CROSS-MARGINS FOR EQUITY INDEX AND INTEREST RATE FUTURES AND OPTIONS

Chapter 12

General Information

Cross-margins programs have become increasingly valuable risk management tools in recent years. There are currently three approved cross-margins programs in place. The programs include (1) the Chicago Mercantile Exchange ("CME"), the New York Clearing Corporation ("NYCC"), and Options Clearing Corporation ("OCC"), (2) the Board of Trade Clearing Corporation ("BOTCC") and OCC, and (3) the CME and the BOTCC. Note: The NYCC clears the trades of the New York Futures Exchange ("NYFE"), the BOTCC clears the trades of the Chicago Board of Trade ("CBOT"), while the OCC clears the trades for all securities options presently listed and traded on national securities exchanges.

The programs allow for cross margining of certain equity index and interest rate futures and options contracts for proprietary, noncustomer, and qualified market professional accounts. It is hoped that these programs can be expanded to include other products and account types in the future.

The cross-margins programs provide for reduced margin requirements and net settlement obligations by combining into one account eligible futures and options cleared by the respective programs. Using the SPAN® margin system and/or the Theoretical Intermarket Margin System ("TIMS™"), the cross-margins programs recognize all components of a related portfolio. This benefit may be available at both the account and clearing levels.

For specific information on the three cross-margins programs, including eligible contracts and agreements, operational and segregation issues and bankruptcy distributions, please contact the respective exchanges and clearing organizations.

Eligible Participants

CME/BOTCC Cross-Margins Program:

Initially, clearing member firms can establish a cross-margins clearing account for house positions only. This includes proprietary and other non-customer accounts as defined by CFTC Regulation 1.3(y). In the future, the clearing organizations will allow firms to establish a customer cross-margins clearing account. This will include CME and CBOT member accounts, as well as non-member customers.

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OCC Cross-Margins Programs:

Prior to April 1, 1998, Federal Reserve Regulation T (Extension of Credit to Customers) limited cross-margins participation. Until that time, Regulation T only recognized futures and options on futures as a reduction in security margin requirements for registered market makers and specialists, not futures locals. Thus, clearing firms were prohibited from giving futures traders a margin reduction on their securities positions based on offsetting futures contracts.

Amendments adopted in April 1998 to Regulation T allow commodities and foreign exchange positions in non-securities credit accounts to be considered in the calculation of margin for any securities transactions. Further, the amendments allow securities exchanges to override Regulation T by adopting rules permitting "portfolio margining".

The OCC cross-margins programs have been approved for proprietary, noncustomer, and market professional accounts. Generally, the programs include, or will include, those accounts defined in CFTC Regulation 1.3(y) for CME, BOTCC, and CCC contracts and those accounts not considered customer as defined by SEC Rules 8c-1 and 15c2-1 or those accounts which are otherwise permitted under OCC rules to be carried in the proprietary cross-margins account.

However, while clearing member affiliates are considered noncustomer accounts under CFTC regulations, they are considered customer accounts under SEC rules and thus, are currently not eligible cross-margin participants. As a result, cross-margin benefits cannot be extended to affiliates yet. As stated above, exchange rules must be amended to allow for portfolio margining in order for the margins of affiliated customers to be reduced based upon offsetting futures positions.

Market professional accounts are those accounts of CME members or firms owning a CME membership, CBOT members or firms owning a CBOT membership, NYFE members or firms owning a NYFE membership, or market-makers, specialists, or registered traders as defined by OCC rules. Unfortunately, at this time, no securities exchange has developed and adopted rules for portfolio margining. Therefore, as indicated below, the limitations on the OCC cross-margins programs still exist.

- Market professional participation is limited to registered market makers and specialists and excludes CME, CBOT, and NYFE members.

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- **Unless an affiliate or employee is a registered market maker or specialist, the clearing member may not pass the reduced margin requirements to the affiliate or employee. However, the clearing member can receive the reduced margin requirements and net settlement obligations at the clearing level.**

The exchanges and clearing organizations are actively working with the regulators to implement the necessary modifications to the margin rules to allow for portfolio based margining. Further, work is being done to amend the rules to include all approved eligible participants.

Cross-margins arrangements can be structured several different ways. A firm that is a member of all participating clearing organizations of a cross-margins program may enter into a joint cross-margins arrangement with those organizations. However, their participation is limited to those organizations where their memberships are held. A clearing member of a least one participating clearing organization with an affiliate at another participating clearing organization of a cross-margins program may enter into an affiliate cross-margins arrangement.

In the past, customers and noncustomers were allowed to use inter-exchange credits to reduce margin requirements. However, for eligible OCC cross-margin participants, these credits have been replaced with the cross-margins program. For the OCC cross-margins programs, inter-exchange credits are still available to those customers and noncustomers not currently eligible for cross-margins and to those clearing members that are not members of another participating clearing organization and do not have an affiliate with a membership at another participating clearing organization.

Margin Collateral and Requirements

Acceptable margin collateral at the clearing level includes cash (only U.S. dollars), U.S. Treasury Securities, and letters of credit. Letters of credit must be in the approved standard format and are subject to the same limitations as letters of credit in the non-cross-margins origin, but computed separately. Pass through letters of credit are not acceptable.

Acceptable margin collateral for cross-margin participants at the account level is the same as non-cross-margin accounts. A clearing member may accept from an account holder as margin any collateral that is acceptable to the exchanges in the

cross-margins programs. This generally includes cash currencies of any denomination, readily marketable securities, and letters of credit subject to certain limitations for the OCC programs only.

As previously noted, the cross-margins programs allow a clearing member to combine into one account eligible commodity and security positions and account equity. This combined account is considered a futures account for regulatory purposes. However, the major service bureaus cannot maintain in one account both futures and security equity positions. Firms should consult with their service bureau regarding their capabilities with respect to cross-margins. Clearing members may have to manually combine the accounts to determine their margin status.

Market professionals and noncustomer accounts are subject to the same margin requirements as any other commodity account. A clearing member must issue, age, and delete calls for margin. An account cannot continue to trade with a margin deficiency after an unreasonable period of time. A reasonable period of time is less than five business days for market professional accounts and four business days for noncustomer accounts.

In determining margin status, the three cross-margins programs are not treated identically. Because the CME/BOTCC program includes only products traded on futures exchanges, accounts belonging to customers participating in the program will be considered with other customer non-cross-margins accounts. Because the OCC programs include products from both futures and equity markets, cross-margin accounts belonging to market professionals are held in a separate origin and are considered separately from the market professionals' non-cross-margins accounts. Excess equity in one origin cannot meet the margin requirements in another origin. The clearing member must transfer equity between the market professional's accounts for the OCC cross-margins programs.

As there are no segregation requirements, a noncustomer's cross-margins account can be combined with its non-cross-margins futures account in determining margin status.

Net Capital Implications for Cross-Margins

Proprietary Accounts:

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Firms must calculate capital charges on proprietary positions in their cross-margins accounts similarly to non-cross-margins futures accounts. Firms can use those positions to hedge SEC-regulated products or use the account's margin requirement as the capital charge for those positions. However, to utilize the joint clearing account's margin requirement as the proprietary capital charge, firms must put the position into their house cross-margin account. CFTC regulations require firms to compute their proprietary capital charges on the clearing organization's margin requirements.

Customer and Noncustomer Accounts:

CME/BOTCC Cross-Margins Program

Noncustomer cross-margins accounts are subject to the same undermargined capital charges as non-cross-margins futures accounts. See Chapter 5. When customer accounts become eligible for this program, they will also be subject to the same undermargined capital charges as other non-cross -margin futures accounts.

OCC Cross-Margins Program

A market professional's and/or noncustomer's cross-margins account may be subject to either the (c)(2)(x) charge or the undermargined charge to capital. The (c)(2)(x)/undermargined charge equals the greater of the (c)(2)(x) deduction (based on Appendix A to SEC Rule 15c3-1) or the margin deficiency (based on the SPAN margin system) in the combined commodity and security cross-margins account. A cross-margins account is never subject to both charges. In computing the (c)(2)(x)/undermargined charge:

- **The (c)(2)(x) charge for a cross-margins account is computed separately from the non-cross-margins security account.**
- **The undermargined charge is computed on the day the account becomes undermargined. It is an immediate charge to capital. Current calls cannot reduce an undermargined charge for cross-margin accounts.**
- **Excess equity in the cross-margins account may reduce the (c)(2)(x) charge for the non-cross-margins security account.**

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- **Excess equity in the non-cross-margins security account may reduce the (c)(2)(x) charge for the cross-margins account. Excess equity in the non-cross margins security account may not reduce the undermargined charge for the cross-margins account. Thus, if the undermargined charge is greater than the net (c)(2)(x) charge, the clearing member is subject to an undermargined charge that can only be reduced once funds are transferred to the cross-margins account. Only an equity system transfer is required provided the clearing member maintains excess segregated funds in the cross-margins and non-cross-margins origins.**

- **Due to bankruptcy/subordination concerns, excess equity in the market professional's cross-margins account may not reduce the undermargined charge for the non-cross-margins futures account until funds are transferred to the non-cross-margins commodity account. Again, only an equity system transfer is required provided the clearing member maintains excess segregated funds in the cross-margins and non-cross-margins origins.**

- **Further, excess equity in the market professional's non-cross-margins futures account may not reduce the (c)(2)(x)/undermargined charge for the cross-margins account until funds are transferred to the cross-margins account. Only an equity system transfer is required provided the clearing member maintains excess segregated funds in the cross-margins and non-cross-margins origins.**

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Example #1 – Capital Charges for Cross-margins Market Makers:

	XM Account
TE/NLE	**$10,000**
IMR/MMR	**$16,000**
(c)(2)(x) Haircut	**$18,000**
Margin (Deficiency)	**$(6,000)**
Current Calls	**$ 6,000**
(c)(2)(x) Charge	**$ 8,000**

The capital charge is equal to the greater of the (c)(2)(x) charge or the undermargined charge. Therefore, in this example, the capital charge is equal to $8,000.

Example #2 -

	XM Account
TE/NLE	**$10,000**
IMR/MMR	**$20,000**
(c)(2)(x) Haircut	**$18,000**
Margin (Deficiency)	**$(10,000)**
Current Calls	**$10,000**
(c)(2)(x) Charge	**$ 8,000**

The capital charge is equal to the greater of the (c)(2)(x) charge or the undermargined charge. However, because the undermargined charge is an immediate charge for cross-margins, the margin deficiency can not be reduced by current calls. Therefore, in this example, the capital charge is equal to $10,000.

Example #3 -

	XM Account	Non-XM Security Acct.	Non-XM Futures Acct.
TE/NLE	**$10,000**	**$20,000**	**$25,000**
IMR/MMR	**$20,000**	**-0-**	**$10,000**
(c)(2)(x) Haircut	**$22,000**	**$ 5,000**	**-0-**
(Deficiency)/Excess	**$(10,000)**	**-0-**	**$15,000**
Current Calls	**$10,000**	**-0-**	**-0-**
(c)(2)(x) Charge	**$12,000**	**-0-**	**-0-**

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Excess equity in the non-cross-margins security account may reduce the (c)(2)(x) charge in the cross-margins account, but may not reduce the undermargined charge unless funds are transferred between the origins. Excess equity in the non-cross-margins futures account may not reduce either the (c)(2)(x) charge or the undermargined charge for the cross-margins account. Therefore, in this example, the $15,000 excess equity in the non-cross-margins security account may eliminate the $12,000 (c)(2)(x) charge in the cross-margins account. This excess may not reduce the $10,000 margin deficiency. The firm will take a $10,000 capital charge for the cross-margin deficiency. No capital charge will apply to the non-cross-margins security or futures account.

Example #4-

	XM Account	Non-XM Security Acct.	Non-XM Futures Acct.
TE/NLE	$30,000	$10,000	$15,000
IMR/MMR	$10,000	-0-	$25,000
(c)(2)(x) Haircut	$ 5,000	$25,000	-0-
(Deficiency)/Excess	$20,000	-0-	$(10,000)
Current Calls	-0-	-0-	-0-
(c)(2)(x) Charge	-0-	$15,000	-0-

In this example, the cross-margins account has excess funds and is therefore, not subject to any capital charges. The $25,000 excess equity over the (c)(2)(x) haircut may be applied against the $15,000 (c)(2)(x) charge in the non-cross-margins security account. The excess equity in the cross-margins account may not be applied towards the undermargined charge in the non-cross-margins futures account. As the non-cross margins futures account has been undermargined for greater than five days and therefore, has no current calls, the firm will take a $10,000 undermargined charge for this account. No capital charges will apply to the cross-margins account or the non-cross-margins security account. In addition, the firm may disburse the excess margin funds of $20,000 in the cross-margins account to the customer.