

to the customer has not been answered by the third business day following the issuance of the call. Rule 1.17(c)(5)(ix) similarly requires a capital charge for noncustomer accounts if a noncustomer fails to answer a margin call by the second business day following the issuance of the call. When first adopted, these rules allowed collection periods of five business days for customer accounts and four business days for noncustomer accounts following the issuance of a margin call before a capital charge had to be taken. In 1980, the number of days was reduced to three business days for customer accounts and two business days for noncustomer accounts in recognition of the increased use of electronic communication for issuing and collecting margin calls.¹⁵

The Commission is now proposing to reduce the collection period before a capital charge would have to be taken to one business day following the issuance of a margin call for both customer and noncustomer accounts. The Commission is making this proposal in recognition of: (i) The advancements in electronic communications and the ability to transfer funds electronically which allow market participants to more easily meet a margin call; (ii) the increase in the number of products offered on futures markets since 1980, and the higher volatility associated with some of these products; and (iii) the expansion in the scope of FCM operations, including outside of the United States. In addition, the Commission believes the proposed amendment is consistent with the proposal to adopt a Risk-Based Capital computation.

An effective margining system is a key component of a sound financial risk management system. Such financial risk management should include a correlation between the time permitted for margin collection and the performance bonds or risk margin levels established for each contract. Because the Commission is proposing minimum capital requirements based on a percentage of risk maintenance margin required, not collected, a corresponding change to the allowed collection period for margin deficiencies is being proposed.

As noted previously, the SPAN margining system is intended to result in a level of maintenance margin that is

expected to cover the probable one-day price move for a particular futures or option contract 95 percent to 99 percent of the time. Because price moves of that magnitude do not occur each day, the Commission believes it is appropriate to allow an FCM a reasonable period of time to collect the margin calls from customers and noncustomers prior to imposing a capital charge. However, with the increased use of electronic communications and electronic funds transfers, an FCM should be able to minimize the risks inherent in an account that has become undermargined. Reducing the period of time for collection to one business day from the date the margin call was issued for the purpose of taking charges against net capital would reflect the additional risk posed by a longer collection time than is necessary to transfer funds using current technology. It would also serve as an additional incentive to FCMs to issue margin calls and to collect margin promptly. An example of when a margin charge would have to be taken is as follows: on Monday a customer's or noncustomer's account becomes undermargined for the first time; the FCM makes a call to the customer or noncustomer for additional margin on Tuesday; if the margin deficiency is not collected by the close of business Wednesday, then any capital computation prepared as of the close of business Wednesday would include a capital charge for the margin deficiency.

IV. Financial Reporting Requirements for FCMs and IBs

A. Introduction

FCMs and IBs are required to be in compliance with the net capital rule at all times and to be able to demonstrate that compliance whenever requested to do so. Such close monitoring and awareness of capital positions is necessary in the high risk, high volatility futures trading business. Likewise, a sound financial surveillance program recognizes the need to monitor the financial condition of an FCM or IB through the regular collection of financial information. The Commission is proposing several amendments to Rules 1.10, 1.12, 1.16 and 1.18 that: (i) Reflect advances in technology that permit more rapid reporting, (ii) increase regulatory efficiency by harmonizing reporting requirements under comparable Commission and SEC rules, (iii) promote direct supervision of FCMs and IBs by SROs subject to Commission oversight, and (iv) streamline the Commission's reporting requirements by eliminating unnecessary filings. The proposed

streamlined procedures and filing requirements are consistent with the oversight role envisioned for the Commission under the Commodity Futures Modernization Act of 2000 ("CFMA") which includes among its stated purposes "to transform the role of the [Commission] to oversight of the futures market" and "to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act".¹⁶

B. Monthly Filing of Financial Reports by FCMs

The Commission conducts its monitoring of the financial condition of FCMs both directly and through coordination with the SROs. Pursuant to Commission Rule 1.52, an SRO must adopt, submit for Commission approval, and thereafter enforce minimum financial and related reporting requirements for its member FCMs.

Commission Rule 1.10 requires an FCM to file an unaudited Form 1-FR-FCM report on a quarterly basis with the Commission and with its designated self-regulatory organization ("DSRO").¹⁷ FCMs that also are registered as securities brokers or dealers may elect to file, in lieu of a Form 1-FR-FCM, a copy of their unaudited Financial and Operational Combined Uniform Single Report under the Securities and Exchange Act of 1934, Part II or Part IIA ("FOCUS Report").¹⁸ FCM financial reports must be filed with the Commission and with an FCM's DSRO within 17 business days of the end of the fiscal quarter.

The Commission is proposing to amend Rule 1.10 to require each FCM to file an unaudited Form 1-FR-FCM or FOCUS Report with the Commission and with the FCM's DSRO as of the end of each month, including the FCM's fiscal year end. The FCM would be required to file the financial reports within 17 business days of the end of each month.

When the Commission initially adopted its financial reporting rules, quarterly reporting by FCMs was determined to be sufficient for adequate and timely monitoring of the FCM's financial condition. Commodity exchanges and NFA, however, have

¹⁶ Section 2 of the CFMA, Pub. L. 106-554, Appendix E, 114 Stat. 2763 (2000).

¹⁷ The DSRO is the self-regulatory organization that, pursuant to Commission Rule 1.52, is primarily responsible for monitoring an FCM's compliance with minimum financial and related reporting requirements, receiving and reviewing an FCM's financial reports, and auditing the FCM's books and records.

¹⁸ The requirements for the FOCUS Report are set forth in SEC Rule 17a-5.

¹⁵ 45 FR 79416 (December 1, 1980). Under the current rule, if a customer account first experiences a margin deficiency on Monday, the FCM would issue a margin call to the customer on Tuesday. If the margin call had not been answered by the close of business on Friday, the FCM would be required to take a capital charge for its capital computation as of Friday for the amount of the margin deficiency on Monday.