Securities Industry Association

December 5, 2001

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

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

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

Dear Ms. Webb and Mr. Katz:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[13] See Note 8 above.

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

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

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

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

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

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

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

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

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

> position limits, order size limits and profit and loss limits that are adequate to manage the risks presented by customers who pattern day trade.
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> Inasmuch as the Associations recommend that any such margin requirements be adopted by the listing exchanges (or by SROs), we anticipate commenting on any day trading margin proposals (or the absence of such proposals) in the context of such exchange and SRO rulemakings.

II. Security Futures Margin Levels.

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

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

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

A. Outright Margin Levels.

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

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

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

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

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

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

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

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

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

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

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

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

B. Portfolio Margining.

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

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

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

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

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

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

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

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

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

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

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

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

3. Portfolio Margining and SRO Rules.

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

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

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

C. Strategy-Based Margin Levels.

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

III. Other Rulemaking Recommendations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. Conclusion.

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

Very Truly Yours,

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

cc: Commodity Futures Trading Commission

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

Securities and Exchange Commission

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