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# Ask the Professor: Portfolio Margining – How Will Dodd-Frank Impact Its Utilization?

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# Ask the Professor: Portfolio Margining— How Will Dodd-Frank Impact its Utilization?

BY PROFESSOR RONALD FILLER<sup>1</sup>

The short answer to the question raised above is: “by a lot”. However, as with any new legislative change, the devil is in the detail as the regulatory landscape will properly determine its true impact.

The Dodd-Frank Wall Street and Consumer Protection Act<sup>2</sup> (“Dodd-Frank Act”) signed into law by President Obama on July 21, 2010, made important corrections to the bankruptcy laws that were needed to allow portfolio margining to achieve its purpose. In particular, Section 983 of the Dodd-Frank Act specifically provides that futures assets are now subject to the provisions of the Securities Investor Protection Act (“SIPA”).<sup>3</sup> Similarly, Section 713 of Dodd-Frank Act specifically provides that securities may be held in a futures account and thus be subject to the customer segregation provisions of Section 4d of the Commodity Exchange Act (“CEA”)<sup>4</sup> and CFTC Regulation 1.20.<sup>5</sup> Section 713 of the Dodd-Frank Act further provides that the CFTC must promulgate new regulations that will address the customer segregation provisions.

Before speculating as to what these new regulations might be, let’s look back to how portfolio margining has developed over the past several years.

## Background

The Board of Governors of the Federal Reserve System, pursuant to its Regulation T (“Reg. T”), establishes the margin requirements relating to stock and other securities transactions.<sup>6</sup> In particular, Reg. T prohibits a broker-dealer from lending more than 50% of the underlying value of the securities purchased or from extending credit based on more than 50% of such value, taking into account the value of any non-cash collateral held in the customer’s securities account.<sup>7</sup> Thus, Reg. T governs the amount of margin lending that may occur when a customer buys stock, sells stock short or withdraws cash or collateral from its securities account held by the broker-dealer.

In futures, the exchanges, rather than any government agency, establishes the required initial margin requirements for

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each respective futures contract traded on that exchange. Unlike stock margin, which is related to the value of the securities purchased, initial futures margin is determined based on historical risk parameters, known commonly as SPAN, which applies, in essence, a two standard deviation, one day analytical risk model. Futures margin, which generally looks at recent historical futures price changes over the past 60 or 90 days, is designed to provide the minimum amount needed such that a one-day trading loss would not normally exceed the amount of the initial margin requirement for that futures contract.

These differences, between securities and futures, reflect some of the major hurdles that have faced portfolio margining and its effectiveness to date.

## Introduction to Portfolio Margining<sup>8</sup>

As noted above, Reg. T establishes the amount that can be financed by a broker-dealer in connection with stock purchases. Reg. T also permits a securities self-regulatory organization (“SRO”), such as a securities exchange, to adopt rules governing the amount that must be maintained for open securities positions held by the broker-dealer on behalf of its customers.<sup>9</sup> Thus, New York Stock Exchange Rule 431 provides that a NYSE member firm must collect additional margin from a customer whenever the value in the customer’s account falls below a specified level (e.g., 25% for long positions, 30% for short positions).

In 1998, Reg. T was amended to permit, for the first time, an exchanged-approved portfolio margining regime to allow broker-dealers to compute the initial and maintenance margin requirements in a different way.<sup>10</sup> Specifically, this change permits margin requirements to be determined on a risk-based model, more similar to futures, and required that any such exchange risk analytical model be approved by the Securities and Exchange Commission (“SEC”).<sup>11</sup>

NYSE Rule 431 was then amended to initiate this portfolio margining concept for its member firms. It first sought approval from the SEC in 2002, which was initiated in July 2005 under a two-year pilot program.<sup>12</sup>

## Portfolio Margining Today

NYSE Rule 431 specifically states that a member firm may aggregate various products, including stocks, stock options, securities swaps and stock index futures in determining the applicable risk margin requirements.<sup>13</sup> Remember, NYSE Rule 431 was approved by the SEC. However, since broad-based stock index futures, such as the CME’s S&P 500 Stock Index Contract,<sup>14</sup> are subject to the exclusive jurisdiction of the Commodity Futures Trading Commission (“CFTC”), pursuant to Section 2(c) of the CEA, portfolio margining, to date, has not achieved its ultimate goal. Before the Dodd-Frank Act made changes relating to portfolio margining, as described in more detail below, the CFTC took the position and, rightfully so, that customer futures margin must be held in a customer segregated account in accordance with Section 4d of the CEA and CFTC Rule 1.20.<sup>15</sup> Thus, before the Dodd-Frank Act, any customer, such as a long-short hedge fund, that traded a variety of equity products and related stock index futures contracts, had to maintain two accounts with its broker-dealer/FCM, one for its stock transactions, in compliance with Reg. T, and one for its futures transactions in compliance with the CEA. This so-called “two-pot” approach prevented the full effectiveness of a portfolio margining scheme.

For example, let’s assume that ABC Hedge Fund traded a basket of large cap stocks that were highly correlated to the S&P 500 Index, and shorted an appropriate amount of S&P 500 Stock Index futures contracts to be effectively hedged. With respect to its margin requirements, if ABC Hedge Fund bought the underlying stocks on margin, it would be required to pay the appropriate margin amount, as required by Reg. T in its securities account at the broker-dealer, and would be required to post the appropriate amount of initial futures margin requirements, as required by the CME, in its futures account held at the FCM, even though, from a risk-based analytical model, there would be very little, if any, risk to the underlying accounts, given the high correlation of the stocks to the respective index futures position. This two-pot approach has thus raised serious is-

sues as both accounts must be properly margined under different regulatory schemes. For example, if the equity positions made \$1,000 and the futures account, being highly correlated, would thus lose \$1,000 that same day, the increased amount of \$1,000 in the securities account must be moved to the futures account to cover the variation loss in that account. For portfolio margining to be successful as a proper risk-based model, the underlying products must be held in one pot.

## Dodd-Frank Act

The new law provides some important changes that will ultimately enhance the use and effectiveness of a portfolio margin system. In particular, the Dodd-Frank Act amends the 1934 Act and the CEA to authorize joint broker-dealers/futures commission merchants to hold securities that are part of a portfolio margining program in a futures account. Securities products held in a futures account will be treated as futures contracts for purposes of the U.S. Bankruptcy Code. The CEA and applicable CFTC regulations have always allowed securities to be held in a futures account. In fact, most U.S. futures exchanges and DCOs accept listed equities as satisfying most initial margin requirements. The key legislative change is that futures contracts can now be held in a securities account. While, as noted above, NYSE Rule 431(g) included stock index futures as an acceptable product to be included in determining the applicable risks of such an account, the CFTC has never accepted this position, arguing that Section 4d of the CEA and CFTC Rule 1.20 requires futures customer assets to be held in a customer segregated account which does not include a securities account.

Section 713(C) of the Dodd-Frank Act states:

“Notwithstanding any provision of sections 2(a)(1)(C)(i) or 4d(a)2) of the Commodity Exchange Act and the rules and regulations promulgated thereunder, and pursuant to an exemption granted by the Commission under section 36 of this title or pursuant to a rule or regulation, cash and securities may be held by a broker-dealer registered pursuant to section (b) (1) and also registered as a futures commission

merchant pursuant to section 4f(a)(1) of the Commodity Exchange Act, in a portfolio margining account as a futures account subject to section 4d of the Commodity Exchange Act and the rules and regulations promulgated thereunder, pursuant to a portfolio margining program approved by the Commodity Futures Trading Commission ...”

Section 983(a) of the Dodd-Frank Act states:

“Section 9(a)(1) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78fff3(a)(1)) is amended by inserting “or options on commodity futures contracts” after “claim for securities”.

Section 983(b)(1) of the Dodd-Frank Act amended the definition of an “included person” for purposes of SIPA. The term ‘customer’ for purposes of Section 9(a) of SIPA now includes “any person who has a claim against the debtor for cash, securities, futures contracts or options on futures contracts ...”. Debtor for this section of the Dodd-Frank Act means a broker-dealer.

Thus, the stage has been set to implement more fully an effective portfolio margining system. However, the exact impact of these legislative changes rests with new CFTC and SEC regulations which will prescribe the requisite requirements to be imposed on a joint BD/FCM which wants to provide portfolio margining to its key customers.

## Its True Impact

While the Dodd-Frank Act has provided the necessary tools to enhance the effectiveness of portfolio margining, with the to-be-adopted regulations providing important guidelines, a portfolio margining scheme will not necessarily achieve its ultimate purpose of applying a true risk-based portfolio analysis until the clearing houses accept a reduced margin amount when only part, but not all, of the products comprising the portfolio, are cleared by that DCO. Let’s take the following example:

ABC Hedge Fund has a large growth stock portfolio that is highly correlated to the S&P 500 Stock Index Contract traded on the CME. From a pure risk-based perspective, if ABC bought the

stock portfolio on margin via a stock lending program at its prime broker, it is still required to post the full amount of the initial margin required by the CME Clearing House with respect to the S&P 500 futures contracts held in its account at the FCM.

Thus, while the overall margin required by NYSE Rule 431 would be significantly reduced, cash or acceptable non-cash collateral must still be deposited with the CME Clearing House. It is thus critical to the success of portfolio margining that U.S. clearing houses establish a means of margining that recognizes the offsetting risks and permits a reduced amount of the initial margin to be posted. This may require that the clearing house establish a lien on the stock portfolio held by the joint BD/FCM or require the joint BD/FCM to open an account with the clearing house so it has a direct security interest in the stock portfolio, but until such an approach is adopted, portfolio margining will not achieve its ultimate risk-based margin goal.

Also, keep in mind that the Dodd-Frank Act only applies to a joint BD/FCM. If a firm, such as a bank, has separate affiliates registered as a BD and as a FCM, then that bank may be placed at a competitive disadvantage versus investments banks which have registered joint BD/FCMs. A legislative fix may be needed to correct this situation.

#### NOTES

- 1 Ronald Filler is a Professor of Law, the Director of the Center on Financial Services Law and the Program Director of the LLM in Financial Services Law at New York Law School. Before joining the NYLS faculty in June 2008, he was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers. This unique LLM program offers more than 40 courses involving all aspects of the global financial services industry, including five courses on derivatives law and products, four courses on hedge funds and private equity, four courses on banking issues, three courses involving litigation matters, two courses on clearing issues and courses on such topics as AML; Global Compliance Issues; Insolvency Issues; EU Regulation; Executive Compensation Issues; Audits and Examinations; Prime Brokerage, and many other great topics

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- 2 Pub L 111-203, HR 4173 (111<sup>th</sup> Congress, 2010).
- 3 Since its enactment in 1975, futures contracts and assets used to margin futures contracts were specifically excluded from SIPA's provisions. Accordingly, any customer trading both equities and futures were required to maintain two separate and distinct accounts, commonly referred to as the "two-pot approach", one for securities transactions and one for futures.
- 4 7 U.S.C §6d.
- 5 17 C.F.R. §1.20.
- 6 See 12 C.F.R. §220.
- 7 *Ibid.*
- 8 The SEC defines a "portfolio margining system" as:  
"Portfolio margining establishes margin levels by assessing the market risk of a 'portfolio' of positions in securities or commodities. Under a portfolio margining system, the amount of required margin is determined by analyzing the risk of each component position in a customer account ..." See Exchange Act Release No., 34-46292 (July 31, 2002).
- 9 *Supra*, Note v.
- 10 *Ibid.*
- 11 *Ibid.*
- 12 cite.
- 13 NYSE Rule 431(b)(1) requires that a customer deposit "initial margin" greater to the amount specified in Regulation T of the Federal Reserve System or Rules 400 through 406 of the Securities Exchange Act of 1934 or Rules 41.42 through 41.48 of the Commodity Exchange Act, or (2) the amount specified in NYSE Rule 431(c), which is the maintenance margin amounts. NYSE Rule 431(f) (10) defines the margin requirements relating to security futures. NYSE Rule 431(g), the NYSE Portfolio Margining Rule, applies to all margin for equity securities, listed options, unlisted derivatives and securities futures products. NYSE Rule 431(g) then goes on to state:  
"In addition, a member organization, provided it is a Futures Commission Merchant ("FCM") and is a clearing member of a futures clearing organization, or has an affiliate that is a clearing member of a futures clearing

organization, is permitted under section (g) to combine an eligible participant's "related instruments" as defined in section (g)(2)(E) with listed index options on exchange traded funds (ETF), index warrants and underlying instruments." (emphasis added)  
Section 431(g)(2)(E) defines the term "related instruments" to mean "broad-based

index futures covering the same underlying instruments"

- 14 Go to CME website for the contract specifications for this futures contract. [http://www.cme.com/trading/equity-index/us-index/sandp-500-citigroup-growth\\_contract\\_specifications.html#prodType=undefined](http://www.cme.com/trading/equity-index/us-index/sandp-500-citigroup-growth_contract_specifications.html#prodType=undefined)
- 15 *Supra*, Note iv.