Via Email

August 22, 2019

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: RIN 3038-AE88/File Number S7-09-19[1]

Dear Mr. Secretary and Madam Secretary:

We are writing in response to your request for comments on the "proposing amendments to regulations that establish minimum customer margin requirements for security futures" (Joint Proposal).[2] The Joint Proposal would reduce margin requirements for an unhedged security futures position from 20% to 15%, and make certain related changes. Regrettably, we cannot currently support the Joint Proposal because we believe the underlying analysis is (at best) incomplete.

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[1] Customer Margin Rules Relating to Security Futures, Exchange Act Release No. 86,304, RIN 3038, 84 Fed. Reg. 36,434 (July 26, 2019), https://www.cftc.gov/sites/default/files/2019/07/2019-15400a.pdf.
[2] *Id.*
[3] For more information about the Council of Institutional Investors ("CII"), including its members, please visit CII's website at http://www.cii.org/members.

Margin Requirement Risks

Section 7(c)(2)(B) of the Securities Exchange Act of 1934 provides the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission with criteria for proscribing margin requirements for security futures products.[4] Those criteria include "to preserve the financial integrity of markets trading [those products]"[5] and "to prevent systemic risk."[6] The criteria appear to us to indicate potential significant risks to the capital markets and investors by lowering margin requirements.[7]

For example, the Joint Proposal acknowledges that "margin requirements are a critical component of any risk management program for cleared financial products."[8] And that "[h]igher margin levels imply lower leverage, which reduces risk."[9]

The Joint Proposal also acknowledges that "the risk resulting from higher leverage levels [from lower margins] . . . can impose negative externalities on financial system stability, [and] . . . [s]uch market failures provide an economic rationale for regulatory minimum margin requirements."[10]

<u>Costs</u>

The Joint Proposal describes "three types of risk-related costs that could result from the adoption of the proposed amendment."[11] Those costs include:

> The first risk-related cost is reducing margin requirements for security futures that could expose security futures intermediaries and their customers to losses in the event that margin collected is insufficient to protect against market moves and there is a default of a security futures intermediary or its customer. . . .
>
> A second type of risk-related cost might arise where a [Futures Commission Merchant] FCM collects the minimum margin required from customers in order to maintain or expand its customer business. Lower margin requirements might facilitate an FCM permitting its customers to take on additional risk in their positions in order to increase business for the FCM. Such additional risks could put the FCM at risk if the customer were to default, and other customers at the FCM could risk losses if the FCM or one of its customers defaulted. A related third type of risk-related cost stems from the possibility of increased leverage among security

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[4] Margin Requirements, 15 U.S.C. § 78g(c)(2)(B) (1934), *available at* https://www.law.cornell.edu/uscode/text/15/78g.
[5] *Id.* § 78g(c)(2)(B)(i).
[6] *Id.* § 78g(c)(2)(B)(ii).
[7] *See, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency (Nov. 13, 2014), https://www.cii.org/files/issues_and_advocacy/correspondence/2014/14_11_13_letter_proposed_rule_covered_swap_entities.pdf (describing some of the bases for CII general support of fully margined derivative transactions).
[8] 84 Fed. Reg. at 36,446.
[9] *Id.* at 36,448.
[10] *Id.*
[11] *Id.* at 36,444.

> futures customers. Customers posting less margin to cover security futures positions might be able to increase their overall market exposure and thereby increase their leverage.[12]

This third type of risk-related cost may result when:

> [T]he greater leverage permitted under the proposed rule amendments . . . result[s] in customers taking on additional risk. Customers who are not aware of these risks may suffer unexpected losses as a result.[13]

<u>Benefits</u>

The Joint Proposal describes two possible benefits that could result from the adoption of the proposed amendment: "increased liquidity"[14] and "reduce[d] costs."[15] More specifically, the Joint Proposal explains:

> The reductions to margin requirements the SEC is proposing will have the immediate effect of improving the liquidity of customers trading security futures through broker-dealer accounts. These improvements to liquidity *could* lead to increased participation in security futures markets with attendant benefits to broker-dealers providing security futures accounts, security futures exchanges, and clearing agencies.
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> In addition, the SEC *believes* that the proposed rule amendments *may* reduce costs for participants in the security futures markets through improved operational efficiency. In particular, the customers of broker-dealers that do not offer portfolio margining may be able to avail themselves of lower margin requirements on security futures transactions without having to maintain separate accounts with broker-dealers that do provide portfolio margining.[16]

Immediately following the description of the above possible benefits, the Joint Proposal states that the SEC admits that it "does not possess data on . . . margin requirements [and is] . . . unable to quantify the benefits . . . resulting from any reduction to minimum margin requirements."[17]

What is most disconcerting to us is not the SEC's lack of historical or current data to support the purported benefits of the Joint Proposal, but rather that it appears that no attempt was made to present *any* substantive analysis of the proposed amendment's possible benefits.[18] On this point, we generally share the following views expressed by SEC Commissioner Robert J. Jackson Jr:

> [T]he proposal's consideration of the consequences of lowering the margin requirement amounts to vague claims about improved market efficiency and liquidity. A serious economic analysis would consider whether reducing margin will actually improve price discovery or simply make it easier for uninformed

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[12] *Id.*
[13] *Id.* at 36,447.
[14] *Id.* at 36,445 & 36,449.
[15] *Id.* at 36,449.
[16] *Id.* (emphasis added).
[17] *Id.*
[18] *See id.*

> investors to migrate into the futures markets in search of leverage. If that happens, we may get *less* liquidity in related markets without improvements in price efficiency. That's a question that can be studied, of course—all that's necessary is collecting the relevant data across stock, options, and security futures markets. Instead the proposal simply speculates, offering no basis for its claims about improved market conditions other [than] hand-waving towards efficiency.[19]

Alternatives

We also believe the Joint Proposal's underlying analysis is incomplete because it fails to consider reasonable alternatives. We note the Joint Proposal provides a one paragraph statement concluding, without any apparent substantive analysis, that the "SEC does not believe that there are reasonable alternatives to the proposal to reduce the minimum initial and maintenance margin levels for unhedged security futures to 15%."[20] This statement appears to conflict with the SEC's own rulemaking guidance which appears to indicate that consideration of reasonable alternatives should include, at a minimum, "the alternative of not adopting a rule."[21] Moreover, we again generally share the views of Commissioner Jackson who observed:

> There are, of course, many alternatives we could and should have considered. Here's one: rather than asking us to lower margin requirements, an exchange could simply reduce the contract size for single-stock futures. Like a stock split for a high-priced stock, reducing contract size could also increase access to single-stock futures for the most popular securities and improve efficiency. Indeed, one of the most liquid contracts in the world, the S&P E-mini Futures contract, is the product of cutting the classic S&P Futures contract in half.
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> That's just one alternative to this proposal. In a study published fifteen years ago, two former SEC economists analyzed these exact questions and came up with a clever alternative: rules-based margin with flexible settlement intervals. Rather than rush to reduce margin requirements, we should have considered those alternatives carefully. Because we didn't, I cannot support this proposal.[22]

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[19] Commissioner Robert J. Jackson Jr., Public Statement, Statement on Margin for Security Futures (July 3, 2019), https://www.sec.gov/news/public-statement/jackson-statement-margin-security-futures (footnotes omitted).
[20] 84 Fed. Reg. at 36,451.
[21] Memorandum from RSFI and OGC to Staff of the Rulewriting Divisions and Offices 1 (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.
[22] Commissioner Robert J. Jackson Jr., Public Statement, Statement on Margin for Security Futures (footnotes omitted).

Thank you for your attention to our concerns. We would be welcome the opportunity to further discuss these issues. If you have any questions or need additional information, please contact me at 202-822-0800 or jeff@cii.org.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel