules in light of the standards set forth in Sections 3(f) [161] and 23(a)(2) [162] of the Exchange Act.

The SEC preliminarily believes that the proposed rules should promote efficiency by setting forth clear guidelines for brokers, dealers, and members of national securities exchanges when collecting customer margin related to security futures. Further, the SEC believes that the proposed rules will provide sound protection from customer default by reducing chances of depletion of margin accounts, and therefore reduce system risk associated with the trading of these new products.

The SEC also preliminarily believes that the proposed rules would not impose any significant burden on competition. The proposed rules serve only to set forth margin requirements for security futures, including establishing margin levels and margin collateral requirements. Lastly, the SEC preliminarily believes that the proposed rules would not have any impact on capital formation because the proposed rules would merely establish rules governing the collection of customer margin. The SEC notes that these proposed margin requirements would protect brokers, dealers, and members of national securities exchanges from customers' default, thus encouraging participation by these market participants in the trading of futures contracts on both single stocks and narrow-based indexes. Therefore, the SEC preliminarily believes that there could be an increased demand for the underlying securities, resulting in increased capital formation. Nevertheless, the SEC believes that the benefits to the capital formation process principally flow from the CFMA itself, which lifts the ban on trading of single stock futures and narrow-based index stock futures.

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

VIII. Regulatory Flexibility Act Certifications

A. CFTC

The Regulatory Flexibility Act (''RFA'') [163] requires that federal agencies, in promulgating rules, consider the impact of those rules on small entities. The proposed rules would affect designated contract markets, registered DTFs, and FCMs. The CFTC has previously established certain definitions of ''small entities'' to be used by the CFTC in evaluating the impact of its rules on small entities in accordance with the RFA.[164]

In its previous determinations, the CFTC has concluded that contract markets are not small entities for purposes of the RFA, based on the vital role contract markets play in the national economy and the significant amount of resources required to operate as SROs.[165] Recently, the CFTC determined that notice-designated contract markets are not small entities for purposes of the RFA.[166] In addition, the CFTC has determined that other trading facilities subject to its jurisdiction, including registered DTFs, are not small entities for purposes of the RFA.[167]

The CFTC also has previously determined that FCMs are not small entities for purposes of the RFA, based on the fiduciary nature of FCM-customer relationships as well as the requirements that FCMs meet certain minimum financial requirements.[168] The CFTC is proposing to determine that notice-registered FCMs,[169] for the reasons applicable to FCMs registered in accordance with Section 4f(a)(1) of the CEA,[170] are not small entities for purposes of the RFA. Brokers or dealers that carry customer accounts and receive or hold funds for those customers, and are notice-registered as FCMs for the purpose of trading security futures, similarly have a fiduciary relationship with their customers and must meet analogous minimum financial requirements.[171]

Additionally, the CFTC notes that Congress mandated that customer margin for security futures be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act.[172] In proposing these rules, the Commissions have striven to fulfill this requirement in the least burdensome way possible.

Accordingly, the Acting Chairman, on behalf of the CFTC, certifies pursuant to 5 U.S.C. 605(b), that the proposed rules will not have a significant economic impact on a substantial number of small entities. The CFTC invites the public to comment on this finding and on its proposed determination that notice-registered FCMs are not small entities for purposes of the RFA.

B. SEC

Section 3(a) of the RFA [173] requires the SEC to undertake an initial regulatory flexibility analysis of the proposed rules on the small entities unless the Chairman certifies that the rule, if adopted, would not have a significant economic impact on small entities.[174] Proposed Rules 400 through 404 would apply to brokers, dealers and members of national securities exchanges.

Introducing brokers (''IBs'') and FCM may register as broker-dealers by filing Form BD–N. However, because IBs cannot collect customer margin they are not subject to these rules.[175] In addition, the CFTC has concluded that FCMs are not considered small entities for the purposes of the RFA.[176] Accordingly, there are no FCMs or IBs that are small entities that would be affected by the proposed rules.

The proposed rules would also apply to broker-dealers and members of national securities exchanges. With one exception, all members of national securities exchanges registered under Section 6(a) of the Exchange Act are registered broker-dealers. The SEC believes that some small broker-dealers could be affected by the proposals, but that the proposals will not have a significant impact on a substantial number of small broker-dealers.

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[159] 15 U.S.C. 78w(a)(2).

[160] *Id.*

[161] 15 U.S.C. 78c(f).

[162] 15 U.S.C. 78w(a)(2).

[163] 5 U.S.C. 601 *et seq.*

[164] 47 FR 18618–21 (April 30, 1982).

[165] *Id.* at 18619.

[166] 66 FR 44960, 44964 (August 27, 2001).

[167] 66 FR 42256, 42268 (August 10, 2001).

[168] 47 FR at 18619.

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

[170] 7 U.S.C. 6f(a)(1).

[171] *See* Exchange Act Rule 15c3–1(a)(2), 17 CFR 240.15c–1(a)(2).

[172] 15 U.S.C. 78f(a).

[173] 5 U.S.C. 603(a).

[174] 5 U.S.C. 605(b).

[175] *See* 7 U.S.C. 1(a)(23).

[176] *See* 47 FR 18618–21 (April 30, 1982). *See also* 66 FR 14262, 14268 (March 9, 2001).

In addition, national securities exchanges registered under Section 6(g) of the Exchange Act may have members who are floor brokers or floor traders who are not registered broker-dealers. Floor brokers and floor traders, however, are not eligible to clear securities transactions or collect customer margin, and thus would not be subject to the proposed rules.[177]

Accordingly, the Chairman of the SEC has certified that the proposed rules, if adopted, would not have a significant economic impact on a substantial number of small entities. This certification is attached as Appendix A to this notice.

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.

IX. Statutory Basis and Text of Proposed Rules

The SEC is proposing Rules 400 through 404 pursuant to the Exchange Act, particularly Sections 3(b), 6, 7(c), 15A and 23(a). Further, these rules are proposed pursuant to the authority delegated jointly to the SEC, together with the CFTC, by the Federal Reserve Board in accordance with Exchange Act Section 7(c)(2)(A). *See* Appendix B.

List of Subjects

17 CFR Part 41

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

17 CFR Part 242

Brokers and Securities.

Commodity Futures Trading Commission

17 CFR Chapter I

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

PART 41—SECURITY FUTURES

1. The authority citation for Part 41 is revised to read as follows:

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

2. Part 41 is amended by adding §§ 41.43 through 41.48 to read as follows:

[177] 7 U.S.C. 1(a)(16) and (17).

§ 41.43 Customer margin—authority, purpose and scope.

(a) *Authority and purpose.* Sections 41.43 through 41.48 are issued by the Commodity Futures Trading Commission (CFTC), jointly with the Securities and Exchange Commission (SEC) 17 CFR 242.400 through 242.404, pursuant to authority delegated by the Board of Governors of the Federal Reserve System under Section 7(c)(2)(A) of the Securities Exchange Act of 1934 (the ''Exchange Act'') (15 U.S.C. 78g(c)(2)(A)). Its principal purpose is to regulate margin collected by brokers, dealers, and members of national securities exchanges relating to customers' transactions in security futures and imposes, among other requirements, minimum customer initial and maintenance margin levels for such security futures positions.

(b) *Scope of section.* (1) Regulation T (12 CFR part 220) shall apply to financial relations, including margin arrangements, between a creditor and a customer with respect to security futures and any related securities or futures contracts that are used to offset positions in such security futures, to the extent consistent with this part.

(2) This part does not preclude a regulatory authority or creditor from imposing additional margin requirements on security futures, including higher margin levels and risk-sensitive criteria, consistent with this part, or from taking appropriate action to preserve its financial integrity.

(3) This part does not apply to:

(i) Financial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules that have become effective in accordance with Section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the Commodity Exchange Act (the ''Act'') (7 U.S.C. 7a–2(c));

(ii) Financial relations between a foreign branch of a creditor and a foreign person involving foreign security futures;

(iii) Margin requirements that clearing agencies registered with the SEC or the CFTC impose on their members; and

(iv) Credit extended, maintained, or arranged by a creditor to or for a member of a national securities exchange or a registered broker or dealer if:

(A) Such creditor makes a good faith determination that the borrower is an exempted borrower;

(B) The borrower otherwise qualifies for exemption pursuant to Section 7(c)(3) of the Exchange Act (15 U.S.C. 78g(c)(3)); or

(C) The borrower is a member of a national securities exchange or a national securities association registered under Section 15A(a) of the Exchange Act (15 U.S.C. 78*o*–3(a)) and the borrower:

(*1*) Does not directly or indirectly accept or solicit orders from any customer or provide advice to any customer in connection with the trading of security futures; and

(*2*) Is registered with such exchange or such association as a security futures dealer, pursuant to regulatory authority rules that have become effective in accordance with Section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the Act (7 U.S.C. 7a–2(c)), that:

(*i*) Require such member to be registered as a floor trader or a floor broker with the CFTC under Section 4f(a)(1) of the Act (7 U.S.C. 6f(a)(1)), or as a dealer with the SEC under Section 15(b) of the Exchange Act (15 U.S.C. 78*o*(b));

(*ii*) Require such member to comply with applicable SEC or CFTC net capital requirements;

(*iii*) Require such member to maintain records sufficient to prove compliance with this paragraph (b)(3)(iv)(C) and the rules of the exchange or association of which the borrower is a member;

(*iv*) Require such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis; and

(*v*) Provide for disciplinary action, including revocation of such member's registration as a security futures dealer, for such member's failure to comply with §§ 41.43 through 41.48 or the rules of the exchange or association.

§ 41.44 Customer margin—definitions.

(a) For purposes of this part only, the following terms shall have the meanings set forth in this section.

(1) *Contract multiplier* means the number of units of a narrow-based security index expressed as a dollar amount, in accordance with the terms of the security future contract.

(2) On any day, *current market value* means with respect to a security future:

(i) If the instrument underlying such security future is a stock, the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable number of shares per contract; or

(ii) If the instrument underlying such security future is a narrow-based security index, as defined in section 3(a)(55)(B) of the Exchange Act (15 U.S.C. 78c(a)(55)(B)), the product of the daily settlement price of such security

future as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.

(3) *Examining authority* with respect to a creditor means:

(i) The regulatory authority of which such creditor is a member, if such creditor is a member of only one regulatory authority;

(ii) The regulatory authority designated responsibility by the SEC pursuant to § 240.17d–1 of this title for examining such creditor for compliance with applicable financial responsibility rules, if a regulatory authority is so designated; or

(iii) The regulatory authority designated in accordance with § 1.52 of this chapter, if such creditor is a member of more than one regulatory authority and the SEC, pursuant to § 240.17d–1 of this title, has not designated responsibility for examining such creditor for compliance with applicable financial responsibility rules.

(4) *Initial margin* means the margin as defined in Section 3(a)(57)(A) of the Exchange Act (15 U.S.C. 78c(a)(57)(A)), that is required when a security future position is opened.

(5) *Maintenance margin* means the margin, as defined in Section 3(a)(57)(A) of the Exchange Act (15 U.S.C. 78c(a)(57)(A)), that is required to be maintained in a customer's securities account, as defined in § 1.3(ww) of this chapter, or futures account, as defined in § 1.3(vv) of this chapter, at the end of each trading day.

(6) *Regulation T* means Regulation T promulgated by the Board of Governors of the Federal Reserve System (''Federal Reserve Board''), 12 CFR part 220.

(7) *Regulatory authority* means a self-regulatory organization that is registered as a national securities exchange under Section 6 of the Exchange Act (15 U.S.C. 78f) or a registered securities association under Section 15A of the Exchange Act (15 U.S.C. 78*o*–3).

(8) *Daily settlement price* means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, under the rules of the applicable exchange or clearing organization.

(b) Terms used in this part and not otherwise defined in this section shall have the meaning set forth in Regulation T (12 CFR part 220).

(c) Terms used in this part and not otherwise defined in this section or in Regulation T (12 CFR part 220) shall have the meaning set forth in the Exchange Act.

§ 41.45 Customer margin—customer margin levels for security futures.

(a) *Applicability.* No broker, dealer or member of a national securities exchange may effect a transaction involving, or carry an account containing, a security future position with or for a customer, without obtaining proper and adequate margin as set forth in this section.

(b) *Amount of customer margin*—(1) *General rule.* The minimum initial and maintenance margin levels for each security future contract shall be 20 percent of the current market value of such contract.

(2) *Exceptions. Provided that* such higher margin levels or calculation methods have become effective in accordance with Section 19(b) of the Exchange Act (15 U.S.C. 78s(b)), nothing in this section shall prevent a regulatory authority from:

(i) Requiring initial and/or maintenance margin levels that are higher than the minimum margin levels specified in paragraph (b)(1) of this section; or

(ii) Using a method for calculating required initial and/or maintenance margin that may result in margin levels that are higher than the minimum margin levels specified in paragraph (b)(1) of this section.

(c) *Procedures for certain margin level adjustments.* An exchange registered under Section 6(g) of the Exchange Act (15 U.S.C. 78f(g)), or a national securities association registered under Section 15A(k) of the Exchange Act (15 U.S.C. 78*o*–3(k)), may raise or lower the required margin level to a level not lower than that specified in this section, in accordance with Section 19(b)(7) of the Exchange Act (15 U.S.C. 78s(b)(7)).

(d) *Offsetting positions.* Notwithstanding the minimum margin levels specified in paragraph (b)(1) of this section, customers with offset positions involving security futures and one or more related securities or futures contracts may, pursuant to regulatory authority rules that have become effective in accordance with Section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the Act (7 U.S.C. 7a–2(c)), have initial or maintenance margin levels that are lower than the levels specified in paragraph (b)(1) of this section, *provided that* such margin levels are not lower than the lowest customer margin levels required for any comparable offset positions involving option contracts traded on any exchange registered pursuant to Section 6(a) of the Exchange Act (15 U.S.C. 78f(a)).

(e) *Change in exempted borrower status.* Once a broker, dealer, or a member of a national securities exchange ceases to qualify as an exempted borrower, it shall notify the creditor of this fact before establishing any new security future positions. Any new security future positions will be subject to the provisions of this part.

§ 41.46 Customer margin—time limits for collection of margin.

(a) *Initial margin.* The amount of initial margin required or permitted by § 41.45 shall be obtained by the creditor as promptly as possible and in any event within three business days after the position is established, or within such shorter time period as may be imposed by applicable regulatory authority rules that have become effective in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, section 5c(c) of the Act (7 U.S.C. 7a–2(c)).

(b) *Maintenance margin.* The amount of maintenance margin required or permitted by § 41.45 shall be obtained by the creditor as promptly as possible and in any event within three business days after the margin deficiency is created or increased, or within such shorter time period as may be imposed by applicable regulatory authority rules that have become effective in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, section 5c(c) of the Act (7 U.S.C. 7a–2(c)).

(c) *Extension of time limits.* The time limits for collection of initial margin may be extended upon application by the creditor to its examining authority to the extent permitted by applicable regulatory authority rules that have become effective in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the Act (7 U.S.C. 7a–2(c)).

§ 41.47 Customer margin—forms of collateral.

(a) A broker, dealer or a member of a national securities exchange may accept as margin collateral:

(1) Cash;

(2) Margin securities;

(3) Exempted securities as defined in section 3(a)(12) of the Exchange Act (15 U.S.C. 78c(a)(12)); or

(4) Other collateral permitted under Regulation T (12 CFR part 220) to satisfy a margin deficiency in the margin account.

(b) Nothing in this section shall prevent a regulatory authority from prescribing margin collateral requirements (other than margin levels) including the type, form, and use of collateral for security futures, that are

consistent with the requirements established by the Federal Reserve Board, pursuant to section 7(c)(1)(A) and (B) of the Exchange Act (15 U.S.C. 78g(c)(1)(A) and (B)), subject to approval by the SEC in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, subject to notice to the CFTC in accordance with section 5c(c) of the Act (7a U.S.C. 7a–2(c)).

(c) For the purposes of this section, security futures are not margin securities.

§ 41.48 Customer margin—filing proposed margin rule changes with the CFTC.

(a) *Notification requirement for notice-registered contract markets.* Any regulatory authority that is registered with the CFTC as a designated contract market under section 5f of the Act (7 U.S.C.7b–1) shall, when filing a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)), concurrently provide to the CFTC a copy of such proposed rule change and any accompanying documentation filed with the SEC.

(b) *Filing requirements under the Act.* Any regulatory authority that is registered with the CFTC as a designated contract market or derivatives transaction execution facility under section 5 of the Act (7 U.S.C. 7) shall, when filing a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)), notify the CFTC as follows:

(1) If the regulatory authority elects to request CFTC prior approval for the proposed rule change pursuant to section 5c(c)(2) of the Act (7 U.S.C. 7a–2(c)(2)), it shall concurrently file the proposed rule change with the CFTC in accordance with § 40.5 of this chapter.

(2) If the regulatory authority elects to implement a proposed rule change by written certification pursuant to section 5c(c)(1) of the Act (7 U.S.C. 7a–2(c)(1)), it shall concurrently provide to the CFTC a copy of the proposed rule change and any accompanying documentation filed with the SEC. Promptly after obtaining SEC approval for the proposed rule change, such regulatory authority shall file its written certification with the CFTC in accordance with § 40.6 of this chapter.

Dated: September 26, 2001.

By the Commodity Futures Trading Commission.

Jean A. Webb,

Secretary.

Securities and Exchange Commission

17 CFR Chapter II

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

PART 242—REGULATIONS M AND ATS

1. The authority citation for part 242 is revised to read as follows:

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

2. Sections 242.400 through 242.404 are added to read as follows:

§ 242.400 Customer margin requirements for security futures—Authority, purpose and scope.

(a) *Authority and purpose.* Sections 242.400 through 242.404 are issued by the Securities and Exchange Commission (SEC), jointly with the Commodity Futures Trading Commission (CFTC) 17 CFR 41.43 through 41.48, pursuant to authority delegated by the Board of Governors of the Federal Reserve System under section 7(c)(2)(A) of the Securities Exchange Act of 1934 (''Act'') (15 U.S.C. 78g(c)(2)(A)). Its principal purpose is to regulate margin collected by brokers, dealers, and members of national securities exchanges relating to customers' transactions in security futures and imposes, among other requirements, minimum customer initial and maintenance margin levels for such security futures positions.

(b) *Scope of section.* (1) Regulation T (12 CFR part 220) shall apply to financial relations, including margin arrangements, between a creditor and a customer with respect to security futures and any related securities or futures contracts that are used to offset positions in such security futures, to the extent consistent with this part.

(2) This part does not preclude a regulatory authority or creditor from imposing additional margin requirements on security futures, including higher margin levels and risk-sensitive criteria, consistent with this part, or from taking appropriate action to preserve its financial integrity.

(3) This part does not apply to:

(i) Financial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules that have become effective in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and, as applicable, section 5c(c) of the Commodity Exchange Act (''CEA'') (7 U.S.C. 7a–2(c));

(ii) Financial relations between a foreign branch of a creditor and a foreign person involving foreign security futures;

(iii) Margin requirements that clearing agencies registered with the SEC or the CFTC impose on their members; and

(iv) Credit extended, maintained, or arranged by a creditor to or for a member of a national securities exchange or a registered broker or dealer if:

(A) Such creditor makes a good faith determination that the borrower is an exempted borrower;

(B) The borrower otherwise qualifies for exemption pursuant to section 7(c)(3) of the Act (15 U.S.C. 78g(c)(3)); or

(C) The borrower is a member of a national securities exchange or national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78*o*–3(a)) and the borrower:

(*1*) Does not directly or indirectly accept or solicit orders from any customer or provide advice to any customer in connection with the trading of security futures; and

(*2*) Is registered with such exchange or such association as a security futures dealer, pursuant to regulatory authority rules, approved by the SEC in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that:

(*i*) Require such member to be registered as a floor trader or a floor broker with the CFTC under section 4f(a)(1) of the CEA (7 U.S.C. 6f(a)(1)), or as a dealer with the SEC under section 15(b) of the Act (15 U.S.C. 78o(b));

(*ii*) Require such member to comply with applicable SEC or CFTC net capital requirements;

(*iii*) Require such member to maintain records sufficient to prove compliance with this paragraph (b)(3)(iv)(C) and the rules of the exchange or association of which the borrower is a member;

(*iv*) Require such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis; and

(*v*) Provide for disciplinary action, including revocation of such member's registration as a security futures dealer, for such member's failure to comply with §§ 242.400 through 242.404 or the rules of the exchange or association.

§ 242.401 Definitions.

(a) For purposes of this part only, the following terms shall have the meanings set forth in this section.

(1) *Contract multiplier* means the number of units of a narrow-based security index expressed as a dollar amount, in accordance with the terms of the security future contract.

(2) On any day, *current market value* means with respect to a security future:

(i) If the instrument underlying such security future is a stock, the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable number of shares per contract;

(ii) If the instrument underlying such security future is a narrow-based security index, as defined in section 3(a)(55)(B) of the Act (15 U.S.C. 78c(a)(55)(B)), the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.

(3) *Examining authority* with respect to a creditor means:

(i) The regulatory authority of which such creditor is a member, if such creditor is a member of only one regulatory authority;

(ii) The regulatory authority designated responsibility by the SEC pursuant to § 240.17d–1 of this chapter for examining such creditor for compliance with applicable financial responsibility rules, if a regulatory authority is so designated; or

(iii) The regulatory authority designated in accordance with § 1.52 of this title, if such creditor is a member of more than one regulatory authority and the SEC, pursuant to § 240.17d–1 of this chapter, has not designated responsibility for examining such creditor for compliance with applicable financial responsibility rules.

(4) *Initial margin* means the margin as defined in section 3(a)(57)(A) of the Act (15 U.S.C. 78c(a)(57)(A)), that is required when a security future position is opened.

(5) *Maintenance margin* means the margin, as defined in section 3(a)(57)(A) of the Act (15 U.S.C. 78c(a)(57)(A)), that is required to be maintained in a customer's securities account or commodity interest account at the end of each trading day.

(6) *Regulation T* means Regulation T promulgated by the Board of Governors of the Federal Reserve System (''Federal Reserve Board''), 12 CFR part 220.

(7) *Regulatory authority* means a self-regulatory organization that is registered as a national securities exchange under section 6 of the Act (15 U.S.C. 78f) or a registered securities association under section 15A of the Act (15 U.S.C. 78*o*–3).

(8) *Daily settlement price* means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, under the rules of the applicable exchange or clearing organization.

(b) Terms used in this part and not otherwise defined in this section shall have the meaning set forth in Regulation T (12 CFR part 220).

(c) Terms used in this part and not otherwise defined in this section or in Regulation T (12 CFR part 220) shall have the meaning set forth in the Act.

§ 242.402 Customer margin for security futures.

(a) *Applicability.* No broker, dealer or member of a national securities exchange may effect a transaction involving, or carry an account containing, a security future position with or for a customer, without obtaining proper and adequate margin as set forth in this section.

(b) *Amount of customer margin*—(1) *General rule.* The minimum initial and maintenance margin levels for each security future contract shall be twenty (20) percent of the current market value of such contract.

(2) *Exceptions. Provided* that such higher margin levels or calculation methods have become effective in accordance with Section 19(b) of the Act (15 U.S.C. 78s(b)), nothing in this section shall prevent a regulatory authority from:

(i) Requiring initial and/or maintenance margin levels that are higher than the minimum margin levels specified in paragraph (b)(1) of this section; or

(ii) Using a method for calculating required initial and/or maintenance margin that may result in margin levels that are higher than the minimum margin levels specified in paragraph (b)(1) of this section.

(c) *Procedures for certain margin level adjustments.* An exchange registered under section 6(g) of the Act (15 U.S.C. 78f(g)), or a national securities association registered under section 15A(k) of the Act (15 U.S.C. 78*o*–3(k)), may raise or lower the required margin level to a level not lower than that specified in this section, in accordance with section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)).

(d) *Offsetting positions.* Notwithstanding the minimum margin levels specified in paragraph (b)(1) of this section, customers with offset positions involving security futures and one or more related securities or futures contracts may, pursuant to regulatory authority rules approved by the Commission in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), have initial or maintenance margin levels that are lower than the levels specified in paragraph (b)(1) of this section, *provided that* such margin levels are not lower than the lowest customer margin levels required for any comparable offset positions involving option contracts traded on any exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)).

(e) *Change in exempted borrower status.* Once a broker, dealer, or a member of a national securities exchange ceases to qualify as an exempted borrower, it shall notify the creditor of this fact before establishing any new security future positions. Any new security future positions will be subject to the provisions of this part.

§ 242.403 Time limits for collection of margin.

(a) *Initial margin.* The amount of initial margin required or permitted by § 242.402 shall be obtained by the creditor as promptly as possible and in any event within three (3) business days after the position is established, or within such shorter time period as may be imposed by applicable regulatory authority rules approved by the Commission in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)).

(b) *Maintenance margin.* The amount of maintenance margin required or permitted by § 242.402 shall be obtained by the creditor as promptly as possible and in any event within three (3) business days after the margin deficiency is created or increased, or within such shorter time period as may be imposed by applicable regulatory authority rules approved by the SEC in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)).

(c) *Extension of time limits.* The time limits for collection of initial margin may be extended upon application by the creditor to its examining authority to the extent permitted by applicable regulatory authority rules approved by the Commission in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)).

§ 242.404 Forms of collateral.

(a) A broker, dealer or a member of a national securities exchange may accept as margin collateral:

(1) Cash;

(2) Margin securities;

(3) Exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)); or

(4) Other collateral permitted under Regulation T (12 CFR part 220) to satisfy a margin deficiency in the margin account.

(b) Nothing in this section shall prevent a regulatory authority from prescribing margin collateral requirements (other than margin levels) including the type, form, and use of collateral for security futures, that are consistent with the requirements established by the Federal Reserve Board, pursuant to Section 7 (c)(1)(A) and (B) of the Act (15 U.S.C. 78g(c)(1)(A) and (B)), subject to approval by the Commission in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and, as applicable, subject to notice to the CFTC in accordance with section 5c(c) of the CEA (7 U.S.C. 7a–2(c)).

(c) For the purposes of this section, security futures are not margin securities.

Dated: September 26, 2001.

By the Securities and Exchange Commission.

Margaret H. McFarland,

Deputy Secretary.

Note: Appendix A and B to the preamble will not appear in the Code of Federal Regulations.

Appendix A—Regulatory Flexibility Act Certification

I, Harvey L. Pitt, Chairman of the Securities and Exchange Commission (the ''Commission''), hereby certify, pursuant to 5 U.S.C. § 605(b), that the rules proposed in Section 242.400, *et seq.*, under the Securities Exchange Act of 1934 (''Exchange Act''), which would regulate margin collected by brokers, dealers, and members of national securities exchanges relating to customers' transactions in security futures and impose, among other requirements, minimum customer initial and maintenance margin levels for such security futures positions, would not, if adopted, have a significant economic impact on a substantial number of small entities.

The proposed rules would affect brokers, dealers, and members of national securities exchanges. Futures commission merchants (''FCMs'') and introducing brokers (''IBs'') may register as broker-dealers by filing Form BD–N. The Commodities Futures Trading Commission has concluded that FCMs are not considered small entities for the purposes of RFA.[178] In addition, because IBs cannot collect customer margin they are not subject to these rules. Accordingly, there are no FCMs or IBs that are small entities that would be affected by the proposed rules.

The proposed rules would also apply to broker-dealers and members of national securities exchanges. With one exception, all members of national securities exchanges registered under Section 6(a) of the Exchange Act are registered broker-dealers. The Commission believes that some small broker-dealers could be affected by the proposals, but that the proposals would not have a significant impact on a substantial number of small broker-dealers.

In addition, national securities exchanges registered under Section 6(g) of the Exchange Act may have members who are floor brokers or floor traders who are not registered broker-dealers. Floor brokers and floor traders, however, are not eligible to clear securities transactions or collect customer margin, and thus would not be subject to the proposed rules.

Accordingly, the proposed rules, if adopted, would not have a significant economic impact on a substantial number of small entities.

Dated: September 25, 2001.

Harvey L. Pitt,
Chairman.

Appendix B

March 6, 2001.

Mr. James E. Newsome,
Acting Chairman, Commodity Futures Trading Commission, Three Lafayette Centre, 21st Street, NW., Washington, DC 20581

Ms. Laura S. Unger
Acting Chairman, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

Dear Acting Chairman Newsome and Acting Chairman Unger: Section 206(b) of the Commodity Futures Modernization Act of 2000 (CFMA) amends the Securities Exchange Act of 1934 (SEA), in part by adding a new section 7(c)(2) to provide the Board of Governors of the Federal Reserve System with authority to prescribe margin regulations for brokers, dealers, and members of national securities exchanges extending credit to or collecting margin from customers on security futures products. The Board must prescribe regulations establishing initial and maintenance margin levels for these contracts or delegate the authority jointly to the Commodity Futures Trading Commission and the Securities Exchange Commission (the Commissions).

The Board has long taken the position that the regulatory authorities most familiar with the operation of the financial markets should play a key role in federal oversight of margin policy for these markets. In addition, the Board believes that the most important function of customer margin requirements should be prudential, that is, protection of lenders from credit losses. The Commissions have responsibility for regulating the securities and futures markets and will jointly oversee the exchanges trading security futures products. Furthermore, the Commissions are responsible for all other prudential supervision of the broker-dealers and exchange members covered by the new margin authority. These factors lead the Board to conclude that the Securities Exchange Commission and the Commodity Futures Trading Commission, jointly, are the most appropriate entities to exercise the functions assigned to the Board under section 7(c)(2) of the SEA.

Accordingly, the Board hereby delegates its authority under section 7(c)(2) of the SEA to the Commodity Futures Trading Commission and the Securities Exchange Commission, jointly, until further notice from the Board. The authority delegated by the Board is limited to customer margin requirements imposed by brokers, dealers, and members of national securities exchanges. It does not cover requirements imposed by clearing agencies on their members. Furthermore, the Board notes that section 7(c)(3) exempts the financing of proprietary positions of certain broker-dealers and members of securities exchanges as well as the financing of their market making and underwriting activities from the scope of federal margin regulation. Under the CFMA, futures commission merchants (FCMs), floor brokers, and floor traders who trade security futures products must become broker-dealers or members of a national securities exchange, and therefore, may be exempt under section 7(c)(3) from regulation pursuant to the delegated authority when they obtain credit. The exempt status of FCMs and floor brokers will depend upon whether a substantial portion of their business consists of transactions with persons other than broker-dealers. In the current open-outcry environment, the Board believes that floor traders act as market makers and therefore would be exempt. The Board expects to have further discussions with the Commissions to identify the conditions under which floor traders would act as market makers in an electronic trading environment.

The Board requests that the Commodity Futures Trading Commission and the Securities Exchange Commission, either jointly or severally, report to the Board annually on their experience exercising the delegated authority. In particular, the Board requests that the Commissions provide an assessment of progress toward adopting more risk-sensitive, portfolio-based approaches to margining security 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.

Very truly yours,

Jennifer J. Johnson,
Secretary of the Board.

[FR Doc. 01–24574 Filed 10–3–01; 8:45 am]

BILLING CODES 6351–01–P; 8010–01–P

[178] *See* 47 FR 18618, 18618–21 (April 30, 1982). *See also* 66 FR 14262, 14268 (March 9, 2001).