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To: Committee Members and Staff

From: Rob Johnson

Subject: The Position of the Working Group Members on Margin Authority.

Date: May 24, 1988

Background:

Current margin authority

Stocks	Federal Reserve
Stock index futures	SRO's
Stock options	SRO's based on SEC approval and Federal Reserve authority.

The Working Group on Financial Markets has produced an interim report. On pages 5-7 the report discusses the views of the various regulators on the question of margin regulation. The results are as follows:

1. Adequacy of margins to insure against prudential risk

   All agree that present margin levels are adequate for this purpose.

2. Should margins be raised in the futures market to dampen volatility?

Chairman Ruder	Yes
Chairman Greenspan	No
Chairman Gramm	No
Treasury	No

3. Should there be federal government oversight of margin setting?

Chairman Ruder	Yes
Chairman Greenspan	Yes
Chairman Gramm	No
Treasury	Yes

4. Who should have the federal government oversight responsibility for margin setting?

Chairman Ruder	SRO sets margin subject to regulator approval and with the Fed to settle disputes between CFTC and SEC.
Chairman Greenspan	SRO sets margin with SRO's primary regulator having authority to disapprove margin changes.
Chairman Gramm	SRO sets margin no federal government oversight.
Treasury	SRO sets margin with SRO's primary regulator having authority to disapprove margin changes.

*****If the vote was on the question of "should the CFTC have margin authority in the stock index futures market" the vote would be 3 to 1 with only Chairman Gramm dissenting.

*****If the vote was on the question of "should the Federal Reserve have authority to set margin over stock index futures and then delegate that to the CFTC if it so desired" the vote would be 3 to 1 with only Chairman Ruder voting for the proposition.

Attachments: A. Language from Working Group Report

B. Table on margin comparisons in various markets.

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In designing these procedures, the Working Group has focused on market events that are so dramatic as to trigger ad hoc and destabilizing market closings. This was manifest during the market break through systems breakdowns, reduced liquidity, and concerns over trading because of fears of counter-party and even clearing corporation failure. The Working Group recognizes that trading disruptions are undesirable. Thus, its proposal is designed to substitute planned for unplanned, ad hoc trading halts without increasing the overall frequency of such disruptions. The Working Group's recommendation also recognizes the need for reopening procedures designed to limit the duration of the halt while providing for information dissemination to permit consideration of buy or sell decisions during periods of stress.

Members of the Working Group have consulted with the SROs, as well as with knowledgeable industry participants, about the design of these procedures. The Working Group believes that its recommendations can be implemented most effectively and expeditiously by SRO-initiated rule changes, with appropriate notice, comment, and agency review.

IV. MARGIN REQUIREMENTS

The Working Group considered the appropriate levels of "prudential" margins for stocks, stock index futures and options, defined as the maintenance margin levels needed to protect broker-dealers, futures commission merchants, and clearing corporations from investor and trader defaults on their margin obligations. Based upon the past price movements of stocks and stock indexes, the Working Group calculated the likelihood that prices would move to a point where various margin levels would not satisfy prudential concerns. See Appendix B.

On the basis of these statistical measures, the Working Group concludes as follows. First, current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements. Because margin levels sufficient to provide protection against all possible price movements would impose unacceptable costs to market participants and the liquidity and efficiency of markets, the Working Group agreed that means other than margins to protect against extreme price movements should be considered. In this connection, the Working Group recognized that other mechanisms are in place that address the risk of large price movements relative to margins, such as capital requirements, clearing-fund guarantee deposits, and intra-day variation margin payments. Moreover, the Working Group's

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recommendations on a circuit-breaker mechanism and credit, clearing, and settlement improvements should add significant protections against financial system risks from extreme price movements.

Second, the prudential maintenance margin percentages required for carrying an individual stock should be significantly higher than the percentage margin required for a futures contract on a stock index. This conclusion follows from the facts that stock indexes have a smaller percentage price variability than do individual stocks and the payment period for margins in the futures market is shorter than the period for stocks. The extent to which stock margins should exceed those for futures depends not only on measured volatilities and stated grace periods, but also on (i) actual margin settlement and position sell-out practices, (ii) portfolio strategies, such as the diversification of stock portfolios and the combination of stock, futures, and options positions, and (iii) the application of margin exemptions.

These conclusions concerning minimum margins relate only to minimum levels of margin set by regulatory or self-regulatory organizations. The Working Group notes that financial intermediaries typically require an amount in excess of these minimums for less credit-worthy customers and those with concentrated positions. Furthermore, capital requirements of firms and clearinghouse guarantee funds further enhance the stability of the securities and futures clearance and settlement systems.

The Working Group was not able to agree on whether or not it is appropriate or effective to raise margins above prudential levels in an attempt to reduce leverage or dampen volatility. Chairman Ruder believes that certain futures-related trading strategies have resulted in a dramatic increase in the size and velocity of institutional trading which, in turn, has resulted in substantially increased price volatility. For this reason, Chairman Ruder believes that, at least as an interim measure, margins on futures and options should be increased, in order to increase investor confidence, decrease derivative market speculative activity, and reduce the illusion that the derivative markets provide sufficient liquidity to allow investors and traders to liquidate quickly large portions of their entire portfolios. Chairman Gramm, the Treasury, and Chairman Greenspan, on the other hand, do not believe that the evidence supports the conclusion that higher margins will reduce volatility. Moreover, higher margins raise transaction costs and could have a negative effect on market liquidity and efficiency, possibly increasing volatility, and risking the movement of futures trading into off-shore markets.

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The members of the Working Group disagreed about the appropriate scope and form of federal oversight of margins.

Chairman Gramm believes, based on the historical record, the different function and practices of futures margins, and the interest of individual firms and clearinghouses in protecting their capital, that the current approach to futures margins -- set by SROs, with emergency authority at the CFTC -- is entirely appropriate. Chairman Gramm also believes that it may be reasonable to have different regimes for equities since such cash market investments can involve purchases on credit and, in many cases, have lengthy settlement periods.

3 to 1 Vote

Chairman Greenspan and the Treasury believe that, while the primary responsibility for setting margins in all markets should be with the SROs, which have the superior expertise and economic stake to perform this role most effectively, there should be authority for each SRO's regulator to disapprove margin rule changes. There is sufficient possibility that at some point SROs might establish margins that were inconsistent enough to present market problems or set them at levels that might present potential costs to other parties that regulatory approval should be established in all markets. Chairman Greenspan and the Treasury do not feel that there is sufficient justification for adding any further levels or mechanisms for federal oversight beyond the primary regulator.

Chairman Ruder agrees with Chairman Greenspan and the Treasury on the need for regulatory rule disapproval authority, but feels that it is important to add a mechanism (i) by which any unresolved disputes that might arise between the SEC and the CFTC over margin levels established by their respective SROs and not disapproved by the relevant regulator would be settled by decision of the Federal Reserve, and (ii) by which the Federal Reserve would have residual authority to adjust margins taking into account leverage and investor protection concerns.

V. CLEARING AND SETTLEMENT RECOMMENDATIONS

The Working Group reviewed existing audit, clearing, and payments systems to identify and set priorities for actions that could be taken to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. In undertaking its review, the Working Group also interviewed major market participants, including large commercial and investment banks, exchanges, and clearing organizations. (The views of these market participants are summarized in Appendix C.)

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Initial Margin Required

	January 23, 1987	October 16, 1987	May 1, 1988
Stock (Specialist)	Approximately 25%***	Approximately 25%	Approximately 25%
CME Floor Trader (S&P 500 Futures)	4%	7%	13%
Institution using Stock	50%*	50%	50%
Institution ** using S&P 500 Future	2%	4%	7%

*Institutions usually do not use margin for stocks, but pay 100%.

** Assumes that institution qualifies for "hedger" treatment for margin purposes, which almost all of them do

*** Specialist only has to put up good faith margin, but banks and lenders will require that the specialist put up around 25%

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