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SECURITY FUTURES — A NEW FRONTIER

The Commodity Futures Modernization Act of 2000 Permitted for the First Time the Trading of Futures on Single Stocks and Narrow-based Indices. The Author Describes the New and Proposed Rules on a Variety of Subjects Relating to the New Trading, Including the Protection of Customer Funds, Reporting and Recordkeeping, Minimum Capital, Margin, and SRO Requirements.

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The Commodity Futures Modernization Act of 2000 ("CFMA"),[1] made fundamental changes in the Commodities Exchange Act ("CEA"),[2] the Securities Act of 1933,[3] the Securities Exchange Act of 1934 (the "34 Act"),[4] the Investment Company Act of 1940,[5] the Investment Advisers Act of 1940[6] and other federal acts.[7] The goal of the legislation was to coordinate the CEA with the federal securities laws and other financial regulation of derivative products, particularly futures on single stocks and narrow-based indices, derivatives and hybrid products which have mixed elements of securities, futures and bank products. The CFMA also modernized and changed the CEA, simplifying regulation of contract markets and providing for the creation of different types of derivative markets. It also provided for direct regulation of the clearing function and registration and regulation of clearing houses.

The CFMA, for the first time, established a system of regulation permitting the trading of futures on single stocks and narrow-based indices ("security futures"). This paper deals with the regulation of security futures as it affects the requirements of broker-dealers ("BDs"), futures commission merchants ("FCMs"), and introducing brokers ("IBs").

BACKGROUND

One of the major goals of the CFMA was that securities and futures markets and intermediaries have a level regulatory field when trading security futures. In order to

1. Pub. Law 106-554.
2. 7 U.S.C. §1 *et seq.*
3. 15 U.S.C. §77a *et seq.*
4. 15 U.S.C. §78a *et seq.*
5. 15 U.S.C. §80a-1 *et seq.*
6. 15 U.S.C. §80b-1 *et seq.*
7. *See e.g.*, Gramm-Leach-Bliley Financial Modernization Act, Public Law 106-102, 113 Stat. 1338.

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accomplish this goal, the CFMA provides that commodities markets (any contract market or derivatives transaction execution facility) that are trading security futures products may notice register with the Securities and Exchange Commission ("SEC") as a national securities exchange.[8] Likewise, the CFMA provides that national securities exchanges or alternative trading markets trading security futures may register as contract markets by notice registration with the CFTC.[9] With respect to intermediaries, an FCM or IB may register by notice filing with the SEC as a BD if it would be required to register only because it affects transactions in security futures products on an exchange registered with the SEC.[10] Likewise, the CFMA amends the CEA to provide for notice registration of BDs as FCMs or IBs as long as the FCM or IB limits its solicitation to security futures products traded on a contract market or registered derivatives exchange.[11] The provision with respect to notice registration of FCMs or IBs as a BD requires such registration if the FCM notice-registered BD proposes to trade any security futures product. However, a BD registered by notice filing as an FCM or IB need only register if it is going to trade a security futures product on a contract market or derivatives exempt trading facility.

The CFMA specifically provides for exemptions for notice-filed BDs from certain of the parts of the 34 Act and related rules. Likewise, it provides exemptions for notice-filed FCMs or IBs from certain parts of the CEA and related rules. Specifically, FCMs or IBs registered as BDs pursuant to the provisions of the CFMA are exempt from the following sections of the 34 Act:

1. Section 8;
2. Section 11;
3. Sections 15(c)(3) and (c)(5);
4. Section 15b;
5. Section 15c; and
6. Sections 17(d), (e), (f), (g), (h) and (i).[12]

It should be noted that FCM and IB notice-registered BDs must be a member of a futures association registered with the SEC as a registered national securities association.[13] The National Futures Association ("NFA") has become a registered national securities association under the limited registration provisions of Section 15a(k) of the

8. 34 Act §6(g), 15 U.S.C. §78f(g).
9. 9 CEA §5f, 7 U.S.C. 7(b).
10. 34 Act §15(b)(11)A, 15 U.S.C. §78o(b)(11)(A).
11. CEA §4f(a), 7 U.S.C. §6f(a).
12. 34 Act §15b(11)B, 15 U.S.C. §78o(b)(11)(B).
13. 34 Act §15A(k), 15 U.S.C. oA(k).

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34 Act. BDs that are notice registered as FCMs or IBs are exempt from a number of provisions of the CEA, including the following:

1. Subsections (b), (d), (e), and (g) of Section 4c;
2. Sections 4d, 4e and 4h;
3. Subsections (b) and (c) of this Section;
4. Section 4j;
5. Section 4k(1);
6. Section 4p;
7. Section 6d;
8. Subsections (d) and (g) of Section 8; and
9. Section 16.[14]

It should be noted that a BD notice registered as an FCM or IB or exempt floor broker or floor trader need not become a member of a futures association registered under Section 17.[15]

Also exempt from BD registration are floor traders and floor brokers who are natural persons effecting transactions only in security futures on a futures exchange registered as a contract market of which they are a member as long as they do not accept orders from the public.[16] It should also be noted that an individual floor broker or floor trader is exempt from registration under the CEA if the floor broker or floor trader trades security futures on a securities exchange and is registered with the SEC and limits his or her futures activities to security futures.[17]

The CFMA also provides a framework for margining security futures products.[18] The margins for particular security futures products are to be set by the Federal Reserve Board, which has delegated responsibility to the CFTC and the SEC. However, the CFMA provides, as discussed below in more detail, the framework for margining of security futures products. Specifically, it requires among other requirements that margin for a security futures product be consistent with the margin requirements for comparable option contracts traded on a national securities exchange.

PROTECTION OF CUSTOMER PROPERTY

General

The CEA has provisions for protection of customer cash securities or other property held by an FCM. Likewise, the 34 Act has provisions for the protection of customer cash, securities and other property held by a BD. Under the CEA, customer funds and customer securities must be held in segregation by a third-party financial institution.[19] Under Section 15(c)(3) of the 34 Act, the SEC has promulgated Rule 15c3-3 which requires that BDs maintain reserve deposits with a third-party financial institution.[20] The amounts of these deposits are computed weekly or monthly based generally upon funds owed to customers minus certain funds due the BD. Rule 15c3-3 also requires that fully paid securities of customers be held in the control and possession of the BD within the meaning of the SEC rule.

Under the CFMA and proposed rules, the handling of customer funds and securities appears to be fairly straight forward. FCMs and IBs notice registered as BDs are specifically exempt from Section 15(c)(3) of the 34 Act and, as a result, from SEC Rule 15c3-3.[21] Thus, if an FCM is notice registered and *is not otherwise a BD* because it trades only futures, futures options and security futures, it need not concern itself with SEC Rule 15c3-3. In such case, any customer funds or securities would be held by the FCM pursuant to the CFTC segregation requirements. Furthermore, the CFMA amended the Securities Investors Protection Act to provide that it would not cover customers of FCMs that are registered as a BD pursuant to Section 15(b)(11)(A) of the 34 Act.[22] Conversely, the CFMA provides that a BD notice registered as an FCM or IB or a floor broker or floor trader

14. CEA §4f(a)(4)(A), 7 U.S.C. §5f(a)(4)(A).
15. CEA §4f(a)(4)(A), U.S.C. 6f(a)(4)(A).
16. 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B).
17. CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A).
18. 34 Act §7(c)(2), 15 U.S.C. §78g(c)(2).
19. *See* CEA §4d, 7 U.S.C. 6d; *See also* Rule 120 *et seq.*, 17 C.F.R. 1.20 *et seq.*; Rule 30.7, 17 C.F.R. 30.7.
20. 34 Act §15(c)(3), 15 U.S.C. §78o(c)(3); 17 C.F.R. 240.15c3-3.
21. 15 U.S.C. §78o(c)(3).
22. Securities Investors Protection Act of 1970 §3(o)(2)(A); 15 U.S.C. §78ccc(i)(a)(A).

exempt from registration with the CFTC, is exempt from the segregation requirements of the CEA.[23]

Proposed Rules

The CFTC and SEC jointly announced on September 25, 2001 proposed rules with respect to customers' accounts holding security futures products (the "joint release").[24]

CFTC Proposed Rules. The CFTC proposes to amend Rule 1.55[25] dealing with risk disclosure statements to provide for certain disclosures to customers that will effect transactions in security futures products. Under CFTC proposed Rule 41.42, the disclosure statement must state in the case of a firm that is fully (not notice) registered as both a BD and an FCM, whether security futures will be held for the customers by the firm: in a securities account; in a futures account; or at the election of the customer in either a securities or a futures account.

The CFTC also proposes to amend its definitional rule to include a definition of a "securities account" and a "futures account." If the firm is an FCM and a notice-registered BD, the security futures must be carried in the futures account. Likewise, if a BD is a notice-registered FCM or IB, the security futures must be carried in the securities account. In addition, disclosures must be made as to the protections of the Securities Investor Protection Act ("SIPA"), SEC Rule 15c3-3,[26] and Section 4d of the CEA[27] for each of the two types of accounts. There must be disclosure of the absence of the applicable protection in the event security futures are to be held only in one type of account. Specifically, if the customer elects to maintain security futures in a securities account, the lack of protection of Section 4d segregation must be disclosed, and, conversely, if the customer elects to maintain security futures in a futures account, the lack of SIPA and Rule 15c3-3 protection must be disclosed. The proposed rule also would require that a customer acknowledge receipt of the disclosure. The rule also provides that in the event that a fully registered BD and FCM changes the type of account in which security futures may be held, the registered BD must give notice to customers and permit the customer to move the account, together with appropriate disclosures as to the protections under one scheme and the lack of protections under the alternative protection scheme. The Securities Industry Association and Futures Industry Association have prepared a standard disclosure which has been submitted to the applicable regulators for their concurrence.

SEC Proposed Rules. The SEC proposes a parallel scheme of regulation. Rule 15c3-3 was amended to add new definitions of "securities account" and "futures account" and a new subsection (o). Rule 15c3-3(o) parallels the choices available with respect to the CFTC rules described above. If the firm is both a fully registered BD and an FCM, it may elect to permit customers to carry security futures in either a futures account or a securities account or the firm may elect only to carry security futures in either securities accounts or futures accounts. If the firm is a notice-registered BD, security futures must be carried in a futures account. If the firm is a notice-registered FCM or IB, the positions must be carried in a securities account. The same disclosures must be made under Rule 15c3-3(o) as under the CFTC rules. In the case of a fully registered BD and FCM, the firm must disclose whether it will permit customers to carry the security futures in a futures account, in a securities account, or elect to carry the security futures position in either a futures or securities account. There must be a description of the SIPA and Rule 15c3-3 protections, and the protection of segregation under Section 4d of the CEA. The firm must also describe the protections that a customer would forego under one scheme or the other. The firm would also be required to obtain the customer's acknowledgment of receipt of the disclosure. Like the CFTC rule, the SEC rule requires disclosure to be made to customers if the firm changes its procedures with respect to the type of account in which security futures may be held.

Segregation Opt Out Rule

The CFMA amended the CEA to permit a Board of Trade to elect to operate as a Derivative Transaction Exclusion Facility ("DTEF") in lieu of seeking designation as a Contract Market.[28] A DTEF may authorize FCMs to offer to its customers that are "Eligible Contract Participants"[29]

23. CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A); *See* CFTC Rule 1.20, *et seq.*, 17 C.F.R. 1.20 and Rule 30.7, 17 C.F.R. 30.7.
24. Release No. 34-44854 (September 25, 2001).
25. 17 C.F.R. 1.55.
26. 17 C.F.R. 240.15c3-3.
27. 7 U.S.C. §6(d).
28. CEA §5a, 7 U.S.C. §7a.
29. CEA §1(a)(12), 7 U.S.C. §1a(12).

as defined in the CFMA (generally large institutions), the option to *elect to have their funds* that are carried by an FCM for purposes of trading on the DTEF *not separately accounted for and segregated.*[30] The CFTC has adopted a new Rule 1.68, which permits a DTEF to authorize its FCM members to offer to its Eligible Contract Participant customers the right to "opt out" of segregation for their funds and assets held for purposes of trading on DTEF.[31] The rule provides that the FCM must make a disclosure to the customer with respect to the election, including an explanation of the advantages and possible disadvantages of segregation. The rule provides that an Eligible Contract Participant may revoke its election (opt-in to segregation) upon five business days' notice. It is interesting to note that if the customer opts out under CFTC Rule 1.68, the CFTC capital rule provides that the funds must be taken into consideration in computing the capital of the FCM.[32] The CFTC's adopting release explains that an opt-out customer would receive the bankruptcy treatment of a non-public customer and not a general creditor, which in essence means that the customer would come ahead of general creditors for customer funds but behind customers whose funds and assets were held in segregation.[33] Although an opt-out customer may move its funds between its segregated account and its opt-out account, the opt-out account may not be used to secure the segregated account if there is a deficit. However, the reverse would be true.

Interestingly, in adopting CFTC Rule 1.68, the CFTC appears not to have considered the impact on BDs that are FCMs. Under SEC Rule 15c3-3, a futures customer's funds held in segregation accounts are excluded from SEC Rule 15c3-3 calculation for the BD's reserve deposit.[34] The net balance, however, may be reduced by netting the regulated and non-regulated commodity account if there is a deficit in the regulated commodity account held in segregation.[35] Funds held in the secured account under CFTC Regulation 30.7 are also excluded from the Rule 15c3-3 computation.[36] As a result of these interpretations, if a customer of an FCM that is registered as both an FCM and BD opts out of segregation pursuant to CFTC Rule 1.68, the customer's funds appear to have to be included as part of the BD's 15c3-3 computation. However, if the FCM is notice registered with the SEC as a BD, the FCM would be exempt from SEC Rule 15c3-3 and would not have to make a Rule 15c3-3 computation and would not have to make a 15c3-3 deposit with respect to the customer's funds. With respect to security futures, this may give FCMs notice registered with the SEC as a BD an advantage over FCMs that are otherwise registered with the SEC. Since most large wire houses and regional firms that handle institutional customers that would qualify as Eligible Contract Participants are both an FCM and a BD, the opt-out provisions of CFTC Rule 1.68 will be nullified by SEC Rule 15c3-3 with respect to their customers that are Eligible Contract Participants. This appears to frustrate the purposes of Congress in attempting to create a level playing field and in mandating opt-out for Eligible Contract Participants trading on DTEFs.

REPORTING AND RECORDKEEPING REQUIREMENTS

Under the CFMA, an FCM or IB that is notice registered as a BD with the SEC would be required to file FOCUS reports with the SEC. The exemption for a notice-registered BD in the CFMA from provisions of the 34 Act does not include an exemption under Section 17(a) which requires the filing of a FOCUS report pursuant to SEC Rule 17a(5).[37] However, under the proposed rules under the joint release, Rule 17a-5 would be changed to provide that notice-registered BDs would not need to file FOCUS Reports.[38] It appears that a BD notice registered as an FCM or IB would only have to file financial reports with the CFTC.

Both the CFTC and the SEC have risk assessment report filings.[39] The CFMA created a level playing field by exempting FCMs and IBs that are notice-registered BDs from the SEC risk assessment reporting regime and by

30. CEA §5a(f), 7 U.S.C. §7a(f).
31. 17 C.F.R. 1.68.
32. Rule 1.17(a)(1)(i).
33. 66 F.R. 20740 at p. 20741 (April 25, 2001).
34. *See* NYSE Interpretation Handbook, p. 624, item /02; SEC Release 34-9922 (January 2, 1973).
35. NYSE Interpretation Guide, p. 624, item /021 SEC Staff to NYSE (May 1978).
36. NYSE Interpretation Guide, p. 624, item /022; NYSE Information Memo (April 20, 1988).
37. 34 Act §17a, 15 U.S.C. §78q(a); SEC Rule 17a-5, 17 C.F.R. 17a-5.
38. Release No. 34-44854 (September 25, 2001).
39. 34 Act §17(h), 15 U.S.C. §78q(h); CEA §4f(c), 7 U.S.C. §6f(c). *See, also* SEC Rules 17h-1 and 17h-2, 17 C.F.R. §240.17h-1 & 2; *see, also* CFTC Rule 1.14, 17 C.F.R. 1.14.

exempting BDs notice-registered as FCMs or IBs from the CFTC risk assessment reports.[40]

With respect to recordkeeping, the joint release proposes that SEC rules apply to security futures carried in securities accounts and CFTC rules will apply to security futures carried in futures accounts. However, either regulatory agency may review records with respect to security futures regardless of whether security futures are carried in a securities account or a futures account.

With respect to SEC recordkeeping Rule 17a-3,[41] the joint release proposes that it would not apply to a notice-registered BD and it would not apply to a BD that is also an FCM that holds security futures in a futures account. Rule 17a-4[42] would be amended to provide that the SEC may examine records for any security futures account, even if maintained as a futures account. Rules 17a-7[43], 17a-11[44] and 17a-13[45] would be amended so that they are not applicable to FCMs or IBs that are notice-registered BDs.

CAPITAL REQUIREMENTS

Both the CFTC and the SEC have capital requirements.[46] The CFMA exempts FCMs and IBs notice registered as BDs from certain provisions of the 34 Act, including SEC Rule 15c3-1, the SEC capital rule.[47] The CFMA allowing BDs to notice register as an FCM or IB for purposes of trading security futures also exempts notice-registered FCMs and IBs from the CFTC capital rule.[48] This treatment preserves the status quo and may not make any difference in some cases, but in other cases it could make a significant difference. Under the CFTC capital rule and under the SEC capital rule, a BD that is an FCM or IB or vice versa is required to have as minimum capital the greater of the capital amount computed according to either of the rules. However, there are some differences in the two rules. Several of these differences continue to frustrate the goal of a level playing field. One of these differences is that the CFTC capital rule does not require a four percent haircut on customer short options.[49] However, the SEC rule requires a four percent haircut on the market value of commodity options granted by option customers.[50] In some cases, this can be a huge difference. It has and will continue to severely impact the capital of BDs that are FCMs who have customers with short option transactions.

It should be noted that there are other differences between the two capital rules. For example, the consolidation provisions and their interpretations for guaranteed subsidiaries and non-guaranteed subsidiaries are different.[51] In the past, the SEC and the CFTC staffs have worked diligently to coordinate their interpretations under their parallel capital rules, each of which incorporates large parts of the other agency's rule for one purpose or another. It would be hoped that these disparate differences would be further ameliorated so that the treatment would conform with the congressional mandate of equal treatment.

MARGINING OF SECURITY FUTURES PRODUCTS

The CFMA Requirements

As noted previously, the CFMA provided that the Federal Reserve Board has authority to promulgate rules regarding any extension or maintenance of credit or collection of margin from customers on security futures products.[52] The CFMA also provides that the Federal Reserve Board may delegate such authority to the CFTC and the SEC which will jointly prescribe rules pursuant to the mandate described below. The Federal Reserve Board has delegated the authority to promulgate regulations to the SEC and CFTC. Knowing the tension between the CFTC and the SEC, Congress in the CFMA wisely provided that in the event that the CFTC and SEC do not agree on prescribed margin rules within a "reasonable period of time" the Federal Reserve Board shall prescribe such regulations pursuant to the criteria set forth in the CFMA. The mandate is to prescribe rules that meet the following criteria:

40. 34 Act §15(b)(11)(B), 15 U.S.C. §78o(b)(11)(B); CEA §6f(a), 15 U.S.C. §7f(a).
41. 17 C.F.R. 240.17a-3.
42. 17 C.F.R. 240.17a-4.
43. 17 C.F.R. 240.17a-7.
44. 17 C.F.R. 240.17a-11.
45. 17 C.F.R. 240.17a-13.
46. *See* CFTC Rule 1.17, 17 C.F.R. 1.17; SEC Rule 15c3-1, 17 C.F.R. 240.15c3-1.
47. 17 C.F.R. 240.15c3-1.
48 .CEA §4f(a)(4)(A).
49. CFTC Rule 1.17(c)(5)(iii), 17 C.F.R. 1.17(c)(5)(iii).
50. SEC Rule 15c3-1b(3)(x), 17 C.F.R. 240.15c3-1(b)(3)(x).
51. Compare SEC Rule 15c3-1c, 17 C.F.R. 240.15c3-1(c) with CFTC Rule 1.17(f), 17 C.F.R. 1.17(f).
52. 34 Act §7(c)(2), 15 U.S.C. §78g(c)(2).

(i) to preserve the financial integrity of markets trading security futures products;

(ii) to prevent systemic risk;

(iii) to require that —

(I) the margin requirements for a security future product be consistent *with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a)* of this title; and

(II) initial and maintenance margin levels for a security future product 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 this title, other than an option on a security future;

except that nothing in this subparagraph shall be construed to prevent a national securities exchange or national securities association from requiring higher margin levels for a security future product when it deems such action to be necessary or appropriate; and

(iv) to ensure 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 Board, pursuant to subparagraphs (A) and (B) of paragraph (1).[53]

The General Scheme

In a second joint release, the CFTC and the SEC proposed rules with respect to margin and margining of security futures.[54] In the margin release, the CFTC and SEC have jointly proposed new CFTC rules 41.43 through 41.48 and SEC rules 400 through 404. These rules establish a number of principles. The key provisions are as follows:

1. The requirements of Regulation T, other than margin levels, apply to the financial relationships between a creditor (which includes a BD, an FCM or an IB) and a customer with respect to security futures;

2. The time limits for collection of initial and maintenance margin from customers is set at up to three business days;

3. The acceptable collateral for margining a security futures transaction is set forth; and

4. The minimum and initial margin levels required are established for carrying a long or short security futures position at 20% of the current market value of such position subject to certain lower margin for certain offset positions.

Regulation T Compliance

Since Regulation T will govern the accounts, FCMs that are notice-registered BDs will need to set up a margining system in compliance with Regulation T for security futures. This will be extremely expensive and will not fit with most of the current software that is used by FCMs. Most firms that are fully registered as an FCM and BD have separate accounting and customer systems. Another unclear area is whether futures which are not carried in a Regulation T margin account would have any value under Regulation T for purposes of margining.

Margin Exclusions

The proposed rules cover any BD or member of a national security exchange effecting transactions for customers involving security futures. The rules, however, exclude a number of categories:

1. Financial relations between a customer and a BD under a portfolio margining system;

2. Financial relations between a foreign branch of a BD and a foreign person;

3. Margin requirements of clearing agencies such as Option Clearing Corporation ("OCC") or the various clearing houses in the futures industry;

4. Credit extended, maintained or arranged by a BD to or for a member of a national securities exchange or registered BD involving the following:

53. 34 Act §7(c)(3)(B), 15 U.S.C. §78g(c)(3)(B) (emphasis added).
54. SEC Release No. 34-44853 (September 25, 2001).

a. margin arrangements with an exempted broker as defined under Regulation T;

b. margin arrangements with a borrower otherwise exempt pursuant to Section 7 of the 34 Act; or

c. financial relations between a BD and a member of a national securities exchange or association.

While there is an exemption for portfolio margining, a satisfactory portfolio margining system has not yet been developed and approved by both the SEC and CFTC. The Commissions jointly urge such a development at the earliest possible time, referring with approval to the OCC's theoretical intermarket margining system ("TIMS") and the standard portfolio analysis risk ("SPAN") used currently for traded futures contracts at both the clearing and customer level.

It is also proposed that floor traders trading on futures exchanges would be included within an exemption. The same relief would be available for a member of a national securities exchange and a creditor where there is an upstairs trading platform trading security futures.

Margin Levels

The rules propose margin levels based upon the CFMA requirements that they be similar to the margin levels for options on securities. The base requirement is proposed at 20% of the "current market value." Current market value is defined as the settlement price on the day of the transaction and not the day before as is customary in the futures industry. There are a significant number of margin offsets that are proposed to be allowed, which follow the offsets for securities option trading, a chart of which is included in the proposing release. The proposed rules provide that any market may require its members to meet higher margin levels.

Under the proposed rules, the margin, both initial and maintenance, must be obtained no later than three business days. For purposes of collateral, the proposed rules provide that a customer can satisfy margin requirements by cash, margin securities as defined in Regulation T, exempted securities as defined by the 34 Act, or other collateral permitted under Regulation T. Self-regulatory organizations may propose different margin collateral as long as those requirements are consistent with Regulation T and approved by the SEC. The Release makes clear that security futures are not margin securities. Security futures would be treated the same as a short option and would have no value for margin purposes. The proposed rules also provide a scheme for approval of changes in margin rules by both the CFTC and the SEC.

Securities Self-Regulatory Margin Requirements

The SEC and CFTC proposals do not deal with the securities SRO initial and maintenance margin. Both the NASD and the New York Stock Exchange ("NYSE") have margin requirements in addition to compliance with the Regulation T initial margin requirements. These regulations require members to comply with the SRO's own initial margin and maintenance requirements. For equities the maintenance requirement is generally 25% of the current market value of the security unless the customer is long and short the same security, in which case it is 5%. These SRO margin requirements create a disparity between FCMs and IBs that are notice-registered BDs, who do not have to comply with NASD rules, and fully registered BDs that are notice-registered FCMs or IBs, who do have to comply with these rules. The NASD and the NYSE day trading rules may present additional issues because futures trading is necessarily short term trading and many accounts would probably fall within the day trading rules if the security futures are actively traded and the firm is a fully registered BD. This creates less than the level playing field contemplated by Congress.

SELF-REGULATORY ORGANIZATION REQUIREMENTS

NASD and NFA Firm Membership

A FCM or IB that is notice registered with the SEC as a notice-registered broker-dealer does not have to become a member of the NASD. Similarly, a registered BD that is notice registered as a FCM or IB does not have to become a member of the NFA. Firms that are fully registered as BDs and fully registered as FCMs or IBs must follow the NASD rules for security futures even though they are members of the NFA. Since the NASD and the NFA are attempting to harmonize their rules for security futures so that they are the same, there should not be any significant difference between the regulatory requirements. In that

regard, the NFA has issued a number of interpretations and the NASD is making appropriate amendments to its rules in this area. The SROs appear to be close to achieving a level playing field.

Registration and Examination Requirements

A person that is registered with the CFTC and the SEC, including notice registration, and who has passed one or both of the Series 3 or Series 7 examinations is eligible to offer or sell security futures. Such associated persons need not be registered with both regulators but will have to participate in the security futures education program described below. The NASDR and NFA will have a security futures education program available on their websites in the beginning of 2002. The joint program includes four elements:

1. basic securities and securities options markets (designed for Series 3 registrants);

2. basics of futures and futures markets (designed for Series 7 registrants);

3. information about the terms and conditions of security futures contracts and trading; and

4. major regulatory requirements for security futures.

In the not too distant future, both the NFA and the NASD will also amend their existing proficiency examinations to include sections on security futures. In the future, persons taking those examinations will not have to participate in a special education program for security futures.

Supervisors of Persons Dealing or Handling Security Futures Business

Under the rules of the NASD and NFA, members must designate one or more security futures principals for each office where the firm is engaged in the security futures business. Persons employed by NFA members but not NASD members and who pass the Series 30 branch office manager exam may qualify as a security futures principal. Current supervisors of NFA firms who have not passed the Series 30 may also qualify as a security futures principal if the supervisor participates in the security futures continuing education program within six months of the trading of security futures in the United States.

In the case of NASD firms, including firms that are both NFA and NASD members, persons who have passed the Series 4 registered options principal or Series 9 or Series 10 (branch officer manager exams) are eligible to be security futures principals. All NASD supervisors are required to complete the continuing education program covering supervisory procedures for security futures.

Opening Accounts

Under the NASD and NFA rules, all new accounts or existing accounts intending to trade security futures must be approved for such trading by a security futures principal. Discretionary accounts trading security futures will also require the approval of a security futures principal. In addition, the security futures principal is responsible for reviewing discretionary activities in the account and documenting such review.

New Employees

The NASD requires review of the central registration depository for derogatory information on prospective employees and their employers. Under NFA Rule 2.9, NFA members will be required to check the NASD's central registration depository for derogatory information on prospective employees and their employers and obtain copies of the employee's Forms U-4, U-8-R or 8-T as appropriate.

CFMA IMPACT ON REGISTRATION

Today many customers, particularly high net worth individuals and large institutions, use both securities and futures products jointly in their portfolio. To maximize the use of leverage and collateral, high net worth individuals and institutions generally maintain their assets in one account at one clearing broker that is both a BD and FCM so that the collateral for securities accounts may be used for futures accounts and vice versa by appropriate transfers between the particular accounts. This permits a customer to make the most efficient use of its collateral. Furthermore, in many cases it reduces the amount of collateral required because with portfolio margining, the regulatory or house margin will be less since securities positions may offset futures and vice versa. With this in mind, it is unlikely that an FCM that is notice registered as a BD would be able to attract high net worth individuals and institutional customers because the FCM would

not be in a position to carry other securities positions which would be needed for hedging, offsetting security futures positions, and correspondingly reducing the amount of collateral. Likewise, a BD that is notice registered as an FCM would be handicapped in maintaining an account for a high net worth individual or an institutional customer that wishes to actively use both futures and securities products. Only at a financial service firm that is both an FCM and a BD may a customer use the full range of products for portfolio management with the minimum amount of collateral. There are a number of other obvious advantages of such an account such as reducing transfers and errors. Further, each day the customer will have a summary of all of its positions. This is not a new issue, but what it means is that most BDs need to be FCMs and vice versa if they are to handle high net worth individuals and institutional customers.

SOME ISSUES NOT ADDRESSED BY THE CFMA

The CFMA and the proposed rules have not addressed the question of give-ups and clearing member transfer agreements ("CMTAs") or prime brokerage. Under these arrangements, a firm executes a transaction for a customer and then transfers the transaction pursuant to the agreements to a clearing firm which clears the transaction and holds the customer's positions and funds. The industry needs to rapidly address the issue of give-ups, prime brokerage and CMTA transactions for security futures positions.

The issue of cross-margining between futures and securities products is also not new, but with security futures there will be a new impetus to have cross-margining between securities and futures products. Under the current regime, BDs that are FCMs are required by customer needs to be members of the clearing houses of a number of futures exchanges as well as members of a number of the securities clearing organizations such as OCC, National Securities Clearing Corporation, and the Government Securities Clearing Corporation. Further, many firms need to be members of foreign clearing houses or organizations. The BD FCMs that are members of numerous clearing organizations are required to post unnecessary collateral because even though positions held at different clearing organizations offset each other economically, they are not carried in the same clearing system and have to be margined separately without taking into consideration the offsets available for a product cleared in another system. The CFMA did not address these issues of cross-margining of security futures or interfaces between clearing organizations in the securities industry and futures industry. However, cross-margining and clearing house interfaces not only with respect to security futures but also other products will be issues that need to be addressed rapidly in the future.

As previously explained, the margin requirements are very high for a futures product. Both the SEC and CFTC endorse portfolio margining which could result in significant reduction in margin levels for offset positions. The current offset positions follow option offsets and are certainly not generous in that they probably do not take into consideration the real risk in a number of portfolios. For this reason, the industry to be competitive globally must move rapidly to portfolio margining of security futures in addition to the current portfolio margining of futures products. ■