

The current capital rule generally has worked well as a measure of the minimum amount of capital an FCM needs in order to augment the Segregated Amount to provide protection for customer funds and to meet the FCM's responsibility of maintaining orderly markets. In recent years, however, the scope of and participants in the commodity business have changed. Trading is conducted on a 24-hour a day basis on markets worldwide. FCMs have become significant participants in this global marketplace as evidenced by increasing numbers of U.S. and foreign customers trading on U.S. and foreign markets through FCMs and the increasing amount of customer funds held by FCMs.⁸ The types of participants in the marketplace also have shifted from primarily agricultural traders to highly sophisticated money managers and financial institutions trading a wide variety of products, with the greatest volume of trading being in interest rate and stock index contracts.

The framework for the current capital rule was developed in 1978 and now should be modernized to reflect these changes. The current capital rule does factor in the risk inherent in the positions carried by an FCM for its customers' accounts to the extent that the amount of capital required is based on a percentage of the Segregated Amount, which, in turn, is partly a function of the margin (or performance bond) required on open futures and option positions. There are, however, a number of material limitations on the current method used to calculate required net capital.

A primary limitation is that the Segregated Amount does not fully reflect the extent to which an FCM is exposed to commodity positions it carries for both customers and noncustomers.⁹ For example, the Segregated Amount does not include funds held by an FCM on behalf of foreign-domiciled customers trading on foreign commodity markets, nor does it include funds held by an FCM on behalf of noncustomers trading on either U.S. or foreign futures and options markets. Furthermore, the Segregated Amount does not include letters of credit deposited as margin or reflect the additional risks posed by open positions

in customer accounts that liquidate to a deficit. Finally, calculating minimum capital as a percentage of the Segregated Amount subjects an FCM to a higher requirement in situations where the FCM requires additional margin from customers or carries free credit balances for its customers, despite the risk reducing effect of holding higher levels of customer funds.

To address the concerns noted above and to conform the Commission's capital requirements to those implemented by the NFA, two exchanges and a clearing organization, the Commission is proposing to adopt a minimum capital requirement calculated as a percentage of the margin required on all domestic and foreign futures and option accounts carried by the FCM on behalf of customers and noncustomers, instead of as a percentage of the Segregated Amount.

B. Proposed Risk-Based Capital Requirement

1. Overview of the Proposed Risk-Based Capital Computation

Margin-based (or risk-based) capital rules have been adopted and put into effect by the Board of Trade Clearing Corporation ("BOTCC"), Chicago Board of Trade ("CBOT"), Chicago Mercantile Exchange ("CME"), and NFA. BOTCC, CBOT, and CME adopted risk-based components to their respective minimum capital requirements for clearing member firms effective January 1, 1998. NFA adopted a risk-based capital component to its minimum capital requirements for member FCMs effective October 31, 2000.

Based upon the effectiveness of these rules as implemented at these organizations, the U.S. commodity exchanges and NFA, through the Joint Audit Committee ("JAC"), have requested that the Commission amend its capital rule by eliminating the calculation based on the Segregated Amount and adopting a calculation based on the required maintenance margin levels for customer and noncustomer futures and option positions carried by an FCM.¹⁰ An additional benefit to FCMs of adopting the proposed risk-based capital requirement is that it would simplify adjusted net capital reporting requirements for FCMs. Commission Rule 1.17 includes among the categories from which an FCM's required net capital is determined "[t]he amount of adjusted net capital required by a registered futures association of which

[the FCM] is a member." Because all registered FCMs that handle customer funds are required to be members of NFA, the NFA's adoption of a risk based capital requirement, which is modeled on the requirement implemented by BOTCC, CBOT, and CME, has effectively required almost all FCMs to perform adjusted net capital computations that are based both on percentages of maintenance margin levels of futures and options positions and on percentages of the Segregated Amount.

U.S. commodity exchanges and numerous foreign commodity exchanges use the Standard Portfolio Analysis of Risk ("SPAN") margining system for calculating margin requirements on futures and option positions. SPAN is a system developed and maintained by the CME that calculates maintenance margin levels in an account containing both futures and option positions on the basis of overall portfolio risk. Commodity exchanges attempt to set maintenance margin levels that exceed the one-day price change for 95 percent to 99 percent of the trading days based upon statistical analyses of day-to-day price changes over a varied number of trading days.¹¹

The SPAN maintenance margin level has two components:

1. The risk component, which covers potential future losses in the portfolio value. Such losses would include a market move against a futures position or a short (written) option; and
2. The equity component (option premium, marked-to-the market daily), which reflects the asset represented by long option positions or the liability represented by short (written) option positions in the portfolio.

The proposal would set the minimum capital requirement at the aggregate of eight percent of the risk maintenance margin level on customer accounts and four percent of the risk maintenance margin level on noncustomer accounts. The equity component of the SPAN maintenance margin level would not be included in the capital computation. Furthermore, as more fully discussed below, the risk maintenance margin imposed on long option positions that were not hedging other futures or option positions could be excluded from the computation. Proprietary (*i.e.*, firm-owned) accounts would be excluded

⁸ Based upon financial reports filed with the Commission, FCMs held on behalf of their customers approximately \$30 billion as of September 1995 and approximately \$69 billion as of April 2003.

⁹ Noncustomer accounts are defined in Rule 1.17(b)(4) and generally are accounts of entities affiliated with the FCM and the accounts of certain employees of the FCM.

¹⁰ The JAC is comprised of representatives of the audit and financial compliance departments of the SROs.

¹¹ For more detailed information on the SPAN margining system, see the report *Review of Standard Portfolio Analysis of Risk ("SPAN") Margin System as implemented by the Chicago Mercantile Exchange, Board of Trade Clearing Corporation, and the Chicago Board of Trade*, prepared by the Commission's Division of Trading and Markets and issued in April 2001. The report is available on the Commission's Web site: <http://www.cftc.gov>.