U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5430
Facsimile: (202) 418-5536

DIVISION OF
TRADING & MARKETS

96-12

January 31, 1996

Re: Margin Requirements Under the Commodity Exchange Act

Dear :

This is in response to your letter dated September 28, 1995, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), in which you ask: "Does the Commodity Exchange Act require that a commodities broker or trader have the investor customer's money in the latter's account with the commodity broker firm *before* the customer investor can make any trade or purchase?"

In commodity futures trading, the funds paid to a futures commission merchant ("FCM")[1/] as a performance bond by each party to the contract to secure the mutual promises represented by the contract are called margin. Futures margin does not represent an extension of credit or result in the passage of title to the commodity, which occurs only in those infrequent instances where a party takes delivery on the futures contract and pays the full value of the commodity. The amount of funds a customer must deposit to enter into a futures transaction is called "initial margin;" when market activity erodes the equity in a customer's account to the "maintenance margin level" (generally, seventy to seventy-five percent of initial margin), a margin call will be issued to restore funds in the account to the initial margin level.

1/ An FCM is defined as "any individual, association, partnership, corporation, or trust that (A) is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market; and (B) in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom." 7 U.S.C. § 1a(12) (1994).

Section 5a(a)(12)(A) of the Commodity Exchange Act ("Act") generally excludes rules relating to margin requirements from Commission approval. The Act provides in pertinent part that each contract market shall:

> except as otherwise provided in this paragraph, submit to the Commission for its prior approval all bylaws, rules, regulations, and resolutions ("rules") made or issued by such contract market, or by the governing board thereof or any committee thereof, that relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market, as such terms and conditions are defined by the Commission by rule or regulation, *except those rules relating to the setting of levels of margin*.2/

There are, however, three exceptions. The Commission has authority to set margins (1) in an emergency (temporary emergency margin levels),3/ (2) with respect to stock index futures or options thereon,4/ and (3) with respect to options trading

---

2/ 7 U.S.C. § 7a(12)(A) (1994) (emphasis added).

3/ Section 8a(9) of the Act, 7 U.S.C. § 12a(9) (1994). See also Order of the Commission in In re November 1976 Maine Potatoes Futures Contract of the New York Mercantile Exchange, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,233 (Nov. 3, 1976), and the subsequent explanation from the Commission concerning its right to change margin levels in emergencies set forth in a letter to the president of the New York Mercantile Exchange, id. at ¶ 20,237 (Dec. 6, 1976).

4/ Section 2(a)(1)(B)(vi) of the Act, 7 U.S.C. § 2a(vi) (1994), requires a contract market in a stock index futures contract or option thereon to file with the Board of Governors of the Federal Reserve System ("Board") any rule establishing or changing the levels of initial and maintenance margin. The section further specifies that the Board may request or direct the contract market to set margin levels appropriate to preserve the financial integrity of the contract market or its clearing house or to prevent systemic risk, and also provides that "[s]ubject to such conditions as the Board may determine, the Board may delegate any or all of its authority under this clause only to the Commission." The Board made such a delegation on March 22, 1993.

generally.[5/]

The rules governing margin requirements are promulgated by the individual contract markets. In general, the contract markets prohibit members from accepting orders for new trades unless the initial margin requirements are met.[6/] However, most of the contract market rules also provide that a contract market member need not have initial margin in the member's possession prior to accepting an order, provided such margin is received within a reasonable time or a member has reasonable assurance that margin will be so received.[7/] One exchange, the Coffee, Sugar & Cocoa Exchange defines "reasonable time" as not being in excess of five business days except for good cause.[8/] Other exchanges do not define the term and, thus, members may look to a customer's past dealings in requiring initial margin in an account prior to making a trade.[9/]

In short, therefore, the answer to your question is no; the Act does not explicitly or specifically require that a customer have margin in his account before making a trade. In particular, an FCM is defined (<u>see</u> footnote 1, <u>supra</u>) in part as one who "accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or con-

---

5/ The Commission has plenary authority concerning options generally under Section 4c(b) of the Act, 7 U.S.C. § 6c(b) (1994). The Commission has exercised this authority to require full payment of option premiums by option purchasers, <u>i.e.</u>, such premiums cannot be margined, but has generally allowed contract markets to establish margin levels for option grantors. <u>See</u> Commission Rule 33.4(a)(2), 17 C.F.R. § 33.4(a)(2) (1995); 46 Fed. Reg. 54500, 54504-05 (Nov. 3, 1981).

6/ Thomas A. Russo, <u>Regulation of the Commodities Futures and Options Markets</u> 1-35 (1983 and Supp. 1994); Philip McBride Johnson and Thomas Lee Hazen, <u>Commodities Regulation</u> 331-32 (1989 and Supp. 1994).

7/ Russo, <u>Regulation of the Commodities Futures and Options Markets</u> at 1-35; Johnson and Hazen, <u>Commodities Regulation</u> at 331-32.

8/ Rules 4.01 and 4.02, Coffee, Sugar & Cocoa Exchange Guide (CCH) ¶ 2601 (1994).

9/ Russo, <u>Regulation of the Commodities Futures and Options Markets</u> at 1-35; Johnson and Hazen, <u>Commodities Regulation</u> at 331-32.

tracts."[10/] However, it also may be instructive to note that when the Commission adopted Rule 33.4(a)(2), which requires full payment of the option premium by an option purchaser, it stated that "[t]he Commission wishes to emphasize that § 33.4(a)(2) does not require payment of the premium prior to the actual purchase of the option so long as prompt payment is contemplated at the time of such purchase."[11/] However, you should also be aware Commission rules specifically prohibit an FCM or introducing broker ("IB")[12/] from in any way representing that it will not call for or attempt to collect initial margin as established by the rules of the applicable board of trade.[13/] Moreover, an FCM or IB also must know that it will be able to collect initial margin from a customer as a matter of internal controls.[14/] Consequently, although it may not be required that margin funds be deposited prior to a broker effecting a customer transaction, margin funds must nevertheless be collected or the broker may effectively be indicating that it will not collect initial margin or that its internal control systems are deficient. Further, an FCM will accrue capital charges if a customer account remains under-margined for more than three business days.[15/]

This letter represents the views of this Division only and does not necessarily represent the views of the Commission or of

---

10/ 7 U.S.C. § 1a(12) (1994).

11/ 46 Fed. Reg. 54500, 54504-05 n.12 (emphasis added).

12/ An introducing broker is "any person (except an individual who elects to be and is registered as an associated person of a futures commission merchant) engaged in soliciting or in accepting orders (other than in a clerical capacity) for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contacts that result of may result therefrom." 7 U.S.C. § 1a(14) (1994).

13/ 17 C.F.R. § 1.56 (1995).

14/ An FCM or IB must maintain internal accounting controls to enable it to promptly complete transactions and promptly discharge responsibilities to customers and other creditors, to avoid material financial loss, to avoid material misstatements in financial reports, and to maintain compliance with the Commission's segregation and secured amount (in the case of an FCM), recordkeeping and reporting requirements. See id. § 1.16(d)(2).

15/ Id. § 1.17(c)(5)(viii).

any other office or division of the Commission. Further, this letter is based upon the representations made in your letter. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion.

I hope the foregoing is helpful to you. If you have any questions regarding this letter, please contact me or Gary L. Goldsholle, an attorney on my staff, at (202) 418-5450.

Very truly yours,

Susan C. Ervin
Chief Counsel